

2017 3rd Quarter Commentary

I apologize for the delay in the quarterly commentary this quarter. As many of you know, my father passed away in mid-October. Even though I was emotionally and mentally prepared, the commentary was delayed.

The portfolio's performance was favorable during the quarter, but more importantly, on the whole, the fundamentals of the companies in the portfolio continued to improve and continue to trade at "cheap" valuations relative to their intrinsic value in White Brook's view. As always returns in the equity portfolios are likely to underperform or outperform over the short term given the concentrated nature of the portfolio.

Market Discussion

There are broadly five investment alternatives one can hold at any time: cash, cash-like alternatives, debt, equity, and real estate.

White Brook continues to believe bond prices will depreciate as the 10-year treasury yield increases from ~2.4% to closer to 3% over an extended time frame. When markets are free, large changes in value tend to occur quickly. It is White Brook's expectation that the long term fixed income market will become more free as the Federal Reserve further unwinds its balance sheet acquired as part of the Quantitative Easing program during the financial crises. I continue to believe that vehicles that trade long term bonds are relatively unattractive and prefer clients hold the underlying instruments directly and to maturity. Short term fixed income instruments are relatively more attractive given the current structure of the yield curve and their resiliency to inflation.

Cash can always be expected to depreciate on a real basis at the rate of inflation less money market yields – currently just north of around 1% a year for most clients. I continue to believe that inflation is likely to be subdued in the near term (even while the long-term outlook is more uncertain). Cash represents an option to invest later and, with potential changes in fixed income markets, for those clients who seek to diversify away from equity, is a more attractive option in the short to medium term.

The cash-like securities market is undergoing a transformation as Bitcoin and other alternative currencies absorb some of the marginal demand for Gold. The Gold ETF (GLD) has not reacted as would have been assumed as apparent risks to the global order emerged this year. While Bitcoin is an acceptable asset class/commodity in my view, the fundamental value of the new currency is hard to determine and is driven by its scarcity - not its usefulness. Bitcoin has a hard

limit of 21mm units that provides scarcity to those that distrust central banking systems and their ability to inflate and deflate the monetary base. In a world of central bank induced inflation and a culture that accepts, “I don’t believe it” as a valid retort to established, tested economic theory, Bitcoin is a viable asset.

The currency also is attractive to citizens in countries that don’t have a reliable central bank, like Argentina or Zimbabwe, or those where the country is known to introduce capital controls to slow capital leaving the country, like China. The anonymity built into the system allows users to avoid their regulating authority, but in so doing also attracts black market participants.

Bitcoin’s continued growth is most notably threatened by:

- 1) Lack of adoption by the established economy. This problem is likely to persist, in my view, as long as banks and other stores of capital have to prove they aren’t being used to launder money. Japan, Australia, and Switzerland’s central banks all began allowing, if not encouraging, its use in their economies, even going so far as to exempt Bitcoin transactions from excise taxes in exchange for acceptance of anti-money laundering regulation. It’s still unclear, however, how widespread Bitcoin’s acceptance in those countries will be or if it will continue to gain acceptance.
- 2) Less stringent Chinese capital controls. As one of the largest economies and creators of “new wealth”, China’s desire to inhibit capital movement has an impact on every market in the world. Bitcoin’s attributes highlighted above that allow currency to be translated to others anonymously is a potentially powerful tool for those that can avail themselves of it.
- 3) Constriction of the money supply by US and European central banks. Born in an environment of historic monetary expansion (to fight the Great recession) and having never endured a major central bank contracting its money supply, it’s unclear how Bitcoin will react when the pace of contraction quickens. If it is in fact “digital gold” as its proponents argue, its value should fall.

White Brook’s recommendation is to take a wait and see approach to Bitcoin at this time despite the tremendous price appreciation.

Like last quarter, with short- and long-term interest rates likely to rise and the economy growing, albeit slowly, assets that store value, but do not yield, are likely to act more like cash (less the money market interest that cash yields). The Trump administration’s retreat from a rational global platform further increases geopolitical instability, however the fracturing of the

GOP is likely to make an already ineffective administration more so. White Brook views the probability of a geopolitical incident to be elevated but believes that in most of the likely outcomes such an incident would impact markets for only a short time. White Brook continues to believe that limited tax reform will be passed before the 2018 election and that very little legislatively will be accomplished starting in the 2nd quarter of 2018. In White Brook's view, tax reform will increase fixed income yields and in its final form have little impact on equity markets. As a result, White Brook's preference is for cash rather than cash-like securities.

The S&P500 is up ~14% through the end of the 3rd quarter and trading at ~17.9x 2018's estimated earnings. However, excluding Google, Amazon, Apple, Netflix, and Facebook (FAANG), the market trades at a much more reasonable valuation.



White Brook hadn't previously analyzed the market by excluding FAANG but believes it's an appropriate lens given the historically unique emergence of these monolithic gatekeepers that control an increasing amount of how consumers purchase goods and services in the US economy.

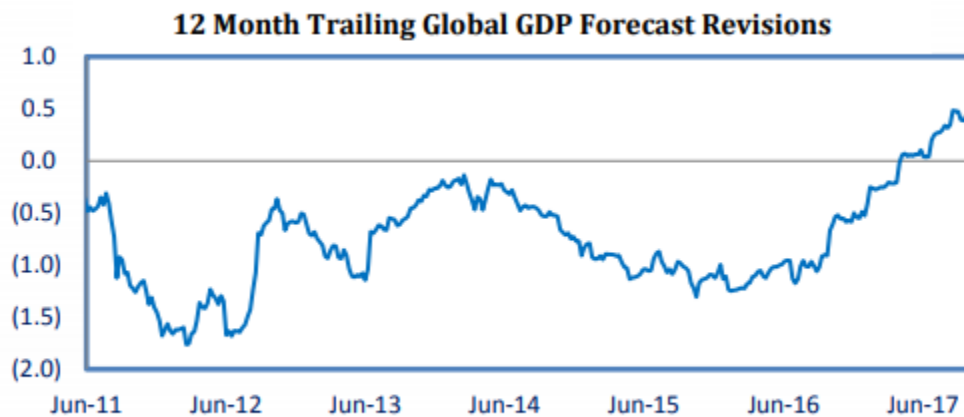
With that backdrop, let's look again at the market's valuation:

Table 2: S&P 500 Valuations -- borders denote metrics trading above their historical average (as of 7/31/17)

Metric	Current	Average	Avg. ex. Tech Bubble	Min	Max	% Above (below) avg	Z-Score	History
Trailing PE	20.1	16.1	15.4	6.7	30.5	25%	0.9	1960-present
Trailing GAAP PE	23.6	19.1	18.2	6.7	122.4	24%	0.4	1960-present
Forward Consensus PE	17.7	15.2	14.2	9.8	25.1	16%	0.7	1986-present
Trailing Normalized PE	20.0	19.0	17.5	9.2	33.9	5%	0.2	9/1987-present
Median Forward P/E	17.9	15.0	14.7	10.0	20.5	19%	1.4	1986-present
Shiller PE	30.2	16.8	16.1	4.8	44.2	80%	2.0	1881-present
P/BV	3.24	2.48	2.25	0.98	5.34	31%	0.8	1978-present
EV/EBITDA	12.3	10.0	9.6	6.0	15.1	23%	1.1	1986-present
Trailing PEG	1.57	1.45	1.43	0.93	2.21	8%	0.5	2001-present
Forward PEG	1.38	1.22	1.20	0.82	1.67	13%	0.9	2001-present
P/OCF	14.1	10.6	9.8	5.6	19.5	33%	1.2	1986-present
P/FCF	24.2	28.3	24.9	12.9	65.7	-15%	-0.4	1986-present
EV/Sales	2.38	1.83	1.73	0.86	2.91	30%	1.1	1986-present
ERP (Market-Based)	720	467	482	136	880	54%*	1.4	11/1980-present
Normalized ERP	436	291	336	-96	947	50%*	0.7	1987-present
S&P 500 Div. Yld. vs. 10yr Tsy. Yld.	0.8	0.6	0.6	0.2	2.3	28%*	0.5	1953-present
S&P 500 in WTI terms	53.0	23.5	20.7	2.7	109.0	126%	1.9	1960-present
S&P 500 in Gold terms	1.95	1.58	1.32	0.17	5.48	23%	0.3	1968-present
S&P 500 vs. R2000 Fwd. P/E	0.95	1.00	0.94	0.76	1.71	-4%	-0.2	1986-present
S&P 500 Market Cap/GDP	1.10	0.59	0.55	0.22	1.29	88%	1.9	1964-present

*Above: average Implied equities are attractive relative to bonds. Note: Trailing P/E based on GAAP EPS from 1960-77, Operating EPS from 1978-87, Pro forma EPS 1988-now. Trailing GAAP P/E based on GAAP P/E for entire series. Market-based ERP based on DDM-implied S&P 500 return less AAA corp bond yield. Normalized ERP based on normalized EPS yield less normalized real risk-free rate.
Source: S&P, Compustat, Bloomberg, FactSet/First Call, BofA Merrill Lynch US Equity & US Quant Strategy

At White Brook, the focus is always on following cash flow and its production over time and not necessarily accounting-influenced earnings. On that basis, the market is relatively cheap compared to its historical multiple. Also consider that earnings for 2018 are expected to grow 12%, above the 8% quoted at the beginning of this year. In a world with no S&P500 multiple growth, that would suggest that stock prices should grow by 12% or in the absence of stock price growth, that the S&P500 multiple contracts by 12% next year. Additionally, for the first time in a long time, the market has been and is likely to continue to be supported by GDP growth estimates that are revised upwards rather than down.



Source: JP Morgan Forecast Revision Index

Additionally, manufacturing growth, the basic, powerful economy builder, has shifted positive globally (above 50) and is an encouraging sign as to the overall health of the global economy.

		2016												2017								
		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Global		50.9	50.0	50.6	50.2	50.1	50.4	51.0	50.8	51.1	52.0	52.1	52.7	52.8	53.0	53.0	52.7	52.6	52.6	52.7	53.2	53.2
Developed Markets		52.1	50.8	50.9	50.5	50.4	51.2	51.5	51.2	51.5	52.6	53.0	53.8	54.2	54.1	53.9	54.1	54.1	53.9	54.0	54.2	54.6
Emerging Markets		49.4	48.9	50.2	49.5	49.5	49.3	50.3	50.1	50.3	51.0	50.8	51.1	50.8	51.3	51.6	50.9	50.6	50.8	50.9	51.7	51.3
Developed	U.S.	52.4	51.3	51.5	50.8	50.7	51.3	52.9	52.0	51.5	53.4	54.1	54.3	55.0	54.2	53.3	52.8	52.7	52.0	53.3	52.8	53.1
	Canada	49.3	49.4	51.5	52.2	52.1	51.8	51.9	51.1	50.3	51.1	51.5	51.8	53.5	54.7	55.5	55.9	55.1	54.7	55.5	54.6	55.0
	Japan	52.3	50.1	49.1	48.2	47.7	48.1	49.3	49.5	50.4	51.4	51.3	52.4	52.7	53.3	52.4	52.7	53.1	52.4	52.1	52.2	52.6
	UK	52.2	50.9	51.3	49.6	50.5	53.1	48.4	53.0	55.6	54.2	53.4	55.8	55.4	54.6	54.3	57.2	56.4	54.2	55.2	56.7	55.9
	Euro Area	52.3	51.2	51.6	51.7	51.5	52.8	52.0	51.7	52.6	53.5	53.7	54.9	55.2	55.4	56.2	56.7	57.0	57.4	56.6	57.4	58.1
	Germany	52.3	50.5	50.7	51.8	52.1	54.5	53.8	53.6	54.3	55.0	54.3	55.6	56.4	56.8	58.3	58.2	59.5	59.6	58.1	59.3	60.6
	France	50.0	50.2	49.6	48.0	48.4	48.3	48.6	48.3	49.7	51.8	51.7	53.5	53.6	52.2	53.3	55.1	53.8	54.8	54.9	55.8	56.0
	Italy	53.2	52.2	53.5	53.9	52.4	53.5	51.2	49.8	51.0	50.9	52.2	53.2	53.0	55.0	55.7	56.2	55.1	55.2	55.1	56.3	56.3
	Spain	55.4	54.1	53.4	53.5	51.8	52.2	51.0	51.0	52.3	53.3	54.5	55.3	55.6	54.8	53.9	54.5	55.4	54.7	54.0	52.4	54.3
	Greece	50.0	48.4	49.0	49.7	48.4	50.4	48.7	50.4	49.2	48.6	48.3	49.3	46.6	47.7	46.7	48.2	49.6	50.5	50.5	52.2	52.8
	Emerging	China	48.4	48.0	49.7	49.4	49.2	48.6	50.6	50.0	50.1	51.2	50.9	51.9	51.0	51.7	51.2	50.3	49.6	50.4	51.1	51.6
Indonesia		48.9	48.7	50.6	50.9	50.6	51.9	48.4	50.4	50.9	48.7	49.7	49.0	50.4	49.3	50.5	51.2	50.6	49.5	48.6	50.7	50.4
Korea		49.5	48.7	49.5	50.0	50.1	50.5	50.1	48.8	47.6	48.0	48.0	49.4	49.0	49.2	48.4	49.4	49.2	50.1	49.1	49.9	50.6
Taiwan		50.6	49.4	51.1	49.7	48.5	50.5	51.0	51.8	52.2	52.7	54.7	56.2	55.6	54.5	56.2	54.4	53.1	53.3	53.6	54.3	54.2
India		51.1	51.1	52.4	50.5	50.7	51.7	51.8	52.6	52.1	54.4	52.3	49.6	50.4	50.7	52.5	52.5	51.6	50.9	47.9	51.2	51.2
Brazil		47.4	44.5	46.0	42.6	41.6	43.2	46.0	45.7	46.0	46.3	46.2	45.2	44.0	46.9	49.6	50.1	52.0	50.5	50.0	50.9	50.9
Mexico		52.2	53.1	53.2	52.4	53.6	51.1	50.6	50.9	51.9	51.8	51.1	50.2	50.8	50.6	51.5	50.7	51.2	52.3	51.2	52.2	52.8
Russia		49.8	49.3	48.3	48.0	49.6	51.5	49.5	50.8	51.1	52.4	53.6	53.7	54.7	52.5	52.4	50.8	52.4	50.3	52.7	51.6	51.9

Source: Markit, J.P. Morgan Asset Management.
Heatmap colors are based on PMI relative to the 50 level, which indicates acceleration or deceleration of the sector, for the time period shown.
Guide to the Markets – U.S. Data as of September 30, 2017.

The question is whether ~18x is too much to pay for that growth next year. The short answer is, I don't know, but it's within the range. The market almost always moves up before the economy and then "corrects" when the economy doesn't justify the valuation. If the S&P500 index were to trade flat next year, and estimates hold true, the market will trade around 16x. At 16x, if growth is above 8%, and the 10 year is below 3%, the market is on the cheap side of reasonable, even with higher interest rates. The economy is running under the proverbial football. White Brook always assumes that a pullback could and will occur in both individual stocks and the market, but in White Brook's view, a market crash is an unlikely event barring a political, terrorist, or Chinese economic crises.

Model Portfolio Update

The White Brook Model Portfolio launched with a mandate of 20-30 positions and a constraint that no more than 1/3 of capital be dedicated to any sector. In May, White Brook started incubating the Concentrated Opportunities strategy that has no limit on position or sector positioning. Populated with a subset of the companies in the Model Portfolio, performance thus far has been encouraging.

During the quarter, Silver Spring Networks (SSNI) was purchased by Itron (ITRI). Silver Spring has high quality assets and was focusing its investment on developing go to market capabilities. I have written about it before in an Ad-Hoc commentary and as a significant quarterly detractor from performance. Itron is a leading meter provider that was increasingly investing in its intelligence suite, which overlapped but was substandard to Silver Spring's solutions. Itron, after its purchase of Silver Springs, will be more vertically integrated with best in class connectivity solution and a readily available industrial wifi network in major metropolises. Itron has a quality management team and ready go to market capability, and I believe the company will be able to readily harvest the synergies from the deal. While Silver Spring was likely undervalued by the purchase price, the return on our investment, especially given our short time investment time frame, far exceeded White Brook's investment return hurdle.

In the 3rd quarter, Silver Spring Networks (SSNI), Dolby Laboratories (DLB), and Covanta (CVA) were the most significant positive contributors to performance. Dolby and Covanta continue to be "core positions". Baker Hughes (BHGE), Envision Healthcare (EVHC), and Chipotle (CMG) were the most significant negative contributors to performance. I believe the declines to be hiccups and Envision and Baker Hughes are likely to be "core positions" for the long term.

No positions were entered or exited during the quarter. Silver Spring Networks will be fully exited during the 4th quarter due to the consummation of the aforementioned acquisition and Monotype Imaging Holdings (TYPE) was entered in the early days of the 4th quarter.

In Focus: Monotype Imaging Holdings, Inc. (TYPE)

Early in the 4th quarter, White Brook Capital entered a position in Monotype Imaging Holdings (TYPE). Monotype holds the copyright for many of the most commonly used fonts globally including well known fonts such as Times New Roman and Helvetica. While typefaces are reproducible without payment, the software code that specifies how to draw a particular font is copyrightable. Leveraging related technology, today's Monotype bought a number of font foundries and became the owner of thousands of fonts in many of the most often used typefaces in the world.

Modern Monotype benefits from several tailwinds. The first is the proliferation of screens. Years ago, Monotype earned a fee when a computer was sold and when a printer was sold, as the operating system developer paid Monotype to use its code to replicate fonts on a computer monitor, while the printer paid to use code to replicate fonts on a piece of paper. As mobile

devices proliferated, the Company started to receive payments from manufacturers for those screens as well. Finally, the “screenification” of other devices, like refrigerators, washing machines, and especially automobiles, have created additional use cases for Monotype’s technologies.

Monotype’s most significant competitor are free fonts. Developed by Google, Microsoft as well as hobbyists, there are a number of free options that attempt to replicate the general look of fonts Monotype holds. However, free fonts often suffer from:

- 1) Incomplete character sets. A complete character set needs all “keyboard” characters as well as special symbols in normal, bold, and italics at a minimum. Complete character sets also include different stylings and spacings and include characters in subscript and superscript. Very complete character sets have a consistent character set in different language scripts as well.
- 2) Lower resolution. High resolution fonts are especially important as screen quality increases. Free fonts are less likely to have been updated as screens have and are more likely to be exposed as lower quality on high quality displays. Retina, Super Retina and HDR displays even on mobile devices highlight errant pixels and expose quality deficiencies which reflect poorly on the brands and publishers that use them.

Almost half of Monotype’s revenue is from the top 10% of brands globally who want to ensure a consistent high quality experience across multiple channels and multiple geographies for their brands. A company with valuable brands like Mondelez or General Mills for instance, might want “Cheerios” or “Oreo” to be stylistically consistent in Latin alphabets like English and German as well as Hindi and Arabic. A deep character set is key for those brands and the cost of the font is de minimis to the overall cost of production and marketing. An increase in omnichannel sales as well as the globalization of brands creates a significant tailwind for Monotype. The growing ease in launching new brands is also a powerful tailwind.

The rest of Monotype’s font growth comes from the world of online advertising. The first are web fonts. Currently 65-70% of the way through realizing the opportunity in White Brook’s view, Web fonts are font repositories that are not pre-installed on computers and instead are downloaded to devices on-demand when a piece of HTML5 content is loaded. Previously, website CSS designers would have to specify a given font, with multiple font fallbacks if it was not installed on a user’s device. With web fonts, HTML5 developers can ask the browser, in effect, “Please download the Helvetica web font file from this URL” instead of hoping that Helvetica might be pre-installed wherever their content is being displayed and falling back to a

different font if it isn't. Web fonts guarantee a consistent and correct font will be displayed everywhere the content is seen.

The largest impediment to web font adoption has been that advertising designers are accustomed to embedding text as an image in their ads. Commonplace before HTML5, ad designers, and their content management systems, were set up to use a font with an image, and then save the whole thing as an image. The font then became indistinguishable from the image. While that means that the font owner was not paid, it also means that the ability to adjust the ad is also impeded. As dynamic advertising has become more important along with the business case to customize ads to suit the distinct preferences of different people at different times, keeping the font and the image separate has gained in importance. During the transition, some ad designers continue to serve 5 different messages with the same image by making 5 different image files with different messages. Truly dynamic, well-constructed digital ad campaigns would allow those same 5 messages to be dynamically served based on the revealed preferences of the user, along with additional preferences around font color and type – and be more truly dynamic. This will increase the number of possibilities significantly, and hopefully increase the effectiveness of an ad. This represents a significant workflow change, however, to creative ad designers and the agencies who administrate serving them and it's clear that the change will be slow.

Within fonts, additional growth opportunities in augmented and virtual reality are not being discounted at all. In a world of pictures and images, high quality text increases in value. White Brook believes Monotype's assets may be unparalleled in this regard. Additionally, pilots with major players like Adobe appear promising, and may result in higher use and monetization of Monotype's assets across the creative class.

Monotype also owns Olapic, a user generated photo advertising asset. The segment currently generates significant negative EBITDA, although the company has indicated that should change by the 4th quarter of 2018. White Brook views Olapic as a free option. In many ways it's positioned well – it's somewhat correlated to growth in visual platforms like Pinterest and Instagram and as those platforms monetize, it should benefit Olapic. Additionally, there are only a handful of players in the industry. That said, in White Brook's view, there is a limit as to how many features can be built on the platform and how the technology can be differentiated over time. Regardless, the absence of continued spending on the segment will result in more consolidated company EBITDA and a likely increasing stock price. If White Brook's pessimism

proves misplaced, and Olapic is able to generate EBITDA, the value of the segment would be much higher, and our position in Monotype further benefitted.

White Brook sees upside of 50% over a multi-year time frame for Monotype, and looks forward to seeing Monotype's business model transition and grow, and the stock returns that are likely to come with it.

As always, feel free to reach out to discuss this or any of your investments at White Brook Capital. I thank you for your support and will strive to continue to earn your trust.

Regards,



Basil F. Alsikafi
Portfolio Manager
White Brook Capital

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