



October 23, 2018

Dear Investor:

The large and small cap indices posted another gain in the third quarter, again taking turns leading the market higher. The large cap S&P 500 index was up +7.7%, while the small cap Russell 2000 was up +3.6%, respectively. Together these results put our Small / Large Blended Benchmark up +4.6% for the quarter. Choice Equities Fund (CEF) largely treaded water for the quarter, down -.6% and -.7% on a gross and net basis. Despite the flat performance in the quarter, we continue to be pleased with the year thus far, up +35.9% gross and +28.5% net, as well as our +37.3% and +29.1% gross and net annualized rates of return since becoming independent at the start of 2017.

EXECUTIVE SUMMARY

In this letter, we will discuss drivers of performance for the quarter with a principal focus on Lawson Products (LAWS) as we discuss the market's delayed recognition of an accretive deal it closed last year. We will provide a brief description of platform companies and their often-advantaged business models given two of our three new holdings fit this description. We will then introduce our new positions in Destination Maternity (DEST) and Yelp (YELP). And as is usual in our quarterly letters, we will close with a brief assessment of the current environment, particularly in regard to the recent return to choppy market conditions.

NOTABLE PORTFOLIO PERFORMANCE DRIVERS

In our last quarterly letter, we likened our investing efforts to fishing. We reminded investors that sometimes we would catch loads of fish and sometimes it would look like we could not catch a thing. We stated that in pursuit of our concentrated style of investing, we would occasionally appear out of sync with the markets or lag our comparisons, but over time, our approach would be well worth it. Our performance this quarter serves as a good reminder of that fact. These occasional inconsistencies in comparisons against our market benchmarks are simply a necessary condition. After all, if we want to be better – and better the market averages as we do – then we are going to have to be different. This means we will not be better all the time or over every short time interval. But over the long haul, I continue to believe this approach will be highly rewarding.

Of course, to continue to do better, we must continue to find value. So, on that score, I am quite enthused with recent changes to the portfolio and the additions we have to share with you this quarter. While each situation is unique in its own right, the common element is *change* as each business is undergoing a transition of some kind. These types of situations suit our investment style well, though as we will highlight below with Lawson Products, they do not always yield results overnight. Our approach is to evaluate the business in its entirety. We look forward over a period of years rather than just the next quarter or two as an increasingly myopic marketplace seems to want to do. With this approach, sometimes we may be rewarded quickly, while sometimes it may take a while for the market to come around to our view. But, if we are right in our assessments, we will be rewarded in due time.

Moving on to performance in the quarter, long time portfolio holding LAWS was the biggest positive contributor, adding +3% to fund performance, ostensibly on enthusiasm about an accretive deal we wrote about *last year* in our 3Q 2017 letter. Drive Shack was the biggest detractor, giving back some of its gains from the prior quarter and hurting fund performance by about -2%.

Taking a closer look at LAWS, as stated above, if we are right in our assessments of value, the market will reward us in due time. But due time can sometimes take a long time, especially in the context of today's on-demand and instant gratification culture. Add in the fact that our primary focus is on the less efficient small cap space, and these impacts can be even more pronounced. Consider that this time last year, we highlighted the company as they had just announced and closed a highly accretive deal that October. The company was performing well, shares traded at a meaningful discount to peers and end markets looked supportive for further gains. We noted our enthusiasm. And then nothing happened for a whole year.

Shortly after announcing the deal, the company held a special call to discuss the acquisition's merits. Anybody who tuned in or read the transcript could see LAWS bought a business that furthered their strategic goals that would soon add 25% - 35% to earnings. The company maintained a clean balance sheet post deal, and they continued their expansion into Canada, an expanding market for the company. Even so, shares barely budged. They reported earnings later that October, again highlighting the deal and strong operational results. Nothing. The same happened again in February. Again nothing. In April, they reported good results again, this time with the deal "in the numbers" though the numbers in this report had a few moving pieces given their adoption of new FASB guidelines that used a slightly different presentation of revenue. Still nothing happened. Then finally, this July after having had the acquisition integrated into the financials for over three quarters, the company printed results that cleanly impacted the income statement and voila – shares spiked up some ~40% over the subsequent three weeks.

We highlight this development because of its impact on our performance but also to point out both the opportunities and vagaries inherent in investing in the small and micro cap space. Though this company resides on the smallish side with a nearly \$300M market cap, it is not completely obscure as it does have two analysts covering it. Considering the above, from our perspective, it is as true today as it was some 70 years ago when Ben Graham remarked that "in the short run, markets are a voting machine; in the long run, they are a weighing machine." For those interested in a closer look at the company, we wrote the company up in December on SumZero and that presentation has since been posted to the [website](#).

PORTFOLIO ACTIVITY

First, let's discuss the sales. Early in the quarter, we completed the sales of our positions in building products companies GMS and BMCH which we began exiting earlier this spring. With rates likely heading higher and investors to soon follow the playbook to sell all building products companies, both were sold to lessen our exposure in this area and make room for what we believe are higher returning investments. Though we have lightened up in this area, we still own two building products companies in Bluelinx (BXC) and Beacon Roofing (BECN). We are holding on to them, despite the market's temporary concerns, because we believe they represent highly compelling values. Additionally, we exited our position in Nexeo warrants with a price gain of ~50% after the company was acquired by a larger peer. Given its small position size, it only contributed +.4% to fund performance. Lastly, we covered our profitable short in an unprofitable and overvalued online retailer whose shares had surged some 5x after it became associated with Bitcoin this past winter.

Now let's turn to the additions in the quarter. We added an overlooked retailer that the market had left for dead – which we do not think is dead – and two companies that broadly fit the description of platform companies. We will discuss our investment in retailer Destination Maternity further below, but first, what is a platform company?

A platform company, according to Alex Moazed and Nicholas Johnson of "Modern Monopolies: What It Takes to Dominate the 21st Century Economy" who quite literally wrote the [book](#) on the subject, are companies that pursue "a business model that facilitates the exchange of value between multiple user

groups, consumers and producers.” There are many kinds. They can be marketplaces for goods or services. Or they can accommodate payments or investments, social networking, communication, gaming, content or even software development. In practice, they build networks that bring together buyers and sellers, so these parties can do business and meet each other’s needs more efficiently. They often act as a go-between or a middleman and take a small cut off each transaction the platform facilitates. They are two-sided toll takers or a new era distributor of sorts. The larger the network grows, so do its profits and attraction to buyers and sellers who can increasingly locate one another there.

Page by page, the authors lay out the playbook for building a profitable platform. Step one of course, is build the platform. This is easier said than done as the architects must figure out a way to initially attract users, often starting from scratch. Though not easy, the task tends to gather momentum as the platform scales. Step two is to then monetize the platform, often through advertising or by charging small transaction fees, hopefully in a way that does not alienate the user base. The authors then discuss the unending process of protecting the platform, constantly curating it and monitoring user engagement to safeguard its blossoming profitable network effects. (Think of those Bird scooters that are [everywhere](#) all of a sudden. There is a reason they got air-dropped on your town overnight. The [first-mover advantage](#) in these networks can be real and lasting.)

Moazed and Johnson then move on to discuss the financial merits of these businesses. As connectors, rather than the typical manufacturer of yesteryear, they are capital light and benefit from low marginal costs and low ongoing maintenance capex needs. Their minimal capital requirements allow them to reinvest in other high returning projects spurring faster and more productive growth. Warren Buffett seems to share this view, noting after the 2017 Berkshire [meeting](#) that the then top five largest companies in the US (Apple, Microsoft, Amazon, Google and Facebook), “required virtually no capital to run... and that was not the case in the past.” The authors of Modern Monopolies put an even bigger exclamation point on the subject and assert that the 7% of S&P 500 net income that platform companies together comprised in 2015 will grow to 50% by 2040. It is not immediately clear if this assertion is a touch optimistic or perhaps hyperbole, but the point is the same. Many of these platforms are fantastic companies with advantaged business models. And they are growing quickly.

YELP – Yelp fits the bill as a platform company. It is a two-sided marketplace which brings together consumers as both review providers and review users into a digital community that shares information primarily about local businesses. Founded by current CEO Jeremy Stoppeleman 14 years ago, its origins trace to a vision to become an online competitor to the Yellow Pages where users could enjoy the added benefit of being able to share recommendations with one another. The reviews are particularly valuable to local, small and medium businesses (SMBs) like restaurants, salons, landscapers and various service businesses as they provide a scalable and cost-effective platform to cultivate a reputation-based marketing message. Starting essentially from scratch, Yelp has grown to become a top 25 website by traffic with ~70M users on the website and 30M unique app downloads. All in, the platform has a market leading total review base of ~150M views with 200,000 SMBs who pay for advertising services which together generate ~\$1B in sales.

Despite the impressive growth to date or the vast and still growing nature of the local advertising end market (which is estimated at nearly \$150B annually), Yelp’s market cap pales in comparison to those with similar traffic counts. We believe this presents a compelling opportunity, particularly considering the company appears to be at an inflection point. With step one of building the platform now complete, the company is moving on to step two as it seeks to better monetize the traffic on its platform. For years the company offered advertising placement on its site to SMBs through an annual fee of \$4,000. This made sense considering the Yellow Pages offered a similar pricing schedule. But now with the Yellow Pages little more than a memory and the Yelp platform established, the company has begun experimenting with

no term contracts, or something akin to a pay-to-play advertising contract with a term structure that only lasts one month. The smaller commitment of this new contract structure makes it easier for SMBs to join the platform, making it more efficient and transactional which further reinforces the positive network effects.

Engagement with the platform is healthy as users and revenues have been growing at ~20% per year. Results with the no term contracts look to be off to a good start too, as the number of paying advertiser accounts shows some signs of accelerating, most recently up 31% in 2Q 2018. Yelp is also adding other service offerings as it attempts to better monetize the platform through the cross selling of services. One intriguing offering is called Request-A-Quote, where users receive bids for household projects they have posted to the site from local service professionals, often within an hour or two. Though small at a \$35M run rate in sales, it is growing quickly, up 50% from last quarter.

Impressive as these growth stats are, they are obfuscated in some degree by the transition to the non-term structure. The company also recently sold its Eat 24 business to delivery partner Grubhub which has a distortional effect on the company's numbers. Accordingly, the consolidated financials only point to ~12% topline growth rather than the 20% plus run-rate the ongoing business is currently generating. The Yelp financial model is a strong one, as the company enjoys strong gross margins of ~94%. With only moderate selling expense associated with each new sale, ~40% of incremental sales fall to the bottom line. Capex is similarly light at just ~3% of sales, meaning the company can easily direct resources to other growth initiatives or shareholder friendly uses of capital. With ~\$800M in cash on the books, the company is in a strong financial position. The CEO and founder owns ~\$100M of stock and, after some recent changes in executive compensation, is now only taking a salary of \$1 per year. With shares trading at 2.5x EV / Sales or 14x EBITDA versus peers at considerably higher multiples, we believe the company is well positioned to compound investor capital at high rates of return over the coming years.

New Position – As we are currently establishing a position in a second platform company, we will hold off on providing its name at this exact moment. But like Yelp, the company has a proven CEO with a strong track record and is also undergoing a change where consolidated financials do not currently portray the whole picture. Looking through these changes, we see another asset light company emerging with impressive double-digit topline growth and high incremental margins. Unlike Yelp, this one is much smaller in terms of market cap, only lightly followed by sell-side analysts and trades with approximately half of its market cap in cash on the books. We look forward to updating you on this one in due time.

DEST – Destination Maternity is the world's largest designer and retailer of maternity apparel. Like many retailers, the company thrived in the 1990s and 2000s with growing same store sales and an increasing store footprint as malls and shopping centers proliferated across the country. Also like many retailers, the company has struggled over the last five years as Amazon and the growth of the online channel have diverted sales away from brick and mortar locations and left many participants with too many stores and bloated and under-absorbed cost structures. Unlike most other retailers, the company was further plagued by poor management and questionable corporate governance practices that did not always position shareholders and management with aligned incentives.

This past winter a team of activists identified these issues and waged a battle for control of the company. An ugly proxy battle ensued, but the activists emerged victorious and have since installed an impressive new board and a CEO with solid retail and turnaround experience.

There is much work to do, but there is much to build on. Despite the recent issues, the company maintains an impressive customer list with a market leading share in a category known for customer loyalty. The company has a store base of ~1,000, comprised of ~400 company-operated locations and ~600 leased

locations inside department stores. The stores operate under the three banners: Motherhood Maternity, Pea in the Pod and Destination Maternity. Together, the company earns an impressive 50%+ gross margin but has an SGA margin that is worst in its class. Combined with a store footprint where ~50% of the stores will be up for lease by the end of 2019, it seems there is an opportunity for addition by subtraction for the company. Additionally, the company has been late to the eCommerce game. But recent initiatives there auger well there too. The online channel has grown from practically zero a year ago to nearly a quarter of the sales mix today and is still growing at a high teens rate. Our conversations with the new CEO point to a team that is intent on furthering these initiatives and cutting costs to create a leaner and more profitable company.

Recently changing hands at a little north of \$4 per share today, the company is trading at 5x FY2018 EBITDA and .4x sales versus peers who generally trade around 6-8x and 1-1.5x TEV / sales. The activist case suggests improved performance could again position the company to soon earn \$2 as they nearly did in 2013. It is unclear if this outlook may prove optimistic. But even if new management is able to get half way there towards the goal of \$2 of EPS, it seems shares still represent a compelling bargain.

Shorts/Hedges/ETFs – Ending the quarter we continue to hold a few small short positions in four ETFs as well as some cash from recent sales we look to deploy opportunistically in the near term.

OUTLOOK – From an economic perspective, we do not have too many meaningful changes to report in our broader investment views from last quarter. The economy continues to grow, and earnings growth continues to be very strong, likely coming in above 20% again for 3Q 2018. However, soon the arithmetic effect of the tax cuts will dissipate, and earnings growth will optically slow. But while the rate of growth may be peaking, the economic picture continues to be bright and supportive of further solid earnings growth into 2019.

From a market perspective, the placid environment of 3Q which had no daily moves in excess of 1% have given way to choppier conditions, and stocks have begun to sell off entering 4Q. This go around, small cap stocks are leading the markets lower. The Russell 2000 recently entered “correction” territory and is now off over 10% from its highs just over a month ago. Many stocks in the market cap weighted index have fared worse, with over half of the stocks in the index off 20% or more. With rates going up, some change in the estimated value of the expected future cash flows of these companies is certainly warranted. But with over 1,000 stocks down over 20% or more in just the last month, it seems markets might be throwing out a few babies in all that bath water.

If past precedent is an indication, our stocks will not be immune to the decline, and we will participate in the selloff to some degree. But with prices down and earnings up, bargains are likely developing. Our charge is to find them, and we have several in our sights. As in prior selloffs, we are more than happy to deploy cash or swap out existing holdings for higher returning opportunities. As in prior selloffs, we expect our portfolio will again be likely to emerge with higher prospective returns. As stated earlier, if we are right on our assessments, we will be rewarded in due time.

CONCLUSION

In closing, while I know our approach will not yield outperformance each and every quarter, I continue to believe it will be well worth our while over the long haul. Perhaps more importantly, given the majority of our 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

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1. All market and company data is sourced from Factset and company filings and is current as of 9/30/18.
 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.

APPENDIX

CEF GOALS, PHILOSOPHY, APPROACH AND ALIGNMENT

GOALS – Our primary objective is to outperform the Russell 2000 and S&P 500 over a multiyear time horizon and grow investor capital at the highest and safest after-tax rates of return achievable in pursuit of methods consistent with our value investing discipline. 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 three-year outlook, and we only pursue investments we believe offer us a reasonable chance to double our money 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?*