

Fourth Quarter 2023 Commentary

Year in review, and a look forward

Performance Review

As of December 31st, 2023

NAV increase, net	Cum Incept	Ann Inception	PF 2019	2020	2021	2022	2023
WBCP	76.12%	13.67%	17.60%	19.05%	37.16%	(15.38%)	8.38%
S&P 400	51.77%	11.77%	5.72%	13.66%	24.76%	(13.06%)	16.45%
S&P 500	72.04%	15.57%	9.36%	18.40%	28.72%	(18.10%)	26.04%

Inception of White Brook Capital Partners was August 16, 2019

Performance figures are provided by the administrator. Prior years are audited. 2023 is unaudited.

Performance is net of all realized and accrued fees

Market Review

The S&P 500 is expensive. Propelled by the country's largest technology firms, the S&P 500 appreciated by over 26% in 2023. Over the course of the year, the market performed better than morose expectations as the economy outperformed and enthusiasm built over the prospects of the development and implementation of artificial intelligence. We expected overall market appreciation at the start of the year, but 26% exceeded any expectation.

The Positive Theme

Driving much of the gains was a positive shift in sentiment toward the company's largest technology firms. Except for Netflix, each of the Magnificent Seven, the country's largest technology stocks, is perceived as a leader in developing and implementing artificial intelligence. Except for Nvidia, which delivers processors to train and implement these models, the rest of the Magnificent Seven and the tech sector have significantly less to show for the AI hype.

I do not see sufficient consideration of several issues by most AI investors today.

- 1) The lawful use of data and its utility,
- 2) open source versus proprietary base models,
- 3) the value and appropriateness of general versus vertical models, and finally,
- 4) how to monetize it.

The utility of general models will be to answer the most straightforward questions and then aggregate traffic and direct it appropriately to better-equipped vertical models to answer more advanced queries. They will monetize via advertising and kickbacks/commissions from vertical models or, for more sporadic queries, pay vertical models for answers to retain their ability to aggregate traffic. Vertical

models will compete against others in the same space and must navigate the highlighted issues diligently. Their ability to earn early revenue or to attract significant early financing will prove essential to capture differentiated industry data and pay for exclusivity. At this time, there are no obvious leaders.

One of the issues that I haven't seen solved yet is an AI model that extracts information systematically from its waste. Google's search rapidly improved and became a step function better than others because, for each search delivered, they observed a positive response - the user's selection, and a negative response - the user's non-selection. By being the default search engine, they could accurately assume that each result delivered was meaningful and that the response received was also a meaningful response to their delivery. Every other search engine that wasn't the defacto standard could not make those assumptions, and their development suffered. AI is in a similar position to those other search engines. Given the newness of the technology and the existence of search, which often does an excellent job on its own, a user's click to close after receiving an answer can mean that the answer was good and useful; that it was bad and quickly dismissed as inferior to search; that it was wrong but indiscernible to the user; or that it was known to be wrong and dismissed. General AI models like ChatGPT and Google's Bard improvements thus far have been beneficiaries of indiscriminate investment rather than thoughtful revision, but these issues will become more significant for vertical models with more limited audiences and harder to deliver data.

Today, there's a lot of excitement about AI's advances within pharmaceutical development based mainly on the ability of AI models to suggest compounds for development that were recently discovered to be promising. Is that good? The pharmaceutical industry is already at the forefront of the systematic cataloging of structured data. While I hope AI will help find the next generation of antibiotics, people can already regress already structured data well. Making conclusions from unstructured data, IE, observing an atomic reaction to give us a breakthrough scientists wouldn't have thought significant and progressed to testing in 5 years, is the promised leap forward. It's not clear we're close to there yet. I'm unsure if the dollars invested today or the valuations for companies tangentially related to AI development and implementation currently account for the runway before AI is broadly effective and helpful. What is clear is that the most common first-generation applied AIs in the form of Microsoft's Copilot and Google's Duet are obscenely expensive to develop and implement and poor value for money to use. But the allure of allowing people to be a little bit lazier is business's holy grail, and investment will continue, but perhaps, given the high probability of failure, at lower valuations.

Normalization

Early in 2024, "reversion to the mean" and "getting back to normal" dynamics are playing out in the real economy. A major topic for 2023 was the inversion of the yield curve - the situation where the yields for short-term treasuries were higher than those of long-term treasuries. Today, the treasury yield curve is steepening, and while the whole curve isn't yet uninverted, the five to the 30 year are normal, with

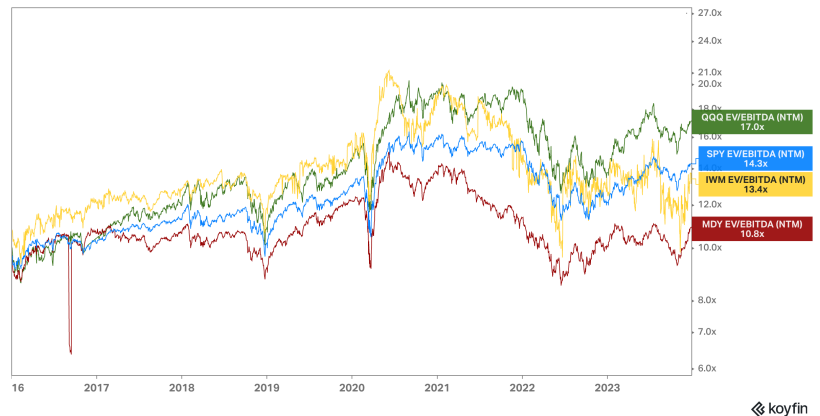
the ten-year already in its long-term sustainable high 3%, low 4% range. This is the impact of lessened certainty in the inevitability of a near-term severe recession, a good thing for the economy's long-term health and a reason to rethink allocations made to cash, stocks, and bonds over the last year.

As interest rate expectations have normalized, so have the expectations around private company valuations. In a change from the recent past, given the market's performance in the fourth quarter of 2023, the IPO market is again open, and access to capital, both in the public and private markets, is easier than it has been. The shadow banking system, now rebranded as "private credit," is the "new" hot asset class with private equity, previously the customer of private credit, also participating. As a reminder, private credit provides private and publicly traded companies financing instead of bank loans or publicly issued traded bonds. Due to higher regulatory and risk hurdles for regulated banks, banks have stopped bringing higher risks onto their balance sheet (although they invest in off-balance entities that are private credit lenders). The lenders like the debt because the yields they have to pay are slightly lower or the same as they'd receive in a high yield/junk bond issue, but there's also a heightened level of flexibility by dealing with far fewer lenders. For private credit funds, the yields received on the financing are junk-like but can themselves be leveraged to enhance the yield to the limited partners. Additionally, unlike a public bond investment, private credit investors don't have to mark their assets to market and can show positive returns, even when real-time debt market pricing would suggest otherwise. Marking to model rather than the market is powerful, and the funds' perceived volatility is low, making them attractive to investors. New to 2024 are the collateralized loan obligations issued by those funds, repackaging and syndicating their loans to yet other investors. It will be a continued topic in financial markets, the source of at least one minor financial problem, but for now, it means that companies of decent financial footing can access the funding they need.

Transportation markets are also reverting to the mean. 2023 was a difficult time for trucking companies in the United States as consumers favored spending on services rather than goods, and inventories that were built, were depleted at slower-than-expected rates as consumers traveled rather than shopped. Those inventories have mostly been worked through now, and recent national spending data indicates that US consumers are shifting their spending habits back to buying goods. Many transportation companies exited the market in 2023, and while it's unclear if enough have, early in 2024, pricing for transportation seems to have bottomed.

In 2023, the indices did not mean revert, and the midcap index continues to be a relative bargain. The S&P 500, which incorporates the country's largest technology firms, signified by QQQ, outperformed significantly. Despite the beginnings of regulatory and antitrust pressure, Apple, Amazon, Alphabet, Meta, Microsoft, Netflix, and NVIDIA had uncommon performance for companies of their size, again driven by the prospects for AI. They now comprise an all-time high of approximately 30% of the S&P 500 market-weighted index.

While not at historically extreme valuation, the QQQ and the S&P500 are relatively high compared to their history and the country's smaller companies. It's important to note that the last time the multiple exceeded its current level investors expected a significant post-Covid recovery. Those sales ended up being more expensive than expected and led to stock losses as the multiple depreciated in 2022.



Middle capitalization companies are a more even cross-section of the country's economy. They are relatively cheap, having not appreciated to the same degree as the S&P 500, despite expectations of increased fortune. This presents an opportunity as the effects of the Inflation Reduction Act, the CHIPS Act, and the rejuvenation of the nation's manufacturing infrastructure, currently being built and deployed, impact the country. As we write this in mid-January, small and medium-sized businesses throughout the country are optimistic about the near future, with expectations of future growth positive and improving.

Portfolio Review

During 2023, the largest contributors to performance were Builders Firstsource Inc (BLDR), The Greenbrier Companies Inc (GBX), and Afya Ltd (AFYA). The largest detractors from performance were Green Plains Inc (GPRE), B. Riley Financial Inc (RILY), and Mosaic Co (MOS).

Few changes were made to the portfolio in the fourth quarter. I continue to be pessimistic about the pricing power of branded merchandise and have avoided companies where future returns depend on a surplus of historical or current advertising spend and the ability to exercise pricing power. The prices of items for most established brands have been maximized in our view and would only engage in situations where the company's products are a price leader in their category, the company has the opportunity to engage in geographic expansion, or the company's margin structure implies ample opportunity to generate significantly higher free cash flow through self-help investment.

Builders Firstsource (BLDR) remains the largest position in the portfolio. As interest rates have settled, single-family home building has accelerated in late 2023 and early 2024, and the country continues to be under-housed. Builders Firstsource generally charges a fixed percentage on the building materials it distributes, excluding its private label brands that usually solve a unique problem for which they price at a discount to the alternative. Management has proven themselves to be excellent free cash

flow-focused operators and good capital allocators. After a year, where the stock was up ~1.5x, I expect a more muted but still positive return in 2024 and beyond.

Mosaic (MOS) and Green Plains (GPPE), our commodity-sensitive investments, remain substantial positions in the portfolio. The companies are a natural hedge to each other in some ways, as the price of corn is a feedstock for Green Plains while it bolsters the purchasing power of Mosaic's customers. On the other hand, higher oil prices are a positive for Green Plains, while the opposite is true for Mosaic.

The Mosaic thesis didn't change during 2023. The world's potash and phosphate needs grow at a ~2% CAGR, and the price for potash and phosphate, which declined from Covid peaks during 2023, is likely to be at least stable in 2024. Mosaic continues to generate substantial free cash flow on a business with lessening capital intensity, and the balance sheet has a very manageable debt load. The Company's CEO, Jack O'Roarke, announced his retirement at the end of 2023, but I expect the company to go from strength to strength as long-time heir apparent Bruce Bodine leads the company in 2024. I believe the company will continue to return capital to shareholders through enhanced stock buybacks while investing in high-return brownfield opportunities that will continue to grow long-term free cash flow per share. Additionally, should battery manufacturers adopt more phosphate in their batteries as Tesla and Ford have begun to do, it could significantly change the demand dynamics of one of its two products and ensure Mosaic's significant cash flows years into the future.

Green Plains is a troubled investment. The stock did not perform as expected in 2023 and has had a difficult start to 2024. The Company continues to be well positioned, generating solid margins on each kernel of corn as the corn crush margin stays meaningfully positive. Furthermore, the industry's progression is clear. There is an opportunity for ethanol producers to increase short and long term profitability by deriving higher amounts of corn oil, specialty alcohols, and high-density feed protein from each kernel of corn. It's also increasingly clear that the required capital will prevent many current operators from transitioning. Green Plains was fortunate to begin its conversion relatively early and to have the scale necessary to complete the transition.

During the year, the regulatory environment bent towards ethanol producers as the federal government stopped preventing several midwestern states from blending a higher percentage of ethanol into gasoline and included their substrates in Inflation Reduction Act climate change subsidies.

Finally, the company is at the forefront of the ethanol industry's sustainable aviation fuel (SAF) development, a future use case that would use a substantial portion of the US' current ethanol production if today's ethanol plants were to supply it. This year's developments were positive for Green Plains and portend a dramatically higher earnings stream within a year, even higher in two and higher still in three, making the stock incredibly cheap, particularly looking two or three years out.

The problem is that Green Plains management consistently overpromises and underdelivers, having pushed out the monetization of its high protein feed and carbon sequestration approval timelines multiple times. Today, the stock price indicates that the street has little confidence in management's ability to execute on the communicated vision. Activist investors are already involved, and I expect one, given the strong strategic position of the company but the flailing stock price, will become active in the stock in the short term. White Brook's view of the company's intrinsic value is a multiple higher than today's price.

Finally, we continue to hold B Riley Financial (RILY). B. Riley was a significant detractor from performance during 2023 as short-selling arguments were very publicly made throughout the year. The first short selling thesis questioned their deposit quality (they don't take deposits) and the wisdom of their investment book (they've mostly worked out very well). They've more recently moved to allegations of fraud, questioning the veracity of Riley's financial statements and the integrity of people the Firm has done business with without evidence that the company itself has committed wrongdoing. While I used to short stocks for a living, and there are short sellers I believe do great work and warrant a sell first, ask questions later philosophy, I believe this group's analysis is mistaken and, in some cases, confused. I assign a low probability to the short sellers' best arguments becoming true. However, even if they are, given the current share price, I believe the shares would still represent a compelling opportunity over time. Today, given the price of its publicly traded equity and debt, very high returns can be achieved by the company just by *shrinking* its principal investment business by letting outstanding loans to customers mature and paying down debt or buying back stock with the proceeds. They can win by doing nothing. Additionally, their base capital markets business, where they take minimal risk, is entering a period of enhanced potential opportunity as hundreds of billions of dollars of debt in Russell 2000 companies becomes due, providing Riley's investment bank the opportunity to help companies arrange mergers and acquisitions or place equity, and firms trade. I like the risk-reward in RILY shares and look forward to a return measured in multiples of its current value.

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 earn your trust.

Sincerely,



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