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2018 Year End Commentary

Performance was mixed this year, outperforming the benchmark S&P Midcap 400, -7.60% vs -11.08% while trailing the S&P500, down -4.38%. As I've written before, the Portfolio is meaningfully differentiated from both benchmarks and its concentration leads to volatility in returns resulting in lumpy but hopefully extraordinary returns over time. I believe the portfolio is as undervalued today as it has ever been.

The Case for Midcaps

I continue to believe an investment in mid-capitalization stocks results in superior long-term performance. Below I've modelled an identical investment in each index and the returns if that investment was held through any exit year between 1992 and today. As you can see, an investment in mid-capitalization stocks in most years, especially when held for the long-term, has resulted in superior returns.

Year Enter Investment (Jan 1)

Year Exit Investment (Dec 31)	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1992	Russell																										
1993	Russell	Russell																									
1994	Russell	Russell	S&P500																								
1995	Russell	S&P500	S&P500	S&P500																							
1996	Russell	S&P500	S&P500	S&P500	S&P500																						
1997	S&P500	S&P500	S&P500	S&P500	S&P500	S&P500																					
1998	S&P500	S&P500	S&P500	S&P500	S&P500	S&P500	S&P500																				
1999	S&P500	S&P500	S&P500	S&P500	S&P500	S&P500	S&P500	Russell																			
2000	Midcap	Midcap	S&P500	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap																		
2001	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Russell																	
2002	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap																
2003	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Russell	Russell	Russell															
2004	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Russell	Russell	Russell	Russell														
2005	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Russell	Midcap	Midcap													
2006	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Russell	Russell	Russell	Russell	Midcap	Russell												
2007	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Russell	Midcap	Midcap	S&P500	Midcap											
2008	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Russell	Midcap	Midcap	Russell	Midcap	Russell										
2009	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap									
2010	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Russell								
2011	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	S&P500							
2012	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	S&P500	Midcap						
2013	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Russell	S&P500	Russell	Russell					
2014	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	S&P500	S&P500	S&P500	S&P500				
2015	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	S&P500	S&P500	S&P500	S&P500	S&P500			
2016	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	S&P500	Midcap	Midcap	Midcap	Midcap	Russell		
2017	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	S&P500	S&P500	S&P500	S&P500	S&P500	Midcap	S&P500	
2018	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	Midcap	S&P500	S&P500	S&P500	S&P500	S&P500	S&P500	S&P500	S&P500	S&P500

The relative large cap strength is due to the contributions of Facebook, Amazon, Apple, Netflix, Google, and Microsoft. I believe the environment for those returns has become incrementally more difficult moving forward for several reasons;

1. President Trump's FCC (Federal Communications Commission) policy expressly favors infrastructure over internet content investment. Poor execution of those advantages thus far has resulted in little change to the competitive landscape, as the skillset, previously dormant, further develops.

2. The public is increasingly suspicious of large capitalization technology companies' privacy controls and user data usage due to the mishandling of consumer data. Facebook has exemplified the problem with scandals surrounding their usage of user data and the measurement of its advertising's efficacy.

   Companies not first thought of as abusers of data are likely to come under the spotlight. Amazon, for instance, competes with an increasing variety of retailers and manufacturers. I believe it will become apparent that the marketplace needs reforms. The company is actively expanding its advertising on the marketplace in 2019 while also continuing to monitor the sales of the marketplace's best sellers and developing its own private label products to compete against them. Combining that capability with the purchase history of its users to target advertising and discounts is a tremendous capability, but the conflicts of interest seem apparent, significant, and likely to generate consternation.

3. A younger, more liberal, and more active Democratic party, newly empowered with investigatory rights is more likely to aggressively investigate potential abuses wherever they arise. While the Trump administration may not like the beneficiaries of tech's wealth generation, looking into abuses of Americans data has not been a priority. It's far more likely the new House Democrats will use their subpoena power to investigate consumer harm. Within Congress, regulating large cap tech in this way is a rare bipartisan issue.

4th Quarter 2018 – What happened?

I believe that the catalyst to the fourth quarter selloff was the Federal Reserves 25 bp increase of the Fed Funds rate. While well telegraphed, the cost of borrowing dollars for overseas investors, companies, and financial institutions increased significantly after the increase with some firms finding it difficult to economically transact business in dollars due to dollar scarcity. While in the US, the ability to access dollars is a given, internationally that is not always true, and accessing dollars efficiently was a problem for periods during the fourth quarter. To meet funding needs, firms sold US dollar denominated assets. Slowing global growth added a fundamental reason and quant and momentum traders added to the pain, resulting in selling that was widespread, constant, coordinated and in my view overshot what would have been a healthy correction.

4th Quarter 2018 - Review

During the 4th quarter, White Brook started a new position in Itron, Inc (ITRI) and First Solar, Inc (FSLR) and exited Realogy (RLGY), Stitch Fix (SFIX), and Flex Ltd (FLEX).

I've kept an eye on Itron since its acquisition of Silver Springs (SSNI), last year, and used the volatility during the 4th quarter to buy shares. The same was true of First Solar, although that followed the more traditional pattern of buying a company that I've tracked for some time with scarce and differentiated assets, positive industry trends, and internal reforms starting to take hold that was trading relatively cheaply.

Performance in the fourth quarter was impacted by the following:

Technical selling: While a good environment for quantitative and momentum traders, it was a tough quarter for White Brook. The outsized gains we aim to achieve are built on our investments achieving multiple expansion as other investors realize their value. In the fourth quarter, the coordinated market decline resulted in multiple contraction and little appetite for investors to look at currently unpopular investment opportunities. Additionally, while I was aware of the dollar funding crises before the market appeared to be, I, as I've stated before, have very little confidence in my macroeconomic forecast or any other and didn't believe it to be an "unusual" period that mandated White Brook to be anything other than fully invested. Instead, individual positions were examined and cleared, given they had little exposure to the fundamental risk. But the selling was indiscriminate and occurred at the end of the year, a particularly vulnerable time for the market that saw prices dominated by technical factors. The portfolio's performance suffered.

After the first two weeks of 2019, the technical and tax loss nature of the selloff has in part reverted to normalcy with the Portfolio up ~9.5% vs the S&P500 up ~3.5%, and the S&P400 up ~5.8%.

1. **The Midcap 400 underperformed.** The Midcap 400 underperformed the S&P500 by over 3% during the quarter. While the relative abundance of mispricings in the mid capitalization space is usually great for selected long-term investment. The relative illiquidity compared to the largest capitalization stocks made it more difficult for the stocks to digest macro selling pressure. Over the long term, and in most years, middle capitalization stocks outperform large capitalization stocks, but in the 4th quarter and for 2018, that was not true. Our repositioning towards relatively smaller value stocks during the year became a headwind. While large cap value did well in the 4Q, mid capitalization stocks that are not currently popular suffered more than their share.
2. **Tax avoidance.** During the first three quarters of the year, we were fortunate to have several acquisitions of portfolio companies generate considerable realized gains. As the market declined in the fourth quarter, the price of our investments declined as well. The needs of individual positions (time – holding through volatility) were outweighed by the needs of the portfolio (fiscal year end and tax minimization) and we sold several stocks. 2 of the 3 positions would not have been sold at any other time of the year (evidence of the technical nature of the sell off - both are up ~20% after two weeks of trading in 2019). But impairing a portfolio's returns due to taxes is foolhardy when they can be replaced by "farm team" candidates that we should do well in as well.
3. **Fundamental molehills turned into mountains by the market decline:** The fourth quarter did see some fundamental hiccups, although had they occurred in another quarter and the market not experienced a technical and correlated selloff, would have been less significant.

   Flex Ltd was a considerable disappointment in the quarter. Flex is a manufacturer of electric components in the healthcare, automotive, and consumer electronics space. They had struck a unique relationship with Nike, producing shoes in Mexico for the North American market that was a source of my enthusiasm for the company.

Footwear manufacturing is difficult. Shoes must be light and durable while using multiple materials, in multiple sizes, while mass manufacturing at low cost and relatively low tolerances. Nike now outsources its manufacturing across a base of manufacturers that they tightly control. For instance, as part of accepting a role in the ecosystem, suppliers agree to share knowledge with other suppliers, who they'd typically regard as competitors. It's a perfect socialist system with Nike sitting at the top, acting as their suppliers' customer and regulator and ensuring that no manufacturer gets too big or gains a competitive edge.

I viewed Flex's JV with Nike to be a gamechanger for its industry. While the economic return of the individual contract would be tightly controlled and regulated by Nike, for the first time the intellectual property associated with making highly advanced footwear could be ported and used to manufacture products for other industries. I believed that that information would be invaluable as Flex manufactured integrated technology into a broad range of new applications and would enhance their manufacturing capability in current categories. I continue to believe that to be true.

During Flex's 3Q earnings, reported during the 4^{th} quarter, Flex and Nike announced the JV would be unwound and that the CEO of Flex would be retiring. Only weeks before, during Nike's earnings call, everything was fine with the JV. The product they were going to make at the JV is central to Nike's product roadmap. It remains unclear what happened between the two earnings calls, but its clear something went wrong, quickly. While I tried to sell after the release, the stock went through the price overshooting warranted valuation given recast expectations. It spent the rest of the quarter making up the difference, until the technical selloff.

Checks in the industry indicated that Flex had operational issues that I believed to be a result of focusing so intensely on getting the Nike JV up and running. With the dissolution of the Nike JV, the Company should be able to refocus on its business while more thoughtfully approaching some of the manufacturing issues that prevented the Nike JV from being successful. Meanwhile, the facilities are in place, the income statement has absorbed significant cost ramping the JV, and they should be able to at least partially fill the factory with smaller, more profitable accounts with a lower cost to ramp those contracts than usual. That said, White Brook was down considerably in the position and the tax loss was too great to not harvest in the short term. The Company has work to do to recover from this obstacle, and we will continue to track the company's progress.

Stitch Fix was another significant decliner during the quarter after reporting two quarterly earnings during the quarter, both missing user growth expectations. We realized the tax loss at the end of the quarter. The original thesis, however, remains fully intact.

The portfolio is composed of companies that mostly underperformed in 2018. The portfolio is also far more socially conscious than it has been at any time since implementation, with the purchase of Itron – a smart technology provider geared at municipalities, and First Solar, the largest thin-silicon solar module provider. Value continues to build across the portfolio even while their stock prices were punished in 2018.

Multiple contraction has resulted in the S&P400 trading at ~13.5x next year's earnings and the S&P500 trading 1 multiple point higher according to Factset's consensus. That's an undemanding price that allows actual results to be worse than expected and still be considered cheap. We've already seen the shift in market behavior this quarter from one that punished companies that merely performed to one that rewards companies for underperforming by less than expected. This is a short term positive.

Looking forward, I continue to expect volatility, but with a reset market valuation the prospect for deploying capital is rosier than it has been.

Housekeeping

No new housekeeping notes this quarter:

1. I continue to more regularly provide 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 nor will we disseminate your email address. My hope is that the updates are concise, insightful, and interesting.
2. White Brook continue to explore the launch of a pooled investment fund. We have encountered several investors who either need or prefer a pooled asset to invest and have begun to see benefits for current investors versus our current managed account structure. The strategy, investment approach, and investment portfolio will remain unaltered in all ways from the one you have come to know. Please reach out if you have a preference one way or another.

Sincerely,

Basil F. Alsikafi

Portfolio Manager

White Brook Capital

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