July 31, 2018

Dear Investor:

The volatility that returned to the markets in the first quarter continued, albeit at lower levels, ultimately giving way to a back and forth market which pushed the Russell 2000 and S&P 500 up +7.8% and +3.4%, respectively. Together these results put our Small / Large Blended Benchmark +6.7% for the quarter. Choice Equities Fund (CEF) posted another solid quarter, up +8.4% and +6.9% on a gross and net basis. We are pleased to build on our strong start to the year and believe the portfolio and recent additions offer continued bright prospects for further appreciation.

EXECUTIVE SUMMARY

In this letter, we will start with a business update and provide a review on our operations to date given the close of this quarter marks our fifth anniversary. We will also offer some thoughts on the active versus passive investing debate given the surge in passive investing over this five year period. We will discuss new portfolio holding Reed's Inc. (REED) and provide a brief update on Beacon Roofing (BECN), due to its increased position size in our portfolio. As is usual in our quarterly letters, we will close with a brief assessment of the current investment environment and market conditions.

BUSINESS UPDATE: FIVE YEAR REVIEW

With the close of the quarter, CEF has now completed its first five years in operation. We are pleased to report substantial outperformance over the Russell 2000 and the S&P 500 over this time. Our 121% total compounded net return likewise compares very favorably against our peers. According to our review of a recent database query of 362 equity hedge funds comprised of 177 long/short and 185 long-bias funds, our returns rank in the top 10 in each of the one, three and five year periods, giving us a high degree of confidence we place among the top 5% of our peers across the country since inception. Of course, we have not outperformed every month, quarter or year. No one does. And our results have at times been lumpy. But as anticipated, we have demonstrated that over a meaningful time horizon our approach is well worth it. (For those interested in viewing the data, just ask.)

While it is an admittedly brief time period, we feel it is worth highlighting that our performance since we became an independent and standalone investment company is even better. For the 18 months beginning in 2017, we have compounded investor capital at an annualized rate of +35% on a net basis. Our broadened investment universe and the steps we have taken to capitalize on it have begun to pay dividends. This is a trend we expect to continue. We recently discussed many of these initiatives in an interview we conducted with our new friends at Hidden Value Stocks. The interview does a good job of highlighting the foundational elements of our investment approach and provides an update on existing portfolio holdings Drive Shack (DS) and Bluelinx (BXC) as well as new investment Reed's. It was recently posted to the website and can be found here https://choice-equities.com/blog-2/.

We are equally enthused to report meaningful growth in the number of our limited partners. No longer is this strictly the family and close friends crowd as it was when we set out on our own. With the additions of the last 18 months, our LP base now spans multiple continents and includes entrepreneurs, company founders, real estate executives, lawyers, consultants, private equity executives, former CEOs and CFOs and former portfolio managers. What began with several friends sending us their IRA accounts has snowballed through their referrals and is beginning to take the shape of the investment operation we envisioned. The mission to build a successful and differentiated boutique investment partnership – built by an individual investor for individual investors – is coming together with each new commitment and quarter in the books. The growth is flattering, and I feel privileged to have this opportunity. As I will discuss below, the outlook for our style of active investing is bright, and I believe there is a high probability the next five years will be as good as the first five, if not better.

Given the five year milestone, one can be forgiven for wanting to stop and reflect for a moment. As I take a look around and consider how the investment landscape has changed over this period, it's hard not to zero in on the torrid growth in passive investing as the most impactful development in the marketplace. Some numbers will help frame the magnitude of this expansion. Data from Morningstar show that 45% of dollars invested in US equities is now done so via passive investment vehicles like index funds and ETFs.[4] In percentage terms, this is up 12% from the 33% levels of 2013. In dollar terms, this means an astounding $1T has been directed to passive strategies in the last five years while active strategies have continued to see outflows each year. As a case in point of just how prevalent passive investing strategies have become, consider that ETFs, which are supposed to hold a market full of stocks or maybe a sector or subindustry, now actually outnumber stocks themselves.

While the numbers largely tell the story of the pressure on the industry of active management, for me personally, it is simply hard to forget the Wall Street Journal's 2016 declaration that active investing was dead.[5] The paper made the subject a recurring feature, and for nearly the entire month of October, it seemed there was a new article every day chronicling the death of active management and the underperformance of mutual funds and hedge funds alike. While elements of the headlines were tough for active managers, being one myself, I couldn't help but feel these headlines carried a similar message many headlines do. Namely, it is time to go the other way… take the other side of the trade.

Headlines do a lot of things. Primarily they sell papers. "If it bleeds it leads" they say. But they also have a way of capturing the feeling of the moment, the prevailing consensus view. As the press is wont to do, they build their articles by examining a topical issue of the day. The reporter writes the article. And then the editor comes along and slaps a headline on it that is intended to both stir emotion and capture the leading thinking of the time. When popular opinion is involved, this often suggests a consensus has been formed. And when markets are involved, this often means participants have played their hand accordingly. For investors, this moment can be a good contrarian indicator and one that suggests it is time to go the other way. Or at a minimum as Mark Twain once said, "whenever you find yourself on the side of the majority, it is time to pause and reflect."

I viewed that point in late 2016 as one of those moments. I felt strongly then as I do now there would always be a place for active management, especially for those conducting their business the right way. (Broad generalizations typically require considerable explanation, so for the sake of brevity and for anyone wondering, I'll confine my comments about "the right way" to highlighting two of the critical hallmarks of our investing philosophy I consider of paramount importance: manager/investor incentive alignment and appropriate levels of portfolio concentration). Perhaps unsurprisingly then, it seems active management and associated performance has again begun to show signs of life. Likely not coincidentally, this seems to have occurred concurrently with the bottoming of interest rates as it has in prior cycles. And that moment in October 2016, now a seemingly distant memory, seems to mark the crescendo of the narrative about the demise of active management, at least for the time being.

Despite the modest renaissance, the amount of dollars that continue to flow towards passive strategies is tremendous. With nearly half of all equities investing dollars now going towards passive investing, questions abound. How are markets changing? How much passive is too much passive? How long will passive investors be able to free ride on the valuation work of active investors before serious misallocation of capital results? What are the implications for our economy? How will the everyday investing public respond when these products are truly tested? Of course, the honest answer is the real impact of this development on the investment industry and their investing clients won't be known for years.

But if you're like me, what you really want to know is how these changes affect us today. So, we look at what we know. And what we know is that there are fewer investor dollars going to fewer active managers than before. Active investor trading volumes are shrinking and commensurate with that, fewer trading commission dollars are being generated. In tandem with this trend, soft dollars, which are generated from this trading activity and typically finance buyside investors' research budgets, are also declining. Regulatory changes like the European implementation of MiFID rules are accelerating this development. Following this trail of crumbs to its inevitable end, these declining budgets mean fewer and fewer sell-side analysts are receiving attractive or even adequate compensation for their work, and fewer and fewer reports are being published on their covered companies.

With less information being circulated, market inefficiency will presumably grow. So, are markets becoming completely inefficient? No. That does not come for another 12 years – at least according to a recent study mentioned in the Financial Times that concluded all markets would be entirely passive by 2030 if the current rate of passive investing growth continued unabated.[6] So, we clearly are not there yet. But it looks like we are heading there. As is often the case, these impacts are most prevalent in the small cap space where the dollars traded were already smaller due to the smaller size of these companies. Consider another recent study from Reuters that found the number of small cap companies in the Russell 2000 receiving no formal attention from Wall Street sell-side analysts increased more than 30% in the last three years.[7] That means that now nearly a quarter of the companies in the Russell 2000 only have two analysts – a number I suspect even the academics would admit is too low to support the accurate and timely dissemination of information an efficient market would require.

At the annual Daily Journal meeting earlier this spring, Charlie Munger reminded investors about the rules of fishing. "Rule number one" he said, "is fish where the fish are." Like much of his plain-spoken yet sage wit and wisdom, it is as obvious as it is useful. To catch a bunch of fish, you simply must be where the fish are. That is precisely why we devote our greatest efforts to identifying mispriced securities in the small cap space. Yes, we occasionally look at large caps which also get misunderstood or neglected from time to time, but considering the average large cap has 22 analysts, we think it simply makes more sense to fish in the small cap pond.

As I think about our activities over the last five years, I'm pleased to share that we have found a nice little fishing hole. In it, we have caught some nice fish. And 18 months ago, we bought a bigger tackle box and added some new lures. In another stroke of good fortune, many of our fishing buddies who poke, prod, measure and scare the fish, are leaving. Perhaps they are moving on to other game, but wherever they are going, they are taking their noisy movements and scales and rulers with them. Information inefficiency is growing. And we have this these new lures. So, for all these reasons, we greet the next five years with great enthusiasm. While I know there will again be periodic lulls where it seems we cannot catch a thing, on the whole I hope and expect we will add even more and nicer fish to our trophy room.

NOTABLE PORTFOLIO PERFORMANCE DRIVERS

Moving on to portfolio drivers for the quarter, DS, BXC and Chipotle Mexican Grill (CMG) were the biggest contributors to the quarter's positive performance contributing +4%, +3% and +3%, respectively. Little has fundamentally changed since our prior updates at either DS or BXC though both appear to have benefitted from increased discovery of their investment prospects. (Please note the Hidden Value Stocks interview contains a full and current investment thesis for each in greater detail.) With the elimination of the external management contract, DS has recently begun acquiring institutional shareholders, a positive development. BXC continues to look attractive, with shares trading around 4x proforma EPS at recent levels. We will discuss CMG further below.

On the negative side, Entercom (ETM) and BECN each detracted -1% while short market hedges detracted almost -1% as well. Regarding ETM, the CBS radio integration does not appear to be a smooth and effortless one, and their first quarter reporting as a combined company highlighted some struggles in this endeavor. This is not a completely unsurprising development given the scale of the newly acquired company, but it looks as though the management team, significant shareholders themselves, are continuing to do the right things for the long-term benefit of shareholders. We continue to see value in shares at current levels. We will discuss BECN, which has again become a big position for us, at further length below.

PORTFOLIO ACTIVITY

CMG – This past May I again had the good fortune to visit our friends at Semper Augustus in St. Louis who hold the annual Tulipomania investment roundtable. The event spans a couple of days and about 20 experienced and well-regarded investors come together to discuss stocks and markets and other investment topics of the day. I view my invitation there as a real honor, and my two trips there have been both fun and highly educational experiences. It is simply a great group of folks – and not a bad place to find some interesting new stock ideas either.

Chipotle, at the time our most recent investment, was the stock I presented during my hour. I made a somewhat reaching analogy that the company embodied many of the same attributes of "Mr. Invisible", probably unknown to most as Izzy Stradlin, the former guitarist of Guns 'N Roses. I had recently read an article in the Wall Street Journal highlighting that lead singer Axl Rose wasn't much of a fan of Izzy's stage presence, or lack thereof, and had accordingly labeled him as such.[8] After lamenting I was now old enough to be learning new things about bands I grew up with in venerable financial newspapers, I made the comparison that Chipotle, once a pioneer of the fast-casual restaurant segment, had somehow become the Izzy Stradlin of its industry. The comparison stemmed from the fact that recently installed CEO Brian Niccol, well-regarded for his marketing acumen, used the word "in/visible" nine different times in his first earnings call in relation to Chipotle's brand and recent efforts to increase its visibility. I discussed the various reasons why this applied, how and why it might be changing and what implications that may carry for shareholders. Fortunately, that thesis looks to be on the mark. That memo will soon be posted to the website for those interested.

BECN – Beacon Roofing, which was a small position entering the year, has again become a meaningful holding for us. After a ~20% decline on the back of their 2Q earnings report, shares are now down ~35% for the year and off ~40% from a trading high from as little as six months ago. Like most housing related stocks, shares have been punished as investors have taken last year's profits on concerns of rising rates and pinched margins from increasing input prices. Beacon Roofing seems to have been further penalized for its recent acquisition of peer Allied Building Products (Allied) as the company now screens poorly on backward looking financials due to the higher than average debt load used to finance the deal. Add in a big miss from their 2Q earnings' report, a seasonally light quarter where results have historically swung in a wide range, and the seeds for a selloff have been sewn.

The bear case for shares rests on several pillars, some of which have merit, but many of which are quite short term in nature. They include: 1) the underperformance relative to expectations in the 2Q report, 2) a squeezed gross margin profile as increasing asphalt prices push shingle prices higher 3) concerns on housing stocks in general around rising rates and 4) questions about their recent acquisition and its associated synergies. Regarding the first point, their 2Q quarter which ends in March is often the toughest one to predict. It carries the lowest sales of the year, but a similar level of fixed costs as other quarters. Accordingly, earnings' results can swing wildly with good or bad weather as they have in the past due to varying degrees of fixed cost leverage. Regarding the gross margin in the second point, unless shingle inflation is permanently moving to a high-teens double digit annual level, it seems likely the company will eventually pass these costs along to their customers and recoup most of its lost gross margin points. Even if they do not recapture their *gross margin level*, shingle selling prices are increasing. So, while the margin rate may show a moderate decline, it should come with higher sales which will likely bring a higher number of *gross profit dollars*. On the third point, nearly 80% of the company's sales are primarily driven by repair and remodel spending, not newbuild construction, so the impact of rising rates is likely less applicable than some suggest. Finally, regarding Allied, this purchase is simply an extension of the company's long running acquisition strategy. It was only three years ago that the company successfully used a similarly judicious level of debt to acquire peer Roofing Supply Group and successfully achieved the synergies targeted.

While the share price has been all over the map of late, little has changed with regard to company fundamentals or its strategic direction. I have met with the company many times over the years and have observed no recent changes in corporate strategy or leadership. The Allied deal now pushes them to be near equals in market share with industry leader ABC Supply and further solidifies their competitive position. And the current growth trajectory looks much like it has in the past. While it is unclear when the margin fears will abate, this quarter, next quarter, or next year, I suspect they will. When they do, investors will see earnings power of ~$4 / share emerging which should look pretty attractive on a $40 stock that has historically traded around 18 – 20x NTM PE. Over the years insiders have proven infrequent purchases of their own stock, although it augers well that several insiders have recently made some acquisitions.

REED – Reed's Inc. is a company that has had its ups and downs. You may know it as a market leading manufacturer of ginger beer and a pioneer in the small but rapidly growing craft consumer beverage segment. As the only leading player making ginger beer that actually has ginger in it, the company is well positioned to expand on its lead in the space and capture much of the growth in this category. But it was not always this way.

Chris Reed, the company's founder, essentially brought the category mainstream and grew this company from scratch to an organization with multiple brands together doing near $50M of sales per year. He should be commended for building such a well-regarded brand, an effort he initiated largely on his own. But the company had its share of missteps. The most costly one was an ill-fated and strategically questionable foray into expanding its manufacturing operations with a major investment in a new plant in 2015. This move diverted capital away from marketing spending and brand building initiatives and brought operational execution risk into the picture. Later that year the company began having problems fulfilling its commitments to customers, and the company was hurt by increased distribution costs and lost sales. Further troubles soon followed which ultimately led to the installation of a new board and management team last summer.

The new Chairman of the Board is John Bello, founder of Sobe and former Chairman of Izze. A year ago he tapped a new CEO, Val Stalowir, who I had the pleasure of meeting for lunch in Greenwich, CT a few months ago at a restaurant named, quite appropriately, The Ginger Man. He likewise has impressive experience within the industry with prior leadership and operational experience. The new team is appropriately transitioning the company to an asset light strategy. The intended sale of its L.A. based plant will finalize the move away from the capital-intensive manufacturing operations and the company will devote the lion's share of its resources towards marketing and brand building going forward. The focus will be on only their most visible and best positioned brands, Virgil's and Reed's, as these two brands hold leadership positions in categories that are growing at mid-single digits and mid-teens levels annually, respectively. The new team looks intent on developing the brands and potentially positioning them for a sale to a larger player, a common play in the consumer beverage playbook.

This position resides as a smallish for one us as shares are up ~40% from our initial purchase levels earlier this summer. Unfortunately, while we were doing our due diligence, the price moved quickly. Choosing discipline over chasing the stock, we have held steady at a low to mid-single digit size position. Still, if they are able to execute successfully on this plan, it seems shares could double or better from recent levels over some two to three year horizon.

New positions – Late in the quarter we began initiating a position in a company we believe to be trading at a low single digit multiple of NTM EPS. And we are hard at work in deep due diligence on another. We look forward to updating you about these positions in future correspondences once our positions are fully established.

Shorts/Hedges/ETFs – We continue to hold a few small short positions in four ETFs and one currently small single position short. The ETFs are primarily focused on lowering our exposure to housing and building products and enable us to own larger positions in BECN and BXC, positions which we believe have a high degree of merit due to their specific circumstances and risk/reward dynamics.

2018 OUTLOOK – We again have no meaningful changes to report in our broader investment views from our 1Q 2018 report a few months ago. The economy continues to grow and the impacts of tax reform are showing up in consumer and business confidence. Our focus as always is on earnings which are quite strong and are growing in excess of 20% for the quarter, driven in part by the benefit of the lower tax rate. The multiple for the market continues to look full, though we are enthused about recent additions to the portfolio and continue to believe our prospects are more exciting than what can be found in the broader market itself.

CONCLUSION

As always, we are happy to discuss any portfolio holdings or our investment outlook with you at any time. Please reach out to us at any time. In closing, we are honored and privileged you have entrusted us in managing your capital, and we look forward to continuing our relationship further into the future.

Best regards,

Mitchell Scott, CFA
Portfolio Manager

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1. All market and company data is sourced from Factset and company filings and is current as of 6/30/18.
2. CEF uses the S&P 500, Russell 2000, a custom Blended Small/Large Benchmark 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 custom Blended Small/Large Benchmark is provided to capture a larger proportion of small cap performance versus large cap performance (at a 3:1 ratio) due to the similarly high proportion of small caps found on the Good Businesses Focus List as well as the strategy's general preference of having an investment mix more heavily weighted towards investment in small caps. 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 hypothetical results calculated from actual gross results in a manner consistent with the 1% management fee and 18% performance fee offered to clients.
4. https://www.morningstar.com/lp/fund-flows-direct?cid=CON_DIR0020&con=11136http://graphics.wsj.com/passivists/
5. http://graphics.wsj.com/passivists/
6. https://www.ft.com/content/15dd3552-3fad-11e7-82b6-896b95f30f58
7. https://www.reuters.com/article/us-usa-funds-research-idUSKBN1AN221
8. http://online.wsj.com/public/resources/documents/print/WSJ_-A013-20180529.pdf

APPENDIX

CEF GOALS, PHILOSOPHY, APPROACH AND ALIGNMENT

GOALS – We seek to generate market-beating returns over any rolling multiyear investment horizon while minimizing the risk of permanent impairment of capital. Additionally, we seek to communicate with our investors in a transparent and straightforward manner and ask only that they accept investment risks that we ourselves are willing to take. *Given the majority of our investable capital is invested alongside theirs, we invest our limited partners' capital as if it were our own, because it is.*

PHILOSOPHY - We approach investing in public equities as an opportunistic businessman would. We spend most of our time studying businesses and building circles of competence in areas likely to offer attractive investment prospects and invest in only our most compelling opportunities. We view risk primarily as the likelihood of a permanent impairment of capital and pursue a carefully balanced willingness to trade some short-term portfolio fluctuations for the opportunity to earn higher returns over the long-term. We focus on growing, understandable businesses and seek to buy them at a substantial discount to our estimate of their intrinsic value. When we find them trading at attractive prices, we often act in size and weight our best ideas accordingly. And all things being equal, we prefer to devote more of our efforts to small stocks where we believe greater price/informational inefficiencies can often be found.

APPROACH – We invest via a long-bias hedge fund structure and concentrate our long investments in our best 10 to 15 ideas. Our work begins with a two or three-year outlook, and we only pursue investments we believe are likely to offer us a reasonable chance to generate an annualized return of 20% or better. While we pursue long-term oriented investments and seek to compound capital in a tax efficient manner, we readily acknowledge the often-turbulent markets do not always fit neatly into this framework and know some trading activity is sure to follow as a result. In the short book, we seek to generate absolute profits in a few stocks where we have uncovered a company entering financial duress or an excessively optimistic valuation where we feel their earnings outlook is likely to worsen materially. We will also use industry or market specific ETFs to mitigate market risk and will look to employ options and other opportunistic hedges when conditions appear favorable.

ALIGNMENT – We believe appropriate alignment of interests is the bedrock upon which all successful partnerships are built. Our primary means of ensuring proper incentive alignment is through significant co-investment of our personal wealth alongside our limited partners. Secondarily, we offer an investor friendly fee structure. We charge a modest management fee to support investment operations and charge an annual incentive fee on new profits only. Finally, commensurate with our fee structure which is intentionally structured such that the majority of fund earnings will be earned only if we generate compelling investment results, we commit to operating the fund as a boutique shop with a limited asset size. As many of our best investments often come from small stocks, we believe it is important to preserve our ability to take concentrated positions in our best ideas. Our size and structure ensure we are incentivized to generate compelling returns, not gather assets.

Think of it this way. *On the one hand, we are incentivized to generate the best investment results possible. On the other hand, we are unwilling to invest in a way we feel is likely to result in a meaningful loss of our own investment capital. What more could one want from an investment manager?*