October 27, 2022

Dear Investor:

I hope this letter finds you well. Choice Equities Fund generated losses of -1.7% on a net basis in the third quarter, taking year-to-date performance to -35.8%. This compares to the Russell 2000's -2.2% loss for the quarter and -25.1% loss year-to-date and the S&P 500's loss of -4.9% for the quarter and -23.9% loss year-to-date. Since inception in 2017, the fund has generated annualized gains of +14.7% versus +5.0% and +10.5% for the Russell 2000 and S&P 500, respectively.

EXECUTIVE SUMMARY

In this letter, we provide a brief overview of the recent quarter and discuss the environment's impact on our performance. I discuss a few new positions, Wesco Inc., (WCC), Papa Johns, Inc. (PZZA), Shake Shack, Inc. (SHAK) and Brinker International (EAT). Finally, I conclude with a few thoughts on the current outlook and provide a closer look at recent small cap valuations and their implications for forward returns in the coming years.

QUARTERLY COMMENTARY

It remains a tough environment for virtually all owners of assets. Though stock prices fluctuated wildly over the last 90 ninety days, most indices ended a little lower than where they began. Inflation readings continue to come in at 40-year highs, while the Fed continues a rapid rate hiking cycle in response. Equities traded lower as they repriced for higher discount rates.

Our stocks behaved similarly. Our portfolio was up in the first half of the quarter, but down in the second half. In total, our stocks were down a little more than ~2% while hedges contributed a little less than 1% to our quarterly return.

PORTFOLIO COMMENTARY

As briefly highlighted below, several of our cheap stocks got cheaper. Throughout the quarter, as typical I attempted to capitalize on the volatility to embed attractive future returns within our portfolio while balancing an effort to minimize further mark to market losses. In more typical times, this continuous endeavor has revolved around finding the most heavily discounted and deepest mispricings available. These have often come from among the unloved, overlooked or unappreciated. Over the years, this approach has been fruitful and produced a number of multi-baggers for us.

However, in this environment, partly out of respect for the volatility of the day and partly due to the attractiveness of today's opportunity set, for new purchases I have placed a greater emphasis on acquiring more liquid, higher quality names as many of them feature equally discounted valuations. As in the past, I continue to believe an active approach to managing the portfolio with an appreciation for the forces of the market provides our best likelihood of success.

SITE – I exited SiteOne Landscaping Supplies, Inc. a few weeks after I wrote about it in our last letter. Though it is a fantastic company with a monopoly-like stronghold in landscape distribution supply and the majority of their earnings and cash flows come from serving durable repair / remodel and maintenance needs, it is a housing derivative. In the context of a 30-year mortgage rate at 6% and moving to 7%, I felt it would be prudent to move to the sidelines and monitor performance for now.

WCC – For most of its history since its carveout from Westinghouse Electric Corporation almost 30 years ago, Wesco, Inc. was one of a handful of leading distributors of electrical products. The business was often characterized as "three bids and a buy", given their utility customers highly planned capital project spending and their desire to shop around for the best price. Spending was somewhat cyclical, and pricing was competitive.

Wesco's 2020 purchase of Anixter Inc. improves on many of these dynamics. Now the #1 player by size in the US, the company is benefitting from an expanded customer list while capitalizing on greater economies of scale in areas like purchasing and distribution. The company's end markets have changed for the better too, with a higher proportion of sales now driven by secular needs that support the growth of electricity demand and green energy. Initiatives like grid modernization and expanded electric vehicle charging networks are durable investment themes, particularly considering the government spending increases that supports these infrastructure buildouts.

The purchase of Anixter has been a good one, enabling Wesco to move operating margins a step function higher as it capitalizes on synergies gained in the acquisition. After quickly de-levering their balance sheet from above 6x to now less than 3x since the acquisition, the company recently authorized a sizeable stock repurchase program. Now trading at ~8x PE and ~7x EBITDA, the stock presents a compelling value, particularly for a company with a monopoly-like competitive position, durable end market drivers and a low-double digit or better earnings growth profile.

Restaurants – I bought a mini basket of restaurant companies in the recent quarter. As a group, they stand to benefit from a couple commonalities. For starters, as an industry over the course of history, restaurants have seldom, if ever, given back pricing gains. In this context, incoming deflation in the cost of goods offers ongoing margin benefits at the gross margin line. Additionally, today's wage increases may not be as harmful to operating margins as feared. Moderate expansion in the pool of labor available relative to the past couple years and the high rate of employee turnover at most restaurants means many restaurants have the opportunity to bring on new employees at potentially lower wage levels. Finally, continued normalization of consumer traffic patterns may drive volume gains, though this is a highly idiosyncratic factor. Against this backdrop, I believe Papa John's Inc. (PZZA) and Shake Shack, Inc. (SHAK) are undervalued relative to their attractive long-term growth prospects and expectations for near-term margin improvement appear underappreciated. Brinkers International, Inc. (EAT), another stock trading at a single digit multiple of forward estimates that seems to be considerably more out of favor, could see earnings per share nearly double from their current rate in the next couple years if the new CEO is able to achieve the margin gains he has identified.

CROX – Also with a PE multiple of ~8x today, shares of Croc's Inc. continue to present attractive value. The HeyDude brand is posting impressive growth, now in its third consecutive year of triple digit percentage sales gains, as it benefits from the greater distribution and marketing capabilities the legacy Croc's brand enjoys. Like many brands today, it trades at a historically cheap valuation. However, unlike many other brands, we continue to think both HeyDude and Croc's still offer attractive growth opportunities. The HeyDude brand in particular remains highly underpenetrated, with recent brand awareness readings in the 20% ranges, suggesting meaningful head room to legacy Croc's 90% levels. Additionally, because the company will likely approach its <2 leverage target in a quarter or two, management will soon have the opportunity to re-engage in some form of capital return initiatives for shareholders as they have in the past.

OEC – Shares of Orion Engineered Carbons remain attractive at recent market prices. Its rubber black segment, which accounts for 45% of the firm's total EBITDA continues to benefit from a market in structural supply deficit. OEC's specialty business, which provides conductive materials for EV batteries and represents 55% of total EBITDA at higher margins, is expected to see significant growth in 2023 as three new plants in Italy, China, and Texas are projected to start producing at full capacity. As we have experienced with other holdings, the company continues to trade at a historically low valuation in comparison to its past trading range, most recently trading at ~6x PE and ~5x EBITDA, a valuation which appears quite low relative to its likely future cash flows.

FARM – Shares of Farmer Brothers continue to trade at a deep discount to asset value and earnings power. Recently, the company attracted the attention of an activist, a longtime shareholder who appears intent on helping the company realize the value inherent in the company's assets. The team of potential board members recently nominated have impressive experience and have been successful in prior episodes, catalyzing value with a sale of the company in prior instances at both Jamba Juice and The Pantry. I look forward to you updating you on progress here.

OUTLOOK

Most elements of the outlook I described in our last quarterly letter remain the case today. Balance sheets of consumers, corporations and banks remain an underdiscussed positive. However, sentiment of investors and businesspeople remains highly discussed and quite low. Negatives like inflation, war, global nuclear threats, politics and recession fears perpetuate the negative news cycle. Interest rates are rising. Equity valuations continue to cheapen.

Thus far, though slowing from recent periods, and consistent with last quarter, earnings continue to be better than feared. Disjointed pockets of strength and weakness continue to show up in companies' results as our economy continues on an uneven path to normalization after the effects of the shut / stimulate / open playbook policymakers followed in response to the pandemic continue to reverberate across the economy. To date, the market decline remains nearly entirely attributable to lower multiples, with equities receiving competition for capital from fixed income offerings for the first time in over a decade.

Looking within the markets, rather than just at the headline indices, considerable values continue to develop. In recent years, I have commented on how lopsided the markets have become quite frequently. This remains the case today, as the pandemic-era adulation of a few mega cap tech stocks has created stark dichotomies in valuations across the markets. Strategist Ed Yardeni has taken to grouping these darlings as the MegaCap 8. They include Microsoft (MSFT), Tesla (TSLA), Meta (META), Apple (APPL), Nvidia (NVDA), Alphabet (GOOGL), Amazon (AMZN) and Netflix (NFLX). Entering the pandemic, they had previously accounted for 15% or less of the market cap of the S&P 500, but for most of the last three years, they have comprised ~25% or more of the index's market cap. A year ago, they traded at ~33x forward earnings estimates. Today, they trade around ~23x. Like the rest of the market, their multiples have contracted meaningfully, though they still command a wide premium. Including them, the S&P 500 trades at ~16x PE, (in line with the market average of ~16x over the last 25 years.) Without the MegaCap 8, the index trades at just under ~15x forward earnings.

Further down the cap scale, valuations continue to cheapen. The MidCap 400 trades at 11x forward earnings while the S&P 600 trades at ~10x forward earnings. More than a third of the 600 stocks in this index trade at single digit forward PEs. Both the MidCap 400 and Small Cap 600 are historically cheap, both on an absolute basis and relative to their larger peers. For small caps, as remarked last quarter, their relative multiple is now as attractive as it has been at any time in the last 20 years. The last time such a dichotomy emerged in the summer of 2002, small caps enjoyed a multiyear period of outsized absolute and relative gains against their larger peers.

Of course, the shortcoming in any analysis of earnings multiples, particularly forward ones, rests on the embedded assumption of the forward estimates. In consideration of this fact, we also examined forward returns of the Small Cap 600 by multiple of book value, a more static metric that we found made for a more predictable point of comparison. As suspected, this analysis was more highly predictive than earnings multiples. Encouragingly, recent trading multiples of ~1.7x book value suggest the S&P 600 is positioned to produce 15% annual returns over the subsequent five-year period.

So, our asset class of focus is on sale. Given the headlines, this seems fitting. The low valuations and dispiriting news flow are traveling companions. We are now a few weeks short of a full year in a bear market. Conversations amongst most market participants have now turned to recession. Most expect earnings to decline given the gathering economic headwinds. And they are likely correct. But how far must earnings decline to negate the attractiveness of today's valuations? It is a different answer for each company. But some clear dividing lines are emerging within the market and many attractive values are present.

CONCLUSION

Though our asset class of focus has become historically attractive, I would like to continue to outperform it as we have in prior years. That is why we run a concentrated portfolio, where we can focus on just a few of our preferred assets within this class. In time, I believe we will again be rewarded for this approach. As we emerge from this bear market, I am quite enthused about what lies just across the emerging horizon.

Accordingly, I know our approach will not yield outperformance each and every quarter, but I continue to believe it will be well worth our while over the long haul. Perhaps more importantly, given the overwhelming majority of my investable assets are invested alongside yours, we would never ask investors to assume risks we ourselves will not.

Thank you for your continued support as we work to grow our capital together. As always, we are happy to discuss our investment outlook with you at your convenience. Please reach out any time.

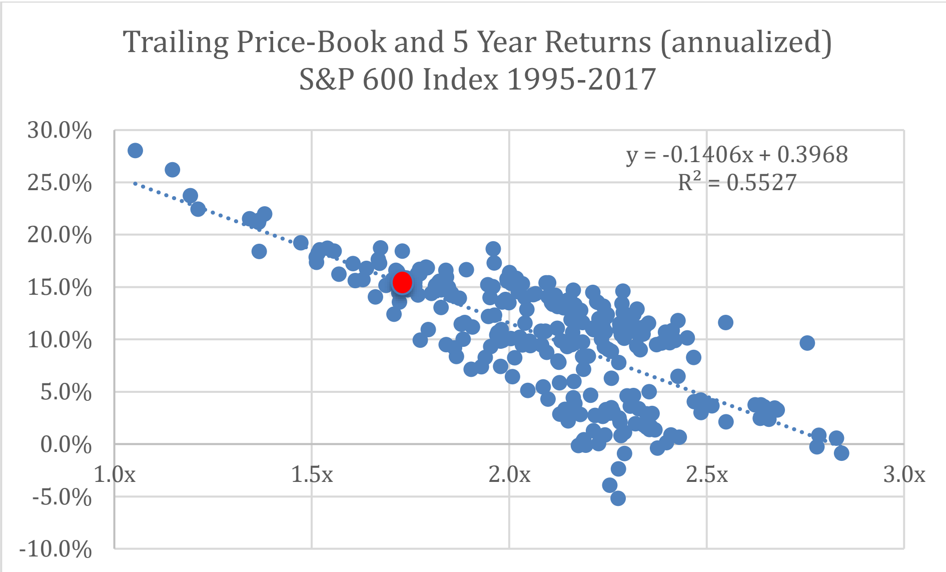
Best regards,

Mitchell Scott, CFA
Portfolio Manager

1. All market and company data is sourced from Factset and company filings and is current as of 9/30/22.
2. CEF uses the S&P 500, Russell 2000 and the Barclays Hedged Long/Short indices as its primary benchmarks. The S&P 500 and Russell 2000 are common large and small cap US equities-based indices. The Barclays Hedged Long/Short index (an index of equities-based hedge funds) serves as an appropriate benchmark over the long-term given the index has a similar long-term goal of capital appreciation through equities investing.
3. CEF Net Returns are consistent with the 1% management fee and 18% performance fee offered to clients.

APPENDIX

S&P 600 Small Cap Index: Price / Book Value and Next Five-Year Returns



- We opted to focus our return analysis by book value on the S&P 600 rather than the Russell 2000 due to the higher proportion of profitable companies within the index. This analysis produced a more predictive regression than other metrics and indices.