April 21, 2022

Dear Investor:

I hope this letter finds you well. Choice Equities Fund generated losses of -20.9% on a net basis in the opening quarter of the year. This compares to the Russell 2000's -7.5% loss, and the S&P 500's loss of -4.6%. Since inception in 2017, the fund has generated annualized gains of +20.9% versus +9.8% and +16.5% for the Russell 2000 and S&P 500, respectively.

EXECUTIVE SUMMARY

In this letter, we discuss the major drivers of performance for the quarter. I highlight the primary detractors from our performance in the quarter and discuss Identiv (INVE), Gypsum Management & Supply (GMS) and The Azek Company (AZEK). I then highlight two new positions in Travelcenters of America (TA) and Orion Engineering Carbon (OEC). Finally, I conclude with a few thoughts on the current outlook.

QUARTERLY COMMENTARY

Our concentrated portfolio was unfavorably positioned for the events of the quarter, specifically the rapid acceleration in inflation and the resultant spike in interest rates. Entering the year, a case could be made our domestic economy was on the doorstep of normalcy. But Omicron shutdowns and then Russia's invasion of Ukraine again deterred the healing of supply chains, and instead of moderating inflation readings, commodity prices surged, accelerating a shift in Fed monetary policy that further quickened a rotation in equities that was already in place. Accordingly, 4Q was a rough reporting season for equities across the board, as shutdown related revenue shortfalls and surging input costs negatively impacted operating results for companies across a wide swath of industries.

While business results of the three companies I'll describe below will be impacted by varying degrees from higher interest rates and higher inflation, equity valuations of these companies moved in near lockstep to the downside as interest rates moved higher. INVE, GMS and AZEK accounted for almost half our just over 70% equity exposure in the quarter, together generating two-thirds of the fund's decline in the quarter. Smaller positions caught up in the market selloff comprised the remainder of the losses while market hedges added about 1% to our return.

Regarding Identiv, after initial purchases the prior April around $12, the stock's price appreciation across the year and particularly in December pushed this holding into a mid-teens percentage size position with shares ending the year around $28. Though interest rates are unlikely to directly influence company operations in the near term, rising rates do change the near-term valuation calculus. As rates continued to rise, growth stocks continued their fall out of favor. Identiv was not immune, as it was a rough start to the year for the stock, quite literally from the very beginning in their case. This backdrop made for a particularly inopportune time for company results to fall short of quarterly expectations. Though the reasons for the shortfall in gross margins do not look to be long lasting, primarily stemming from an unexpected increase in freight costs and a couple product launches that have come online with lower-than-average gross margins as they ramp up, shares continued to sell off, nonetheless. Despite the decline, I believe the long- term elements of the thesis continue to hold and shares offer a lot of value.

Gypsum Management and Supply Co. and The Azek Company both serve housing related end markets. GMS entered the year trading at 7x growing earnings while selling into end markets that are split with sales going 55% to 45% to non-residential and residential uses. Despite the margin of safety embedded in the valuation, shares ended the quarter down about 20% in what became the second worst quarter for most building products stocks in over a decade (as proxied by the price return of the iShares US Home Construction ETF (ITB).

AZEK is a position I initiated late this past fall, about two years after the company's IPO. Together, Azek and fellow peer Trex Co. own the bulk of the composite decking industry. It is an attractive, secularly growing market that now has just over 20% of the total decking market and is gaining two to three points of market share per year from legacy wood decking. The business models are attractive, producing near 40% level gross margins and exceptional returns on capital. Sales are heavily driven by repair/remodel purchases, adding a somewhat defensive element to their demand stream. Together these dynamics, and an aggressive share buyback program, enabled TREX shares to increase 25-fold in the last ten years making it one of the best small/midcap cap stocks one could have owned over the last decade.

Because of these attributes, I have been following AZEK closely since its IPO. This past fall, the stock sold off on concerns their gross margins would be negatively impacted by increasing cost inputs, primarily because polyethylene and polyvinyl prices were moving higher as oil prices increased. Additionally, the company began discussing several investments to expand their production capacity. Together, these two factors created a bit lower growth in near term earnings and cash flows than previously anticipated. As is often the case, sales from investors disappointed in lower near term earning expectations created a decline in the stock.

With shares trading at about half the EBITDA multiple as TREX and AZEK likely to grow cash flows faster in coming years as the company leveraged these investments, I initiated a position. Given the repair / remodel dynamics and secular tailwinds, I reasoned shares would be insulated from any modest rises in interest rates. But the interest rate rises have not been modest. And the anticipated improvement in gross margins from lower input costs have likely been deferred given a renewed rise in commodity prices. While I believe the long-term elements of this thesis still hold, I have less conviction about the short term given these changing dynamics. These are never easy decisions, selling a good company due to short term issues. But the changing opportunity set is a meaningful input as well, and I have opted to move on for now.

ADDITIONAL POSITION COMMENTARY

I have a few other updates to share, and also want to highlight two new positions.

FARM – Farmer Brothers Co. recently provided a positive update at an investor conference earlier this March. The company called out green shoots in critical daily sales measures, and operating results may be on the cusp of an inflection as their customers' volumes return. We put an update piece together which can be found on our website here.

TA – Travelcenters of America is a new position in a prior holding for us. Valuation is undemanding at <6x this year's likely EBITDAR, several turns cheaper than most convenience store peers and also a discount relative to its own history. The valuation discount exists after a ~40% share price decline this year despite our view that the company has one of its brightest outlooks in many years as CEO Jon Pertchik has driven steady improvement in operations since he became CEO in 2019. The company now has a reinvigorated growth opportunity, through refranchising and green field addition initiatives where it can continue to expand in a consolidating industry where the top three truck stop operators enjoy certain toll-road-like elements given their prized locations on valuable real estate on the side of our highways.

OEC – Orion Engineered Carbons is another new company we have recently invested in. It is a high-quality small cap industrial with a strong management team and board that looks underappreciated at the moment. As one of three scaled global producers of carbon black, (a form of powdered carbon used as a reinforcing agent for rubber and an input into many ubiquitous products like automobile tires, mechanical rubber goods, lithium-ion batteries, and various polymers), the company looks set to finally emerge from a massive multiyear investment cycle and soon generate substantial recurring free cash flows.

As the third largest global producer of the more commoditized rubber black offering and the largest global producer of higher-margin specialty carbon black, its production contribution is important to an industry that is tightening in terms of capacity utilization. Much of the recent tightening in capacity utilization stems from Environmental Protection Agency (EPA) mandates originally issued in 2013 that directed byproducts like sulfur dioxide and nitrous oxide be removed from the carbon black manufacturing process across the US. As such, in 2018 and a little after larger peer Cabot Corporation (CBT), the company began a lengthy facility upgrade cycle that will ultimately total nearly $300M in spend and looks set to mostly conclude in the coming months. Though costly, the heavy spending requirements have served as a meaningful barrier to entry to new entrants and the expansion of additional capacity. Accordingly, today the market can be characterized as quite tight, with the potential to tighten further as other capacity shortfalls are emerging across the industry, partly from domestic production issues at a peer's plant and partly as European tire manufacturers seek alternative non-Russian sources of product.

Despite an outlook for improving cash flows and earnings as the company looks set to leverage these investments, the company appears to be a bit underappreciated and potentially misunderstood. Today, shares trade at less than 8x likely FY22 earnings, earnings which may be biased higher given the potential for additional price increases moving forward. But the company has a good story to tell, and they intend to do so at an analyst day coming this June. To wit, OEC appears to be on the cusp of dramatically improving free cash flow dynamics. And as it relates to ESG concerns, after years of investment, the company is now part of the solution, rather than part of the problem. Insiders seem to agree on the outlook, and are acting accordingly, as we note a number of recent insider purchases at recent levels. We look forward to updating you on progress here.

2022 OUTLOOK

There is no shortage of toxic material for the dour headlines of today. Inflation is at 40-year highs. The scenes of the Russian invasion of Ukraine are both tragic and horrific. Covid-19 and its effects on supply chains continue as large cities in China like Shanghai reengage in lockdowns. The Fed is tightening.

Consumers have noticed. Accordingly, per the University of Michigan, US consumers just expressed the fifth lowest reading of Consumer Sentiment since the series began in 1971, and the lowest since 2011. It seems reopening the economy into war and inflation was not the conclusion to the pandemic most had hoped for after enduring two years of lockups. Though events of the last few years have been met with little enthusiasm, there is a bright side, particularly for equities owners, as bad news is typically good news with prior instances of such lows in sentiment portending strong double-digit plus annualized gains from their depths for stocks. Additionally, though discussed less by the financial press, job creation remains plentiful, consumer and company balance sheets are in excellent condition and pent-up demand for experiences and services remains. There are even some green shoots in some of the inflation readings as categories like used cars and trucking freight rates have begun to decline, suggesting that even though price levels are likely to continue to increase from here, their rate of increase may be peaking.

As it seems I have been stating a lot lately, our economy continues to operate in a disjointed fashion. Signs of the K-shaped recovery continue. Spending on goods has more than fully recovered, while spending on experiences and services continues to trail pre-Covid levels in many instances. As examples, consider that seated diners are only just now approaching pre-pandemic levels, and most city offices remain less than half full.

This dichotomy again appears to be captured by the dispersion of valuations within the market. According to J.P. Morgan (on page 12), the spread between the earnings' multiple of the cheapest quintile of stocks and the most expensive quintile within the S&P 500 is now just under 17 multiple points, well above its 25-year average of 11 and still at the generational highs like it has been for the last couple years. Dispersion exists across market cap sizes as well, as the SP 600, an index of profitable, high quality small cap stocks, now trades at a forward PE of 13x, its lowest PE relative to the large caps in the S&P 500 since it began trading in 2005.

Against this backdrop, there are plenty of outstanding businesses available for purchase at attractive valuations. While negative consumer sentiment frequently bodes well for forward returns, it is certainly not a guarantee, nor a sufficient condition on a standalone basis. It is merely a marker, and one that typically carries a high degree of uncertainty about future prospects. It also tends to appear along with declining share prices, and the future opportunities they bring. That said, the issues of the day are serious, and the outcomes unknown. It is quite possible events could deteriorate further before they improve. On the other hand, forward-looking markets may already be starting to discount geopolitical events that are becoming less bad.

As it relates to our portfolio, as always, it is a bottoms-up construction focused on locating specific attractive risk / reward dynamics. Today, we are more diversified across our 12 holdings than we were entering the quarter. Many of our holdings trade at quite discounted valuations, many with single digit earnings' multiples with recent purchases by corporate insiders, the company, or both. Accordingly, I believe there is quite a bit of value embedded in our portfolio today.

PERSONNEL UPDATE

I'm delighted to welcome Eric Dansky to our team. He joined us in February in the Analyst role. Eric comes to us with prior investment experience as an Analyst at ArcanX Partners as well as with the Cooper Family Office. Prior to that, Eric's corporate experience extends to positions with the Development Corporation for Israel Bonds, Running Oak Capital and Watsco, Inc. (WSO), an HVAC distributor that I hold in high regard. Eric holds an MBA and a BA in Finance with honors from Florida Atlantic University. I look forward to introducing him in person in future events.

CONCLUSION

I hope it goes without saying that I'm frustrated with our results for the quarter. Part of this frustration stems from the fact that I had been anticipating both interest rates and inflation to rise, just much more gradually with our companies' earnings growing through modest rate increases. I was simply caught wrong-footed when these inputs accelerated far more quickly than I had anticipated on the back of unforeseen geopolitical events. My macro view, which is but one factor to weigh when evaluating opportunities, is not significantly different than it was at the outset of the year – the increase in inflation and interest rates has merely been pulled forward. Many prices have been lowered, and potential future returns raised.

In closing, I know our results will be lumpy, but when the downdrafts occur, the results are simply not as enjoyable. Even so, I willfully acknowledge they are part of the process and an unpleasant but necessary side effect towards our approach to target superior long-term results. 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 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

1. All market and company data is sourced from Factset and company filings and is current as of 3/31/22.
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.