Q2 2021 Letter to Investors

Khadir Richie

DISCLOSURES

Where all are alike, no one thinks very much. - Walter Lippmann

Dear Partner,

For the second quarter of 2021, the RCG Long Only strategy gained 2.6% while the RCG Long Short Fund lost 2.5%. Our closest benchmarks, the Russell 3000 Index and the Equity Long Short Index gained 8.2% and 2.6% for the quarter respectively.

Portfolio Returns[1]	Q1 2021	Q2 2021	YTD	FY2020	FY2019
RCG Long Only	(-2.5%)	2.6%	0.0%	40.3%	28.7%
RCG Long Short	(-12.3%)	(-2.5%)	(-14.5%)	10.0%	8.1%
RCG Top 10	0.6%	8.1%	9.5%	16.4%	37.6%
Benchmark Returns					
Russell 3000 (broad index)	6.4%	8.2%	15.1%	20.9%	31.0%
Equity Long/Short Index[2]	6.5%	2.6%	9.3%	9.3%	6.9%
S&P 500 (large cap)	5.8%	8.2%	14.4%	16.3%	28.9%

The S&P 500 is up 14.4% for the first half of 2021. Much of these gains were triggered by companies announcing positive earnings expectations for the second half of the year. A record 64% of companies that provided guidance exceeded Wall Street Analyst projections. Most companies have positioned the pandemic in the rear-view mirror and expect things to get better from here. Meanwhile, the Market continues to hit all-time highs, while Wall Street seems to be overly conservative on future prospects. The source of caution stems from expected inflation.

As reported by CNBC[3], US consumer prices in May rose 5% over the year prior, the largest increase since 2008 (shortly before the Financial Crisis). Of note:

- The gasoline index increased 56%
- Used car and truck prices increased 30%
- Existing home prices rose 17%
- Airline tickets increased 24%
- Hotels and motels up 10%
- Food prices increased a modest 2.2%

Much of the above is easily explainable: comparisons to a very weak year. No one was traveling last year during the peak of Covid, and airlines couldn't give tickets away. Now, vaccines are readily available, restrictions lifted, and people are ready for normal.

[1] All portfolio and index returns mentioned are presented **net of expenses and maximum management fees** paid by any account within the composite. All performance is estimated pending year-end performance audit. Completed audit numbers available upon request.

[2] BarclayHedge Equity L/S Index

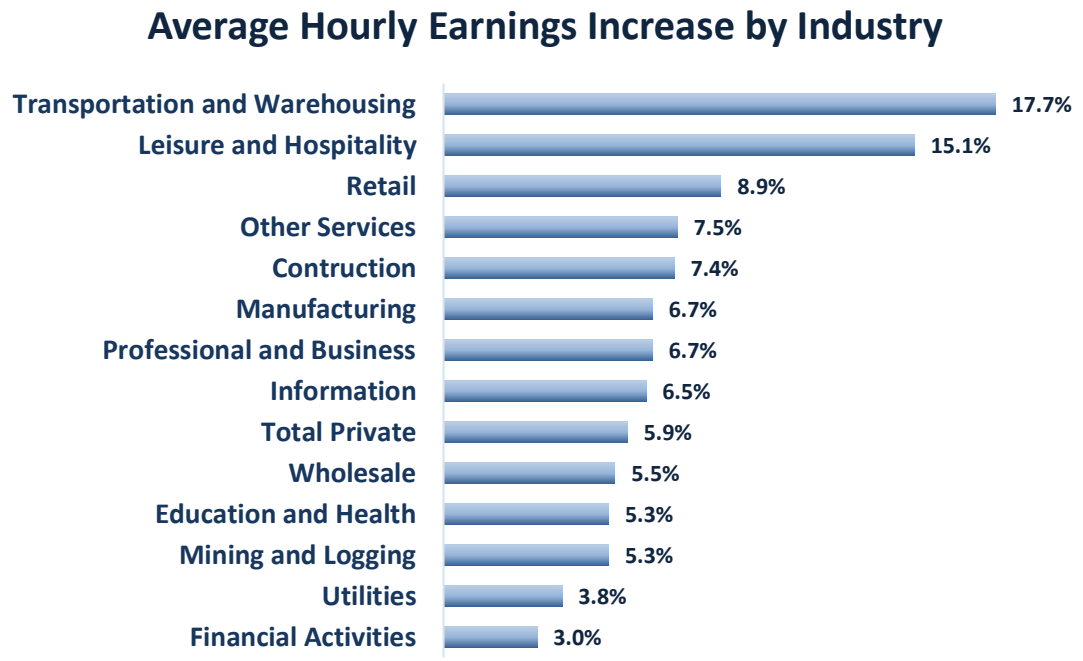
[3] https://www.cnbc.com/2021/06/10/cpi-may-2021.html

2028 E. Ben White Blvd, Suite 502, Austin, TX 78741
Phone: (737) 990-9003

More interesting inflation signals come from labor/higher wages[4]:

- Amazon announced it would hire 75,000 more workers (after hiring 500,000 in 2020), while increasing average pay from $15 to $17/ hour and offering $1,000 signing bonuses
- Domino's Pizza is offering some delivery drivers $1,000 signing bonuses plus $25 an hour
- Chipotle is raising wages to an average of $15 an hour
- McDonald's is raising wages by 10% for more than 36,500 hourly workers
- FedEx and Cardinal Health are paying $500 sign-on bonuses

The industry trends are not surprising:



Source: U.S Department of Labor/Wells Fargo Securities

The largest increases are in the industries hardest hit by the pandemic. Salaries offered need to be higher in industries where millions were laid off: trust was broken, and incentives are required to bring people back.

The Market is divided with some viewing the above indicators as "transitory," while others view it as more permanent. **Both** can be right. With cars, demand is currently outpacing supply due to an ongoing component shortage. Supply will eventually catch up with demand and prices will mean revert. After an initial travel pop based on pent up demand, people will settle back into their normal travel schedules and the post-Covid travel boom will taper off. Transitory.

What is not transitory is salary increases. Cars and flights can go on sale. But when you offer an employee $15 an hour in 2021, you can't approach them in 2022 with $13.

[4] https://www.wsj.com/articles/big-companies-woo-scarce-hourly-workers-with-higher-pay-bonuses-11620930575

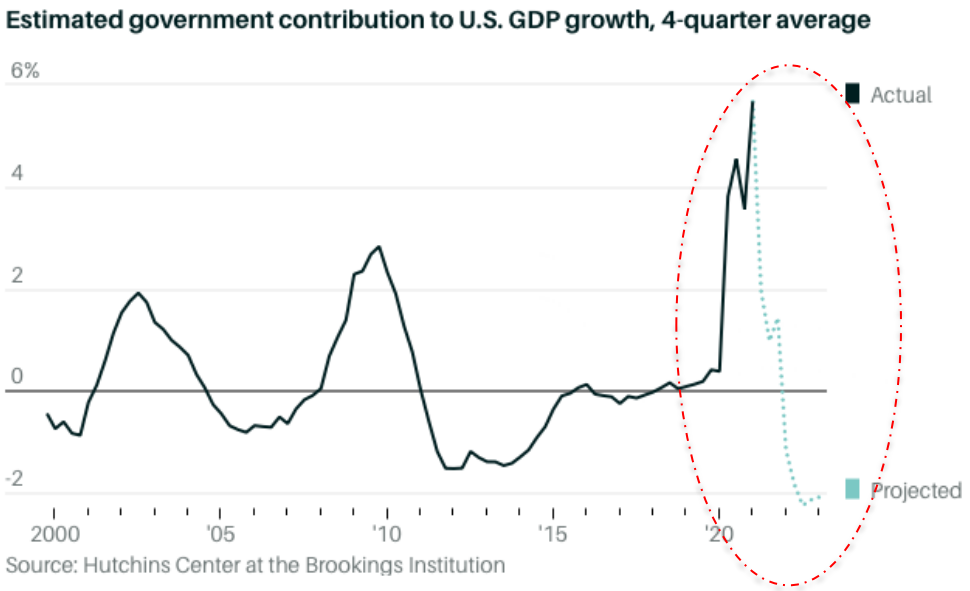
2028 E. Ben White Blvd, Suite 502, Austin, TX 78741
Phone: (737) 990-9003

This can potentially create a vicious upward cycle. If a company has to pay its employees (an input cost) 20% more, they will have to raise prices to cover the added salary burden. If basic consumer staples cost more, consumers feel the pinch and seek higher salaries to maintain their standard of living. Wages and prices then begin to chase each other higher. Eventually, it reaches a point where prices that consumers experience in their day to day lives (gas, groceries, rent) start to drive inflation expectations and perception becomes reality: people start to **expect** prices to increase even more. And similar to the toilet paper panic of 2020, as people expect prices to rise in the future, they buy in advance today, thus reinforcing upward prices. This was the psychology of the 1970s during the oil crisis[5] and it created crippling inflation.

Real inflation is a significant threat to stocks and investment assets.

The good news is **we have a playbook**.

The Economy is recovering faster than expected, and Fiscal policy is projected to transition sharply from boosting growth to holding it back as the economy reopens. This should dampen inflation risks[6].



PPP has ended and enhanced unemployment benefits will end soon. This should end the worker shortage and slow future wage increases. The Fed has already indicated that any further signs of inflation will lead to an immediate switch from boosting growth to holding it back. **The Fed has a playbook** and will raise interest rates in addition to other measures. The challenge will be managing the throttle so that inflation is harnessed without hitting the brakes too fast or too long which could freeze credit markets and send us back into recession. The pandemic has taught us

[5] https://www.npr.org/sections/pictureshow/2012/11/10/164792293/gas-lines-evoke-memories-oil-crises-in-the-1970s
[6] https://www.brookings.edu/interactives/hutchins-center-fiscal-impact-measure/

2028 E. Ben White Blvd, Suite 502, Austin, TX 78741
Phone: (737) 990-9003

that we can shorten (or even end) recessions through abundant government spending. Let future generations worry about the debt and deficit! …Hmm

Selected portfolio discussion:

Delivering sub-par results is never pleasant. Our mandate is to produce outperformance while protecting capital. Our goal is to always stand out from the crowd, but it's not as enjoyable when we are standing out for the wrong reasons.

I have dedicated the lion's share of this letter to performing a deeper dive into our portfolio, specifically our laggards to support why we remain invested and why I believe future performance will improve.

The headline is that our portfolios have a technology focused tilt. This is based on my personal expertise. Since the beginning of the year, the Market has penalized tech names based on valuation concerns. I make investment decisions with a vigilant eye on valuation. However, I also believe you can pay a reasonable price for a great company that may seem expensive on an absolute basis. As an example, paying $200K for a car may be crazy, but it could be an absolute steal for a vintage Ferrari. I make this type of valuation decision as I investigate each company and asses their future opportunities. There are occasions where the Market will disagree with my assumption of future profits. Time will determine the correct answer.

Another thought on technology investments during a period of expected inflation: technology is about innovation and not inflation and unemployment. Technology names are often insulated against erosion caused by inflation. They provide goods and services to consumers and businesses to make their lives better and provide efficiencies and cost savings. A company's fundamentals can outweigh inflation and policy headwinds.

Our biggest detractors for the quarter:

Intelligent Systems (INS – down 19.2% for the quarter and down 21.7% YTD) – INS was one of the largest detractors for the quarter and, because it has long been one of our largest positions, it has had the biggest negative impact on the portfolio as a whole. The company is engaged in payment processing for complex credit transactions. Over the past year, the company has focused on expanding their business and capabilities internationally with office expansion in India and Dubai. However, Covid has created challenges for employees in India including slowing hiring and training. This situation will improve over time.

As growth with their largest customer, Apple, has slowed, INS has focused their attention on growing their business with American Express and ramping up a new undisclosed, large customer. We expect to see impact from these developments in Q3 and Q4.

INS has developed one of the most flexible cloud software architectures. They continue to invest for future growth internationally. And along with the ramp of the new major customer in the second half 2021, management has pointed to potentially 2 new large customers in 2022. INS remains one of our best ideas.

2028 E. Ben White Blvd, Suite 502, Austin, TX 78741
Phone: (737) 990-9003

MarketAxess Holdings (MKTX – down 10.3% for the quarter and down 18.8% YTD) – MarketAxess is a name in the portfolio that I have not previously provided depth on our thinking and so I will add more details here. MKTX is an electronic trading platform for fixed-income (bond) markets. Their platform allows customers to trade a spectrum of fixed income securities in a more efficient manner than legacy systems. What are the legacy systems? According to Bloomberg[7], almost 80% of U.S. bond deals are still completed via phone or over chat services. In some cases, this makes sense. When trading corporate debt, buyers and sellers often want to keep information close to the vest as widely disseminating information about their book can hurt their pricing leverage. However, the sale of stocks has long departed from the days where market makers stood in the stock exchange pit verbally exchanging shares. With a highly organized electronic market, sellers can actually have more anonymity than they have with existing systems[8].

The market for fixed income securities is about 3x the size of the equity market, $119T worldwide. MarketAxess is one of the leaders in the space with 85% market share in electronically facilitated corporate bond trading including 85% of investment-grade and 84% of high-yield debt exchanged on their platform. The company trails competitors in other sub-categories, but MKTX has increased its market share in every quarter since 2009.

MKTX has many of the traits we seek for our investments:

- **Strong Moat –** They benefit from Network Effects. They are already the market leader. And as more market participants join the platform exchanging bonds and other credit instruments, even more market participants will be attracted to the MKTX platform creating a positive feedback loop.
- **Insider ownership –** Management owns a tangible share of the company. This includes founder and CEO Rick McVey who owns shares currently valued in excess of $461M. He has every incentive to make decisions to benefit shareholders.
- **Strong Financials –** The company is highly profitable (earnings and cash flow), has strong margins (50%+ Operating), carries little debt and has $440M in cash at their disposal.

Why is the stock down?
Investors are likely concerned about the current valuation combined with (the perception of) slowing growth. The company has reported lower monthly trading volumes compared to 2020. However, the company experienced record increased trading volumes a year ago as we were experiencing the height of the pandemic. That makes for a tough comparison. Trading volume growth is still healthy, and the company continues to increase market share which is the most important Key Performance Indicator. With the torrid growth the company has experienced over time, it makes sense that shares have become more expensive especially as they become the dominant company in a market where **the winner takes most** of the profits.

[7] https://www.bloomberg.com/news/articles/2018-02-15/electronic-bond-trading-gains-ground-as-market-finally-matures
[8] https://www.sifma.org/wp-content/uploads/2019/10/SIFMA-Insights-Electronic-Trading-Market-Structure-Primer.pdf

2028 E. Ben White Blvd, Suite 502, Austin, TX 78741
Phone: (737) 990-9003

MKTX recently completed its acquisition of MuniBrokers, an electronic trading platform for municipal bonds which will expand MKTX's muni capabilities into the U.K, EU, and Singapore creating truly global capabilities and expanding their addressable market.

Our investment is perfect for a rising interest rate environment. When interest rates rise, more capital (specifically retirement accounts) will flow back to bonds which translates to higher volumes. And we have first-hand experience that during times of market stress, trading activity in fixed income increases and benefits MarketAxess.

Viemed (VMD – down 29 % in the quarter) – The respiratory healthcare services company has experienced a challenging 2021 after benefiting from the pandemic in 2020. Growth has slowed in their core business primarily from Respiratory Technicians having difficulties accessing healthcare facilities due to Covid restrictions. The company was able to offset these challenges last year by providing much needed ventilators to hospitals. Now that economies are opening up, VMD expects to regain access to hospitals and get back to their 30%+ growth. March was their busiest month for new patients since the onset of the pandemic.

The biggest impact on stock performance in the quarter came from the release of a report from the US Department of Health and Human Services, Office of the Inspector General regarding an audit of VMD's home patients. The OIG report claimed that VMD's charging policies did not comply with Medicare requirements and thus VMD's patients overpaid by some $29M. The company vehemently denies these claims and issued a detailed response. I reached out to the COO to clarify the details.

The OIG findings were not aligned with the Centers for Medicare & Medicaid Services (CMS) policy which they follow and comply with. The CMS had previously conducted a detailed audit for the same period. The CMS audit reported a 98% compliance rate (41 of 42) cases, while the OIG claimed non-compliance on all 42 of the **exact same** cases. From VMD's perspective, they are caught in the crossfire between two sister agencies.

VMD has received no negative feedback from their hospital clients. And for all patients, a hospital employee is involved with the sales process for every non-invasive ventilator. The company expects this to pass with limited to no monetary repercussions.

Our top performers for the quarter included:

The Trade Desk (TTD – up 26.3%) – Shares in the programmatic advertising specialist rebounded during the quarter after selling off in Q1. The selloff was part of the previously mentioned market move away from higher priced technology names. The rebound in Q2 was due to Google delaying its phase out of third-party cookies in its Chrome browser to mid to late 2023. This is positive news, but TTD is prepared for the inevitable transition away from cookies. The company has built an industry alternative called UID 2.0 which asks users' permission to receive targeted ads on websites.

UID 2.0 has gained more traction in the digital ad industry vs competing alternatives with many major publishers and advertisers on board. Additionally, TTD's business is diversified across

2028 E. Ben White Blvd, Suite 502, Austin, TX 78741
Phone: (737) 990-9003

numerous channels including video, audio, in-app, native and social. Connected TV is currently their fastest growing business, and cookies are meaningless on that platform as ads are based on first-party data.

MSCI (MSCI – up 25.0%) – The financial-index provider continues to see significant growth and now calculates more than 14,000 market indexes for everything from Chinese stock markets to European bonds. Companies also license MSCI's data and analytic tools. MSCI is taking the lead in the world of thematic indexes such as genomics and blockchain technology. The company also has a leading role in rating companies on ESG criteria.

Adobe Systems (ADBE – up 24.8%) – In the last 15 years, Adobe has transformed itself into a software behemoth, more than tripling its revenue since 2010. The company is famous for its namesake PDF-reader and photo-editing software Photoshop. However, ADBE sells a full suite of software products through a recurring subscription model. The company transitioned from selling boxed software to recurring subscriptions in 2013 and revenues have grown consistently since. The company achieved $13B in revenue in 2020 with 88% Gross Margins.

Our performance has lagged this year, and this is most disappointing for me in regards to our newest clients who have not yet experienced the compounding returns that our longer tenured clients have. My goal is to correct this. Over the last few years, I have made an effort to identify unique names for our portfolios which will generate outstanding returns for many years to come. In the recent past, owning the big 5 performers (Facebook, Apple, Amazon, Microsoft, and Google) has been very lucrative. But I began to wonder, how many more times can these mega cap companies double in value given their current size? (maybe many) But I am determined to identify the **next** Apple and Amazon. And so, I have been searching for smaller companies with much longer runways. It takes grit to avoid the crowd, but we can be different **and** correct. And time will prove out this thesis.

I reserve the right to change my mind on any investment based on new data, but I have strong conviction in the companies in our portfolios. I would never take financial advice from someone who isn't buying what they are selling by the handful. I strive to live by that same mantra, and I remind clients that my family has all of our valuable assets invested in these same names. That should speak to my conviction in what we are doing.

I am also working hard to improve the "business" of Richie Capital Group. We are working on some exciting changes in the coming months. Please reach out to me directly if you would like more information on ways to assist in our evolution.

It is a privilege to manage your very valuable assets.

Khadir Richie
Principal
Richie Capital Group
www.richiecapital.com
"It is a privilege to manage money for others."

2028 E. Ben White Blvd, Suite 502, Austin, TX 78741
Phone: (737) 990-9003