Choice Equities
Capital Management

July 14, 2023

Dear Investor:

I hope this letter finds you well. Choice Equities Fund generated gains of +8.0% on a net basis in the second quarter, bringing year-to-date net performance to +9.0%. This compares to the Russell 2000's +5.2% gain for the quarter and year-to-date gain of +8.1%. The S&P 500 generated a quarterly gain of +8.7%, bringing year-to-date gains to +16.9%. Since its inception in 2017, the fund has generated annualized gains of +15.5% versus +6.6% and +13.2% for the Russell 2000 and S&P 500, respectively.

EXECUTIVE SUMMARY

In this letter, we provide a brief overview of events of the second quarter of 2023. We then discuss major portfolio holdings, including new additions in Magnite, Inc. (MGNI), Stagwell (STGW) and The Children's Place, Inc. (PLCE). Thereafter, we again look at the valuation discrepancies that exist across market caps within the market, using Apple's surge into $3T market cap size as a framing point for potential expectations to come. Lastly, I conclude with a few thoughts on the current outlook.

QUARTERLY COMMENTARY

Better-than-feared earnings and AI-related enthusiasm for large cap tech holdings were the dominant storylines for the market in 2Q. Earnings again defied recession calls and posted narrow growth in the recent quarter, aided in part by companies' collective efforts to adapt to changing economic conditions with streamlined cost structures and efficiency measures. Large-cap tech holdings benefitted from a surge in demand for the build-out of AI infrastructure and built on gains from the prior quarter.

Gains were again concentrated in the largest megacaps of the market. One indication of this concentration can be found in the performance of the QQQ Index, a market cap weighted index of the Nasdaq 100, which was up +38% through June. The top six stocks in the index constitute just over half the weighting of the index. This compares to the QQEW, an equal weighted index of the same stocks, which was up 19% over the same period, implying the rest of the index together produced only modest single digit gains. Interestingly and likely worth noting, the Nasdaq market makers recently announced a special rebalancing to adjust for the lopsided nature of these indices.

Small caps were up +5% for the quarter, again trailing larger peers. Our portfolio benefitted from the upward drift of the market, with a few of our holdings up substantially.

PORTFOLIO COMMENTARY

We generally maintained the same core holdings during the quarter, and these businesses generally continue to perform as anticipated. This includes Croc's Inc. (CROX), SiteOne Landscaping Supply, Inc. (SITE), Wesco International Inc. (WCC), Orion Engineered Carbons S.A. (OEC). Shares of Celsius Holdings, Inc. (CELH) were up nearly 60% a few weeks after our purchases after the company reported strong earnings and investors gained a better understanding of the Pepsi distribution network rollout. As a result, I opted to take gains and move on for now.

We do have some new additions to the portfolio worth highlighting, including a couple that look set to benefit from a pickup in digital advertising spending.

MGNI – The management team at Magnite continues to execute impressively. Shares look to have digested a meaningful decline in 2022 while double digit or better top-line organic growth appears to be ramping up on the back of continued market share wins in CTV and on ad spending that is likely to benefit from political spending over the next year and half. With highly attractive incremental margins and impressive cash generative abilities, shares look attractively valued based on the company's likely trajectory.

STGW – Stagwell is another company likely to benefit from a potential increase in spend in advertising budgets. The company can most succinctly be described as a digitally savvy marketing agency. CEO Mark Penn has built the company through acquisition, starting with the first major platform acquired which was media agency MDC Partners in 2019. With roots tracing to Penn's experience in running polling agencies, Penn has pieced the business together through acquisition, with a focus on adding entities with targeted digital capabilities to help their clients succeed in the digital transformations of their marketing functions. The company counts Apple, Google, Amazon and Microsoft amongst its customers. As a relatively new entity, the agency is devoid of many of the low growth business elements its older legacy-oriented peers encounter with their exposures to decaying media verticals.

Shares look attractively priced, trading at a single digit PE multiple and offering a mid-teens free cash flow yield. The company has a highly cash generative model, offers attractive topline organic growth that is likely moving into the mid-teens going forward on the back of digital tailwinds and a ramp in political spending. Additionally, recent share repurchases have cleaned up the cap table, shrunk the float and should make the story easier to understand for investors who still may be unfamiliar with the name.

PLCE – Children's Place has been suffering from high-cost inventory due to elevated cotton prices and higher than normal freight rates. These headwinds that have endured for much of the past two years have created depressed profit margins for this branded retailer of children's apparel. Should normalized margins follow more normalized input pricing, one can envision the company again generating $150M of EBITDA or better, much like it has for nearly every year in the last 15, except for the last two.

Other recent cost-cutting initiatives like the reduced footprint at corporate headquarters suggest the company could in fact again surpass this baseline of $150M of EBITDA in future years as they have in the past. Today's business performance metrics across multiple channels paint the picture of a healthy and growing business, albeit one with a temporarily impaired profitability profile. In a mildly optimistic but reasonably plausible case, recent share levels could show the company is currently trading at less than 2x normalized EPS. Longtime CEO Jane Elfers seems to agree the company is back on the right track after a difficult two years, and recently bought $1M worth of stock.

OUTLOOK

Dramatic valuation differences across market cap sizes continue. This has been the case for some time now. Perhaps I have spent too much time discussing these dichotomies, as generally, I feel like if we pick the right stocks and manage market exposures thoughtfully, our equities- oriented portfolio will prosper across various market cycles. However, when markets become as lopsided as they have lately, I feel additional discussion on the market environment is worthwhile, if only to help highlight the opportunities that are available and the likely path forward. I expect future discussions to soon be focused again on our moderately concentrated portfolio. But for now, let's take one last in-depth look at how far reaching these valuation dichotomies have again become. (Please note: charts that accompany the following can be found in the Appendix.)

Take Apple, Inc. for example. It is the largest stock by market cap, and fairly considered one of the best companies in the world. The company has been extraordinarily successful and improved standards of living everywhere in the process with their ubiquitous products. Along the way, shareholders have been richly rewarded, with shares increasing nearly fourteen-fold over the last ten years while generating an annualized total shareholder return of 31%, including dividends.

On the back of another big quarter for large cap tech, it is now the first stock to surpass the $3T market cap threshold. This makes its weighting in the ~$37T market cap of the S&P 500, ~8%. It also means this one stock's market cap is larger than that of the entire ~$2.98T market cap of the Russell 2000 index, the first time in history a single stock has outweighed the Russell 2000 – aside from two brief days in September 2020 when Apple's market cap then accomplished the same.

Let's have some fun with numbers for a second to put some context around how remarkable this feat is. To frame the implications of such continued success, let's assume for a minute that the company is able to duplicate this outstanding accomplishment and produce another decade of performance like the prior one. (Overlook for now how truly impressive this would be from a starting NTM PE multiple of 29x, a $3T market cap and topline revenues that are nearly $400B already). At this rate of appreciation, the company's market cap would be greater than the S&P 500's current market cap. Even if the S&P 500 appreciated at 11% over the next ten years, it would still comprise nearly 40% of the market cap of the index, flying well past the prior record of ~8% it currently holds. So, despite the company's attractive attributes of which there are many, an encounter with the law of large numbers seems to be on the horizon.

Moving on from Apple, other megacap tech companies have received similar treatment. The press often refers to these top five companies with some updated version of FANG like FANMA, or the Magnificent 7 or the Megacap 8. They include Apple, Microsoft, Google, Amazon, Meta and then Tesla, Nvidia and Netflix round out the group. For the sake of easier comparisons to prior periods, we'll focus this discussion on the top five holdings. Like Apple, they are wonderful companies, and their valuations convey the investing public recognizes them as such. Today, these five companies' aggregate weighting in the S&P 500 is ~25%. They currently trade at ~30x NTM PE.

This level of concentration across the top five has only been seen a couple times in market history. Though it is said history doesn't repeat itself, it is also said it rhymes. So how might things rhyme this time? As an interesting thought experiment, let's assume for a minute these companies traded down to the market multiple of 19x, not even the 17x where the S&P 493 trades (i.e. the S&P 500 minus these seven holdings). Should investors sell these stocks down to these multiples, the delta in those trading multiples alone would produce ~$3.7T worth of funds.

More interestingly, where might this source of funds flow? To small and mid-cap stocks, categories of stocks that are meaningfully discounted on both an absolute and relative basis by most accepted valuation metrics? (The SP600 and MDY 400 currently trade at 13.6x and 14.1x NTM PE, respectively.). Of course, n = 2 is a pretty small sample size, but that is exactly how these episodes played out following the Nifty 50 era in the mid-1970s and the mid-2000s following the tech crash. Both multiyear periods were marked by highly attractive returns for those categories of stocks, as the flow of funds from highly regarded stocks to the undervalued and unappreciated small and midcaps produced fantastic multiyear tailwinds. Perhaps things "are different this time" and the future will not play out this way. But valuation still marks the starting point for deriving forward expected returns, so on that count, the small and midcap space look due for attractive returns.

Speaking of due, after June's positive performance, the first positive month for the Russell 2000 since January, the index recently emerged from a 17-month long streak of trailing twelve-month negative returns, the second longest on record since the index was formed in 1984. For an index that has a long history of producing nearly 10% annualized returns as measured over more lengthy time horizons, its ~4% annualized total shareholder return over the last five years suggests a catch up is due.

Regardless of the recent market dynamics, our focus continues to be dedicated to bottoms-up analyses of specific stocks, and I continue to believe we are well positioned for attractive future returns. As I stated in our first investor letter, now six and a half years into our journey, I believe we are well on track for our twenty-year goal.

CONCLUSION

As I have highlighted above, I am excited about today's opportunity set and our prospects for the years to come. Even so, 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

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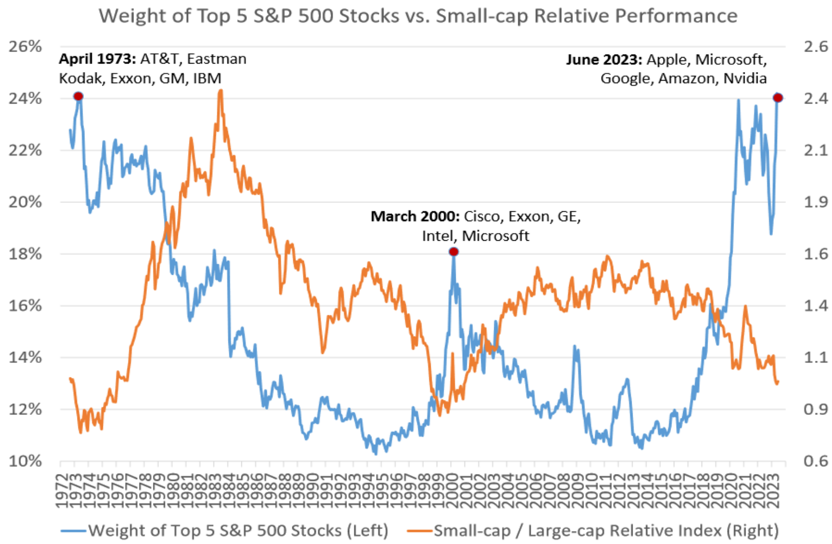
1. All market and company data is sourced from Factset and company filings and is current as of 6/30/23.
2. CEF uses the S&P 500, Russell 2000 and the Barclays Hedged Long/Short indices as its primary benchmarks. The S&P 500 and Russell 2000 are common large and small cap US equities-based indices. The 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



Royce Funds/Furey Research Partners

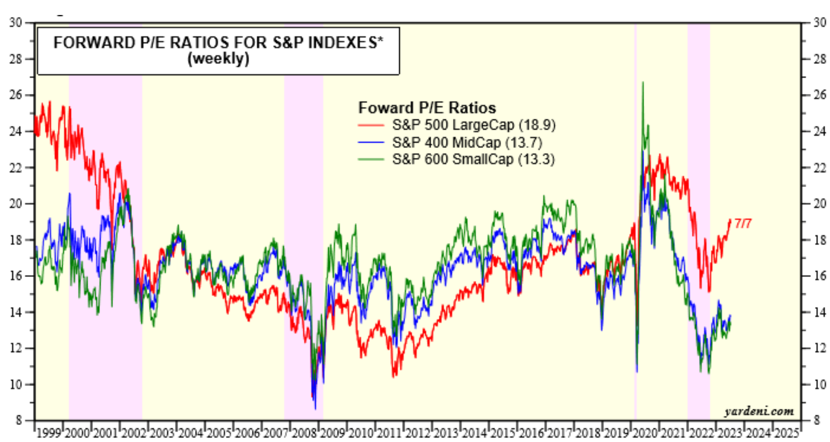
- ➢ The blue line shows small cap performance relative to large cap performance. Periods of heavy market concentration show small caps trail large-caps, but outperform when concentration levels unwind.

Exhibit 4: Small caps remain historically cheap vs. large caps
Relative Forward P/E: Russell 2000 vs Russell 1000, 1985-4/30/2023

Source: BofA US Equity & Quant Strategy, FactSet

BofA Global Research

- ➢ Relative forward PE multiples are discounted relative to historical relationships.



* Price divided by 52-week forward consensus expected operating earnings per share.
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas show bull markets.
Source: I/B/E/S data by Refinitiv.

Yardeni Research

- ➢ Absolute forward PE multiples highlight valuation differences.