

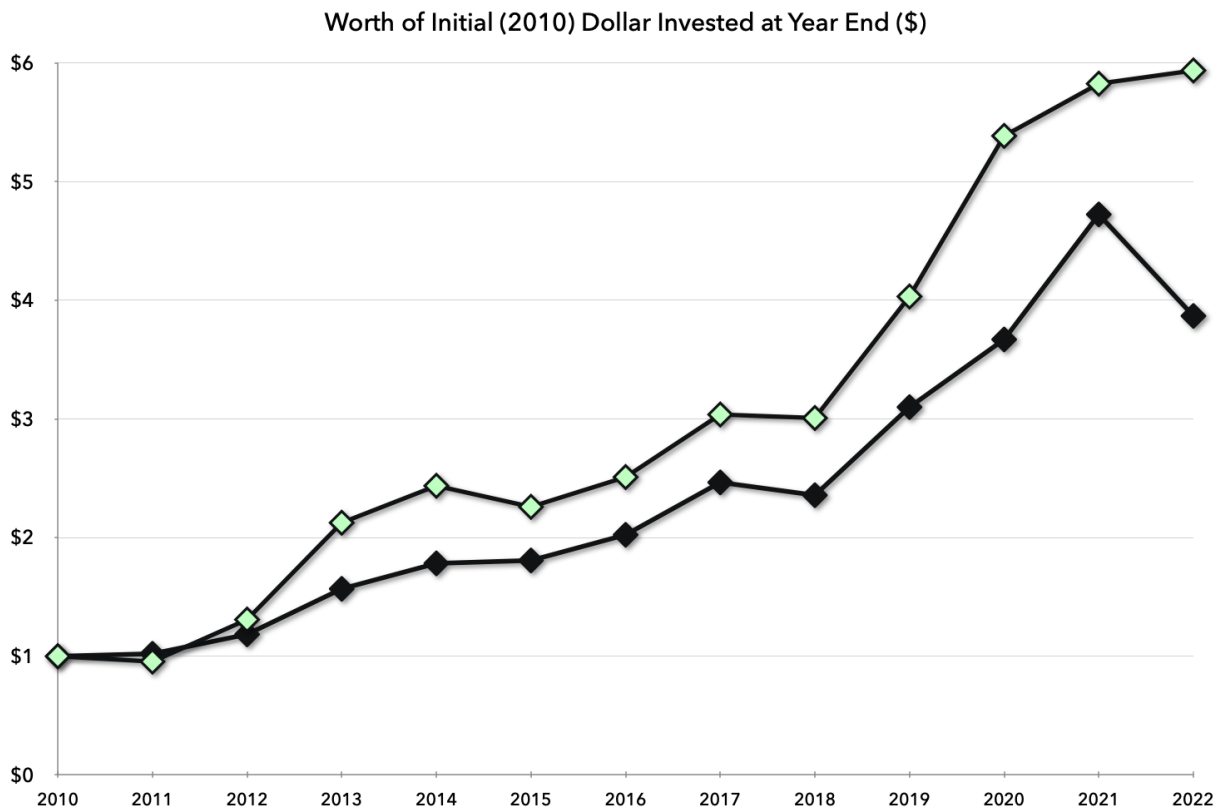
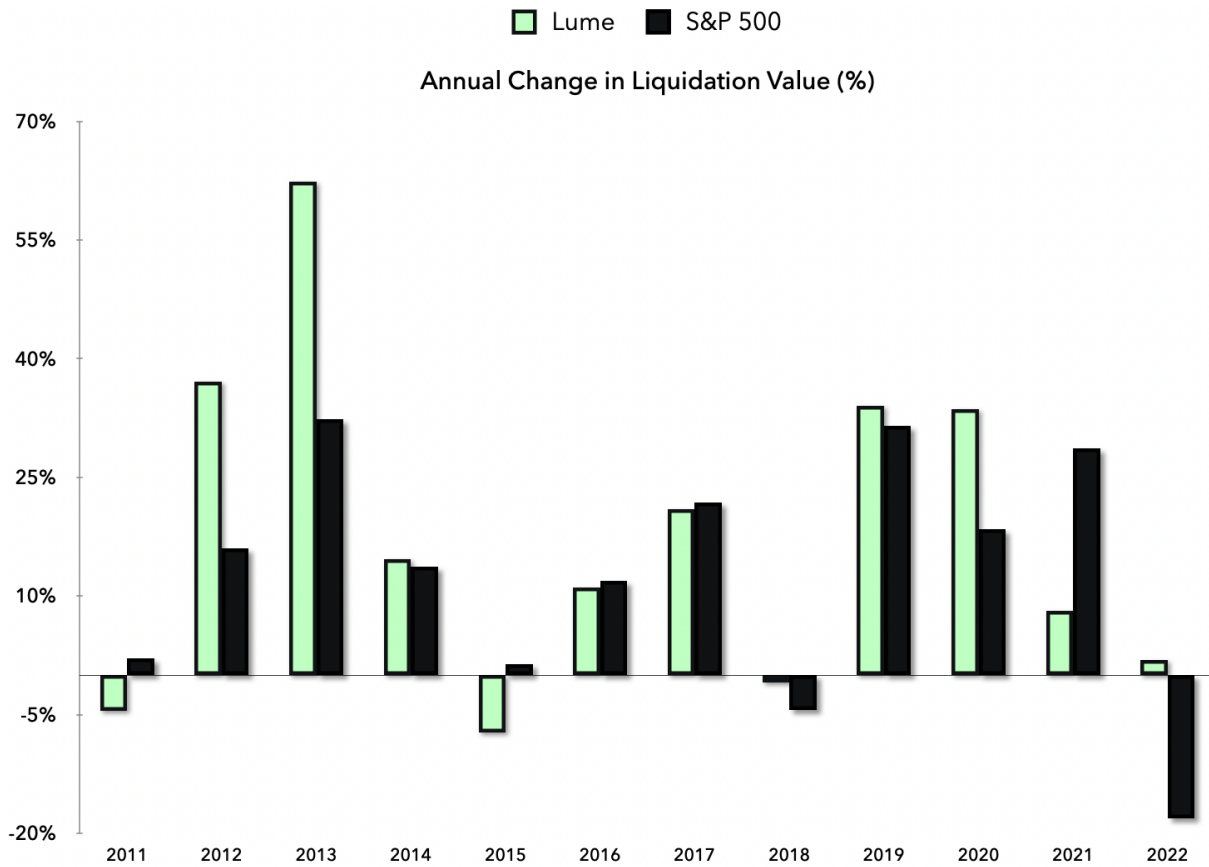


Lume Group

2022 Annual Report

*"The honest man takes Pains, and then enjoys Pleasures;
The knave takes Pleasure, and then suffers Pains."*

– Ben Franklin



All figures pretax.

January 22, 2023

Lume Group's net liquidation value grew 1.9% in 2022, compared with a total return of -18.1% for the S&P 500. Over twelve years, Lume's CAGR was 16.0% (versus 11.9% for the S&P), meaning that each dollar invested at the end of 2010 was worth \$5.94 at year end 2022 on a pretax basis.

On Taking Pains: That Second Chart

In last year's letter, I admitted to a large underperformance relative to the S&P in 2021 as I declined the invitation to join Mr. Market's party. It turns out that the party was a bust.

The past three years on that second chart at the beginning of this letter illustrates the importance of avoiding large losses. Despite underperforming the market by a large margin in 2021, my avoidance of 2022's losses has left Lume in a better position versus the S&P since the end of 2020. Lume is up 10.2% since the end of 2020 versus 5.4% for the S&P despite my underperforming the index in 2021 by a large 20.5%. By avoiding 2022's losses, I now find myself ahead of the index by 4.8% over the past two years.

Despite the fortunate relative results, I made many mistakes over the course of the year. Jumping in and out of special situations ("workouts") at disadvantageous prices and speculating with LEAPs are some areas that need to be improved or abandoned altogether.

My overall focus remains on generating long term returns by seeking out attractive prospects while being forever wary of the risk of ruin. I've found in-depth biographies of investing and business legends that span decades to be especially helpful in guiding my way.

On Taking Pleasure (and Suffering Pains)

Metaverse. AI. Crypto. NFTs. Meme stocks. These are some of the “game-changer” investment opportunities promulgated by fools and knaves alike in recent years. I merely clung to lessons of the greats on this treacherous path:

“The difference between successful people and really successful people is that really successful people say ‘no’ to almost everything.”

– Warren Buffett

“People think focus means saying yes to the thing you’ve got to focus on. But that’s not what it means at all. It means saying no to the hundred other good ideas that there are. You have to pick carefully. I’m actually as proud of the things we haven’t done as the things I have done. Innovation is saying ‘no’ to 1,000 things.”

– Steve Jobs

Investors of late behaved as if the conditions they had grown accustomed to would continue indefinitely. Of course, this aspect of human nature recurs throughout history and is ironically most pronounced at the sharpest inflection points. Abandoned was the prioritization of tangible cash flows and the notion that adverse events could impact investment results. After all, during a once-in-a-century pandemic, bankruptcies were avoided and various assets thrived despite poor fundamentals, so what could possibly go wrong from here?

Absurd logic came into vogue: “valuation” of businesses on a multiple of sales (for those that had sales) or allocation to assets with no promise of cash flows. Stock based compensation, which was conveniently ignored when calculating free cash flow, usurped capital from business owners to employees at many supposed “cheap” businesses, thanks to the owners’ collective negligence. And that was when cash flow was even considered, for usually the focus was on “adjusted EBITDA” or gross profit or merely revenue (and so they climbed higher and higher up the income statement to justify the unjustifiable).

This was all reinforced by pavlovian mechanism: absurd behavior repeatedly rewarded with climbing asset prices, until one day the party was over (and many have not yet even come to terms with it being over). I continue marching on: insisting on high quality businesses that are valued attractively on a conservative basis. Otherwise, I do what many find so difficult to do: I’m saying ‘no’ over and over again.

Conclusion

Whether it concerns inflation, interest rates, or broader markets, there is plenty to say and yet little value in saying much of it. What’s gleaned is that the fundamental nature of our world remains unchanged: volatile and unpredictable in many respects—bound to inflict Pains on those who fail to learn it. My focus? On weathering storms.

Signed,

P. Dalal