Eidelman Virant
CAPITAL

12th of July, 2018

Dear Clients & Friends,

U.S. stock market indices climbed higher in the 2nd quarter with the S&P 500 rising 3.4%. U.S. markets advanced despite President Trump initiating $34 billion of tariffs on Chinese goods, stoking fears of a trade war. While U.S. stocks advanced, the Chinese Shanghai Stock Exchange Index fell 10.2%. Are trade wars cause for concern? Why has the U.S. stock market remained so strong?

In the short term, escalating trade concerns will likely drive volatility higher. President Trump's economic team believes the U.S. has been "losing" on trade and that China's policies on stock ownership, Intellectual property, and tariffs are destroying the manufacturing backbone of the U.S. While President Trump's tactics can be unnerving and headline grabbing, the scope of these disputes are quite small relative to the global economy. The U.S. is charged a weighted average tariff of 6% by our four largest trading partners versus U.S. tariffs of just 3.5%. This difference equates to less than 1/1000 of the U.S. economy. Over the long term, the trade disputes will resolve either through a few more protectionist measures or through a reduction in barriers by our trading partners which would increase global trade and standard of living for all countries.

The good news is most of our investments are currently invested in small U.S. companies with little exposure to international trade. Such companies should outperform in the short run, but multinationals could present opportunity. As an example, Harley Davidson (HOG) recently got nailed with a triple whammy as steel tariffs drove their costs up, then the EU retaliated with 15% tariffs on motorcycles, and lastly Trump publicly lambasted Harley for announcing plans to shift some of its U.S. production overseas to avoid tariffs. Harley stock has fallen 28% and trades at 12x last year's earnings. Companies like Harley which have declined due to fears surrounding trade wars could present buying opportunities; however, we have not made any such purchases yet.

One investment we did recently make is Stitch Fix (SFIX). Stich Fix has created a better way to shop for clothes for people who don't have time or don't like shopping. First, customers fill out a personal profile online. Stitch Fix then assigns a personal stylist based on those preferences who mails the customer a box of five personalized clothing items. The customer keeps or returns any or all items and provides detailed feedback. SFIX stylists use this data to evolve offerings which increases keep rates and customer satisfaction. With online apparel sales still representing less than 20% of the total, Stitch Fix should continue to benefit from the large secular shift to shopping for clothes online.

Founder & CEO Katrina Lake owns 17% of the company, valuing her stake at $400 million. She is now one of the wealthiest self-made women in the world. She has built a 6,000-person workforce of mostly women to reflect their customer base, creating a unique corporate culture. SFIX does over $1 billion in sales annually and is profitable today, but their true earnings power is masked by their large investments in data science, new categories, and marketing. Given SFIX's superior business model, scale, and international expansion, we estimate 1) sales growing 20% compounded thru 2021, 2) after-tax margins reaching 8%, consistent with apparel industry leaders like TJ Maxx & Ross Stores and 3) the stock maintaining a premium earnings multiple which reflects its leadership (30x EPS). In such a scenario, SFIX shares would be worth roughly $50 per share in three years, a potential 22% compounded annualized return from current levels. I have personally been a satisfied Stitch Fix customer and encourage you to give it a try. Send me an email and I can send you a link to try it for free.

In the rest of this letter, we thought we would share some of our answers to the most common questions we receive from current and potential investors. These include questions on succession planning, cash policy, large-cap stocks, selecting a benchmark, and our capacity given our focus on small and microcap value investments. We hope you find it helpful and if you have any additional questions, please don't hesitate to ask.

Sincerely,

Tom Eidelman, CFA
Managing Director

<u>Frequently Asked Questions</u>

Question 1: Succession. How much longer do David Eidelman & John Virant plan on working? What is the firm's succession plan?

David and John have been tremendously successful and are now in their 70s. Following in their footsteps is no small feat. Fortunately, the investment world is not major league baseball, where players peak at 27 and the oldest active player is 44. On the contrary, investment skill compounds like money and David and John are industry giants at the top of their games. Both have been energized by working with their sons. David still works a full day at the office every day and John is more on top of minute-by-minute stock movements than anyone in the company. On a playful note, David is still playing men's senior hardball and batting .400. John Virant just returned from taking his wife on a motorcycle trip across the pacific northwest. If they don't get hurt on the playground, we think the best is yet to come for the both of them. What about the next generation?

I joined the company fifteen years ago to help take our company to the next level. My partner, John Virant Jr. has been here eight years and now acts as key member of the investment team. I'm proud of our results. Our firm assets have grown from $70m to $350m. Our client retention ratio was in the top quintile according to a Schwab Benchmarking Study and 10-year investment results ending 3/31/18 ranks in the top 10% of our peers, earning us a five-star Morningstar rating.

I think we can keep it up. Our investment team has developed an elite understanding of corporate culture that has allowed us to quantify and incorporate fabulously run companies into our investment approach. Our increased firm size and expertise has allowed us to expand relationships with Wall Street firms and gain access to more one-on-one management meetings. We now utilize new tools which make us more productive and give us access to industry leading research. Our compliance program has undergone multiple successful mock audits and our investment results are in the process of getting an updated GIPS verification by a leading compliance firm. Such a process has required our back-office operations to consolidate our CRM, research, and portfolio management systems. Our team is as motivated and well-equipped as ever for future success.

Question 2: Cash. Why do I have X% cash in my account? Shouldn't we be fully invested? Conversely, valuations appear high, shouldn't we have extra cash in the account to be on the safe side? What is your policy on cash?

Our general policy is to stay fully invested for our clients. Due to the nature by which we need to opportunistically buy and sell investments, we define fully invested as having less than 5% of the account in cash. Cash may temporarily exceed these levels if we just sold some investments and haven't yet found the right ideas to fill out the portfolio. From time to time, clients request extra cash for risk mitigation purposes, but most often end up reinvesting that cash soon in the future.

Question 3: Individual Specialization. What industries do you tend to overweight? Do each of you specialize in different industries?

Most of us are generalists in that we all evaluate and debate investments from all sectors. However, we also each have areas of expertise in sector and factors. For instance, David Eidelman is a generalist, but has expertise in banks, healthcare, distressed securities, and corporate incentives. John Virant Sr. is a generalist with expertise in industrials, oil & gas, and activist situations. Stan Finger focuses on low-

priced community banks with favorable income demographics. Ben Weiss focuses on media, entertainment, as well as owner-operated, industry-disrupting businesses. John Virant Jr. is a generalist with a focus on entertainment and consumer branding. Lastly, I am a generalist with an expertise in banks, commodities, technology, and identifying outstanding corporate cultures.

Question 4: Benchmark. What is your benchmark? To what index or return target should we compare your returns to know if you are doing a good job?

The Russell 2000 Value Index is the most relevant index with which to compare our returns. Our philosophy and holdings align with its contents of small cap, low price-to-book ratio securities. When we ran a correlation of our returns with all the various indices, we were not surprised to find that we had the highest correlation to the Russell 2000 Value Index. Due to our expected historical and expected weighting to small and value-oriented investments, we think the Russell 2000 will continue to be the best benchmark going forward.

Having said that, our opportunistic, bottom-up stock picking strategy does not try to specifically manage to the benchmark by investing exclusively in its contents and we are comfortable being compared with any equity index over the long term. At the end of the day, we strive to achieve double digit investment returns while taking less risk than similar investments.

Question 5: Capacity. What are your growth plans? How much money can you manage with your Value Select strategy?

We think we can manage \$500m in our Value Select Strategy before we look to close the fund to new investors. There is currently \$180m in the strategy of our firm's \$350m. The reason for the constraint is the strategy's significant investments in small and microcap stocks.

For example, we currently own shares of Guaranty Federal Bancshares (GFED), a Springfield Missouri bank with a market capitalization of just \$109m. Our firm's clients currently own roughly 2.5% of the company, making our firm the fourth largest shareholder. The largest position we can legally take in a bank is 9.9%, which would be \$11 million worth. If we wanted to take a 2% position for our clients, this would mean the size of the fund could only be \$550m before it became too large to take our desired 2% position. This is an extreme example and the vast majority of our investments in the Value Select strategy have larger market capitalizations and trading volumes than the example above.

Should we decide to grow the firm further, we would look to start a dedicated small cap value fund (excluding micro-cap stocks) or a fund focused on outstanding management cultures. We think both strategies could be successful and have a higher capacity.

Our company owners, including myself, own all the same stocks as our clients, so growing too big and diluting our returns would be bad for both our clients and ourselves. We are dedicated to staying the right size to optimize investment results for our clients.