

## 2018 Second Quarter Commentary

	2Q '18	YTD	LTM	2017	Since Inception
<b>WBC</b>	<b>13.16%</b>	<b>10.13%</b>	<b>25.43%</b>	<b>15.15%</b>	<b>26.81%</b>
S&P 400	4.29%	3.49%	13.50%	11.25%	15.13%
S&P 500	3.43%	2.65%	14.36%	13.49%	16.50%

*Inception of White Brook Capital Concentrated Opportunities Strategy was May 4th, 2017*

*Performance figures are provided by the custodian and reconciled by SS&C Advent. Figures are compiled in accordance with principles outlined by the Global Investment Performance Standards (GIPS)*

*All returns include reinvested dividends and interest.*

### Performance Overview

Since inception, net of fees, the White Brook Concentrated Opportunities Strategy (“The Strategy”, “The Portfolio”) has gained 26.81% vs the S&P400’s 15.13% and the S&P500 16.50%. Year to date, the Portfolio has outperformed the S&P400 by 6.6% and the S&P 500 by 7.4% - with all the outperformance occurring during the second quarter.

The second quarter of 2018 was a good one. White Brook builds the Portfolio to outperform over the long term, and while returns should be expected to be lumpy, this quarter was unusually so. Even while all White Brook’s efforts are focused on generating high levels of consistent outperformance, this level of single quarter outperformance cannot be expected to recur. At the same time, I do not view relative underperformance as an inevitability. Instead, during the quarter a few stocks recognized a step function change in valuation and my expectation is that they will continue along that path, while others also performed well with fewer and less severe detractors than usual.

### Product Overview

As a refresher, the Portfolio is considerably unbounded – able to invest in high concentrations in any security or sector. It should be expected to typically hold around 10 securities and be overweight a few industries. It is an environmentally and socially responsible mid-capitalization portfolio, and a large majority of the investments attempt to take advantage of a dominant theme rather than only be focused on valuation. Investing ahead of the adoption of big data through the economy has worked well so far and is likely to continue to dominate the portfolio in the medium term.

White Brook subscribes to a “buy and hold” investment philosophy. While White Brook will enter and exit stocks in the Portfolio, the bias is to find very good companies trading at a cheap price and to stick with them as they outperform the market over a long period of time. The approach should result in relatively low portfolio turnover and therefore tax efficient gains. Those qualities are an output rather than in input, however, and White Brook should be expected to optimize the portfolio towards the best long-term risk reward. Since inception, the Portfolio has experienced higher than expected portfolio turnover as strategic and financial buyers have found our investments to be good acquisition candidates.

The Portfolio is managed to avoid permanent impairment of capital, but White Brook's philosophy is to welcome daily, weekly, monthly, and quarterly volatility. With 13 months now completed, it's beginning to become appropriate to discuss the portfolio's beta. Beta measures volatility by relating the direction and size of return of the investment to the direction and size of the corresponding benchmark. For an index fund or a diversified mutual fund, the beta will tend to be around 1 as the fortunes of a vehicle that owns a lot of stocks will mimic the benchmark that those stocks are members of. A concentrated investor however can have a very low or very high beta depending on the strategy of the investor. In some cases, it can also be basically sporadic, with either the correlation or the size of the returns in comparison with the benchmark causing the investment to be considered uncorrelated with the market.

White Brook falls into the last camp. White Brook attempts to protect capital by largely buying companies that it believes are undervalued and non-cyclical. The product, as designed, should have a relatively low realized beta, and it does, with a monthly beta relative to the S&P 400 (Mid-Capitalization Index) and S&P 500 of 0.26 and 0.41, respectively. The adjusted r squared, which measures the confidence in that measure, however, is dismal at 0.06 compared to the S&P400 and only 0.28 compared to the S&P500. In common terms, it means that the product is basically uncorrelated to the market. There are a couple reasons for that in my view:

1. White Brook is investing in companies that it believes to be significantly undervalued. In past letters I've written about White Brook's approach to assessing asset value. Underlying that philosophy is that over time the Street should recognize that a business is worth more because it is a better business than previously thought - rather than simply relying on estimate revisions for a change in value.
2. White Brook generally avoids companies that are heavily exposed to the economic cycle. Transportation, financial and industrial companies are a minority of the portfolio. Common factors, like a change in the macroeconomic outlook are less likely to impact the companies in the portfolio.
3. The Portfolio is concentrated. The outperformance of only a couple companies in a given month or year can markedly change the portfolio's overall performance. We only need to be right a couple of times – by design.
4. The stocks that populate the portfolio are typically undergoing some kind of transformational change. When the market realizes the underlying value, they tend to become more favorably regarded suddenly - resulting in a step function change in the stock's level. They then trade with less downward volatility and more upward volatility as market participants attribute greater value to the company.

While White Brook takes a private equity approach to investing that is focused on companies building stronger competitive advantage and asset quality over time, by investing in public market companies our portfolio is marked to market every day, creating some months where we outperform by full percentage points, and others where we underperform by the same. Over time, I believe the portfolio's performance will be superior to many readily accessible alternatives. The trick, to our minds, is to prepare clients and prospective clients of the volatility in returns full well knowing that clients love upside volatility while they hate downside volatility. We believe it prudent to use this opportunity, given the strong outperformance in the quarter, and hopefully the credibility obtained until this point, to do so yet again. My hope is that in the future, we will continue to prove as uncorrelated with the market as we are today.

## **Second Quarter Overview**

The portfolio performed particularly well in the second quarter, up 13.16% in the quarter exceeding the S&P400 by over 8.5% (Up 4.29%) and the S&P500 by over 9.5% (up 3.43%).

During the quarter, White Brook exited its investment in Envision Healthcare (EVHC) and started a new position in Groupon Inc (GRPN).

Box Inc (BOX), Discovery Communications (DISCA), and Stitch Fix Inc (SFIX) were the largest contributors to the Portfolio while Realogy Holdings (RLGY), Groupon Inc (GRPN), and Dolby Laboratories (DLB) were the largest detractors.

Despite an unusually positive result in the quarter, the activities at White Brook were no different this quarter than they have been for the past five and I regard the positive performance to be the result of those cumulative efforts, much like future performance will be the cumulative result of past action and those taken today. While I expect our investments to trade up over time, I expect them to do so while encountering more resistance than experienced this quarter. In my experience, mid-capitalization stocks price relatively inefficiently - especially in comparison to large capitalization companies - and sometimes at least initially contradict their underlying business fundamentals. Overall, results were good for the quarter and irrational negative reactions were fewer. In future quarters, I expect more of our investments to at least temporarily, underperform.

While the performance and reasons for each stock's outperformance were unsurprising and occurred in-line with White Brook's stated theses, there were broadly 3 baskets of outperformance during the quarter.

1. A "reversion to truth". In my view, the ~2% deficiency vs White Brook's benchmarks in the first quarter were created as positions of significant size traded down in opposition to the businesses fundamentals. Stock prices should over time reflect their companies' fundamental performance in a functioning market and this quarter a few of the companies' stocks corrected after being directionally confused initially. In a world where the first quarter has a different end date the confusing price action would have been overlooked and considered unremarkable and the deficiency likely would have been less in 1Q.

2. A significant change in perception. Box, our largest position by a significant margin, is perceived by the market (and by a few clients from my conversations) to be a provider of simple file sync and share document services. During the quarter, a prominent investor promulgated White Brook's view that it is actually a next generation, fully secure, flexible, military-grade, uniquely positioned, content management system that will enable current and yet to be imagined use cases. The market seemed to notice the argument, with the stock making up last quarter's losses. The stock still has very sizable upside, still trading for 50% of the multiple of its closest, yet inferior, comparable and trading at a significant discount vs that implied by the so-called "Rule of 40%" - a loose guideline for valuing SAAS companies and our own view of its intrinsic value.

Similarly, Stitch Fix, which has been dogged by questions surrounding market size, competition, and the cost to acquire customers, was able to grow faster and more profitably than expected. While I don't yet believe that the price embeds White Brook's view of the importance of the platform, the cash generation potential, or the data, intelligence, or brand leads they have in apparel retail - it's finally out of the doghouse where even neutral data points are read as harbingers of doom.

3. Finally, a few of the companies we're invested in saw positive inflections in their underlying industry. While their competitive positions are unchanged, growth is presumed to be easier to achieve going forward.

Underlying each of these reasons, is the simple fact that the market is inefficient where we're investing our time and money.

The worst performer, Realogy Holdings (RLGY) traded down on quarterly results that were in-line to slightly better than expectations while maintaining the forward guidance. Macroeconomic worries about the future health and competitiveness of the housing market weighed on the stock. I continue to see significant value in Realogy.

Envision Healthcare (EVHC), a laggard last year, was acquired during the quarter by a financial buyer for a price that was 70% higher than its lows last year. Even that, as I wrote on the day of acquisition (I attempted to use a new email service which I suspect put it in many of your spam folders, but you can find it on White Brook's website), was meaningfully too low a price. I believe the price was too low for valuation reasons, but if you knew nothing about the business, there are hints from the auction process.

1. All the buyers in the final round were financial buyers. A financial buyer is disadvantaged by limited partners who require returns in excess of those offered in equity markets due to their compensation structure and the investment's illiquidity. A financial buyer also needs to be able to

dispose of the asset within the lifetime of its fund (usually 5-7 years) at a price that compounds by ~15% a year.

2. The highest bidder (KKR & Co) also bought Envision's most troubled asset, its Ambulance unit, earlier this year. They have effectively reconstructed Envision and combined it with a medical helicopter transportation business.
3. Activists created significant pressure on what over time has proven to be a weak board. While I've found myself co-invested with Starboard (twice in past year, probably 5-6 times over the course of the past 5) and been pleased historically, this year, they've proven to be shorter term than I would like. Their presence, along with other activists, pushed for a quick return. Operational improvements currently underway, and a more favorable policy environment are likely in the future and will benefit Envision. The activists had little incentive to wait, however, given their extremely low-priced entry point.

While we did very well on the investment with an IRR that exceeds any reasonable hurdle I can imagine, I lament the exit. This was a solid, well-differentiated company, executing on a likely vision for the industry that was mostly divorced from the macroeconomic environment, still trading at more than 50% discount to intrinsic value for the patient investor. KKR, like White Brook, seems to have a view that aggregated healthcare services companies are needed for participants in the healthcare industry not represented by the interests of payers or hospitals. Over time, either legislation or the market will support the success of those participants – and KKR now will benefit through their takeover of Envision.

Short-term price setters create our opportunities. Occasionally, abetted by a management team sick of myopic capital markets and no longer in need of the capital to roll up the industry they compete in - they'll limit it too. We look forward to taking advantage of these dynamics for the next 30 years.

### **Market Discussion**

Before getting into a discussion of the various markets, I want to again express how little confidence I believe investors should put into any macroeconomic view, both mine and others.

Warren Buffett famously does not pay attention to macroeconomic factors, preferring instead to evaluate each company on a bottom-up basis and treating the broader interest rate environment as a temporary factor. This is the right approach.

In the near term, inflation is the single biggest factor in assessing the US's macroeconomic health and is likely in the short term with the trade war the Trump Administration has started with the US's closest trade partners serving as the primary catalyst. Commodities' prices have increased and the US Dollar has strengthened versus other major currencies driving inflation both in the US and internationally. Inflation is now driving interest rates and I expect the Federal Reserve to continue to raise short term rates.

For inflation to be temporary and be viewed by the Fed as such, trading tensions need to ease relatively soon. However, I believe the administration will continue to pursue hardline trading policies with a variety of trading partners over an extended period. As a result, it is possible the U.S. will experience a longer period of heightened inflation and therefore higher short-term interest rates. This has broad ramifications across both equity and fixed income products with a temporary inversion of the treasury curve (short term yields higher than long term yields) a higher possibility than usual. While treasury curve inversions have predicted many more recessions than have occurred, an inversion would temporarily but negatively impact many businesses that depend on short term lending. It would hit the financial industry, which pays depositors for their savings, the recipients of short term loans, the recipients of vendor financing, and those that have large commercial paper programs most significantly. In other words, capital intensive, cyclical companies. Even so, the large banks are financially secure and an across the board financial crisis is extremely unlikely even if marginal lenders may see some distress.

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

Cash can always be expected to depreciate on a real basis at the rate of inflation less money market yields. With short term yields rising compared to long term yields, the relative benefit of investing in long-term fixed income securities is waning, and the relative attractiveness of holding cash instead is rising.

Relative to last quarter, long-term treasuries are not trading at meaningfully different levels although short term yields have risen as the Federal Reserve continues to increase its benchmark rate. Medium and long term, fixed income securities are not a great investment at this time. Real estate investment is also likely to be impacted by the flattened treasury yields. The ultimate question is how strong the underlying economy is and how much confidence do companies have to continue to expand their operations with an unemployment rate at ~4% to support continued commercial real estate use. I am relatively sanguine about the asset class even while specific opportunities may be attractive.

Most investors have not seen or have forgotten what a non-financial crises economic slowdown looks like. Equities, as an asset class, are somewhat protected from the direct impact of inflation. Individual companies and sectors that are cyclical and that borrow short term debt are likely to be negatively impacted. The short term impacts of a new tariff regime are the cause of the most uncertainty in equities, and while it's likely that over the long term many initially negative changes can be ameliorated, over the short term, there may be some pain in equity markets. Of the potential investment alternatives, I continue to favor equity investment.

Ultimately, I have little idea about the probability of an inverted yield curve, but the Portfolio is invested in a select group of competitively differentiated companies that are likely to do well regardless of cyclical pressures. The companies we invest in are not reliant on continuous short-term funding from the capital markets. Instead, they have assets and market positioning envied by others.

I'm reminded of how humans dominated computers at chess for decades. While computers saw and reacted by calculating probable scenarios multiple moves in advance, humans comprehended and executed moves to position pieces for scenarios that weren't foreseen but were possible. Over time computers saw further and further ahead and reacted earlier and earlier, but humans still won as unlikely events continued to occur. It wasn't until computers were designed to more closely simulate human, strategic thinking that they began to win. Investing strategically - for the long term - not tactically was the key to success. At White Brook, we do the same.

### **Finally**

In the following weeks, I will be releasing materials on a specific investment thesis as I attempt to keep these quarterly commentaries somewhat succinct. If you would like to chat about an individual investment or our overall strategy, please reach out.

Clients should also check their investor portal. There is a new, better experience available and an app for your mobile devices that I hope you'll enjoy.

White Brook's success depends on our clients' satisfaction and trust and we work constantly to earn it. If you know of others who you feel might benefit from speaking with us, please let me know and I'd be delighted to help any way I can.

Sincerely,



Basil F. Alsikafi  
Portfolio Manager  
White Brook Capital

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