

2018 Third Quarter Commentary

	3Q '18	YTD	LTM	Since Inception
WBC	9.91%	21.20%	31.20%	39.56%
S&P 400	3.86%	7.49%	17.91%	19.58%
S&P 500	7.71%	10.56%	14.20%	25.47%

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 was solid again this quarter, outperforming the most comparable index, the S&P Mid-Cap 400 by over 6% and the S&P500 by over 2%. This was plainly a good outcome, especially so given the significant outperformance in the first half of 2018. I'm excited that the Portfolio's returns are meaningfully differentiated from the market's and hope for that to continue over the long term even while I have no ability to forecast behavior over the short term. That said, I believe the portfolio is as undervalued today as it has ever been and the "farm team" of investment opportunities ready to be invested in is as strong as it has ever been.

I designed the Concentrated Opportunities Strategy after over a decade of operating in and observing the hedge fund industry, determining what I thought best practices were, realizing which activities were engaged in primarily for fees rather than outcomes, and understanding my own strengths. I wanted to invest my own money optimally, on client friendly terms, and develop a positive professional reputation that I hoped other investors would find attractive. I wanted to do it the "right way" - where I could be passionate when talking to friends, family, and current and potential investors about White Brook's approach. Finally, I wanted all interested parties to be able to sleep well at night. To that end White Brook continues to invest in the relative safety of the US markets, in "real" companies - while avoiding many of the pitfalls of holdings stocks also held by many well-known funds and the large caps regularly in the headlines. The Fund also avoids some of the moral quandaries that are inherent to investing in many common ETFs and mutual funds that invest in companies that promote vice, death, and whom exploit their customers. I'm happy with the Fund, it's performance, and continue to be excited about the future.

Performance Overview

Since inception, net of fees, the White Brook Concentrated Opportunities Strategy ("The Strategy", "The Portfolio", "The Fund") has gained 39.56% vs the S&P400's 19.58% and the S&P500 25.47%. Year to date, the Portfolio has outperformed the S&P400 by 13.71% and the S&P 500 by 10.64%.

The third 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, I am pleased that rather than pull back after the second quarter's large outperformance, the Portfolio built and extended that lead during the quarter.

White Brook takes a private equity like approach that values the strategic value of a company and its underappreciated assets over purely current revenue and cost estimates and has resulted in multiple positive corporate actions for portfolio companies including the purchase of Integrated Device Technologies (“IDTI”), a large holding for White Brook, during the quarter. It’s important to note that the success of that investment was possible because White Brook is willing and able to hold stocks even while they underperform over the short term. Similarly, new investments entered this quarter and last are those that are expected to be owned for years - not quarters, in companies that are sitting at the bottom of an s-curve of value creation.

During the 3rd quarter, the Company started a new position in Flex Ltd (FLEX) and in Natus Medical Inc (BABY) and exited Integrated Device Technologies Inc (IDTI) following its announced acquisition.

Stitch Fix Inc (SFIX), Integrated Device Technologies Inc (IDTI), and Mosaic Inc (MOS) were the largest contributors to the Portfolio’s performance while Groupon Inc (GRPN), Box Inc (BOX) and Flex Ltd (FLEX) were the largest detractors.

Value continues to build in companies that have performed well but also in our investments that underperformed. Amongst the underperformers, a common theme was the lack of upside surprise rather than substantive underachievement. The market has punished companies that have merely performed, while rewarding outperformers for some time now and given the incentives and limited risk tolerance of most investors who have been skeptical of the market rally for half a decade, we don’t see that dynamic changing in the short term. We’re happy to hold temporary underperformers and continue to contribute capital as we have a chance in preparation of their eventual outperformance.

Investment management is nothing if not a subscription business and for this quarter, at least, I thought it might be useful to discuss the portfolio in similar terms to how I prefer companies discuss their own prospects.

To level set, at the end of the quarter, White Brook had 11 positions in the portfolio. Our mandate is to form a portfolio of 5-15 positions that fit our investment hurdle of above 50% upside with a 2.5-3:1 upside/downside asymmetry over several years. An investor should expect there to be fewer positions in the portfolio when we find relatively few suitable investment opportunities and more positions when there’s many opportunities and it’s difficult to limit to just a few. We believe that 8-12 positions should be considered normal.

Of the 11 positions, I currently regard 2 positions as likely exits over the next 6 months. The stocks have appreciated over the holding period, still have multiple avenues to create a significant amount of value but are relatively less attractive than they once were versus other positions in the portfolio and positions on the “farm team”. They are however currently executing and revealing the fullness of their value and I believe it warranted to continue to hold.

There are an additional 2 investments that I believe are undersized relative to their prospects but am currently unwilling to sell other positions to free up capital for further investment. The 7 positions that remain are the appropriate size, with solid prospects relative to their risks, and that I look forward to a step-function change in price as their value is revealed over the medium term. White Brook tries to maintain 3-5 positions (~40% of the portfolio at the midpoint) on a farm team that are consistently competing against current investments to enter the portfolio. There are currently 4 positions where the work is completed and that are evaluated weekly against current positions to enter the portfolio. This group is as strong as it has ever been and in a world where the portfolio needs to replace 4 current investments immediately, we'd be lucky to hold each one, in size.

I often say that White Brook's investment style is "somewhere between 'Value' and 'GARP'". GARP stands for Growth at Reasonable Price and indicates a relative preference for quality companies that are growing, investing, and executing, rather than for those undergoing a turnaround. White Brook's strategy in one clause is "to buy inflections". Whether it's from negative to flat, flat to growth, or growth to faster growth, companies, pre-inflection are more likely to be undervalued. Done well, we buy companies that are towards the end of doing the hard work of figuring out how to effectively invest in their business and will soon be able to focus more on executing and accelerating growth, or at least, soon be able to take a more balanced view towards cash flow and investment. When wrong, we're typically wrong on the timeline rather than direction. Of the 11 stocks in the portfolio, 5 stocks are in various final stages of their investment period, 4 have finished the hard work and are still underappreciated; and 2 are full GARP stocks that are executing and should sustain high levels of growth or increasing growth that isn't fully appreciated.

In traditional terms, over the second and third quarter of this year, new positions lowered the portfolio's overall valuation multiples as the new investments have lower valuation multiples relative to our previous investments and the market. In both terms of lifecycle and traditional valuation terminology the portfolio is more "value" than GARP than it was 6 months ago and I expect continued oscillation between those poles.

Market Discussion

A significant correction has occurred in the market through the first two weeks of October. White Brook does not time the market or sell when the fundamental long-term value doesn't warrant it and therefore have very actively done nothing so far. I would be unsurprised if there isn't further downside pressure as it seems evident that much of the selling pressure has been indiscriminate, while orderly – an indicator that a combination of algorithmic and risk-constrained strategies are generating a substantial amount of the volume. While many blame interest rates, White Brook's view is that the sell-off is more likely due to a combination of factors that includes China trade, foreign exchange, Brexit, and developing market weakness. White Brook's view is that the correction is likely to be just that - a correction - and not something that induces a recession.



White Brook believes a return to a more historically normal interest rate environment is a good thing and is likely to create new investment opportunities. While we believe interest rates are likely to be structurally lower than they have been in the past, the portfolio has intentionally drifted towards companies that are more capital intensive in recent quarters. When interest rates increase, capital becomes more expensive and given the right industry structure, the industry can raise prices improving its returns on investment. The price of capital in essence becomes a competitive advantage. It's been some time since that's mattered.

Housekeeping

Several housekeeping notes this quarter.

1. I'm more regularly providing insights on various topics in the capital markets. They should be considered complements to this letter as many of my more specific qualitative thoughts are available there. Consider *Insights* to be my best effort at keeping these letters short and easily digestible. You can find them at www.whitebrookcapital.com/insights or whitebrook.substack.com, and you will receive them in your email if you sign up. You will have to provide your email address to access, but White Brook will not use those addresses to solicit you nor will we disseminate your email address. My hope is that the updates are concise, insightful, and interesting.
2. White Brook Capital has moved offices. The new office is at 550 W Washington Blvd, Suite 201, Chicago IL 60661.
3. White Brook is in the early planning stages of launching a pooled investment fund. We have encountered several investors who either need or prefer a pooled asset to invest to our current managed account structure. The strategy, investment approach, and investment portfolio will remain unaltered in all ways from the one you've come to know. I'll be reaching out to existing clients as we get closer to launch to see if you prefer that structure to your current arrangement.

Sincerely,

A handwritten signature in black ink that reads "Basil F. Alsikafi".

Basil F. Alsikafi
Portfolio Manager
White Brook Capital

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