



April 16, 2021

Dear Partner,

The performance of the Kinsman Oak Equity Fund was +3.7% for the first quarter of 2021, net of all fees and expenses<sup>1</sup> compared to the benchmarks set forth below.

Performance (%)	Q1 2021	YTD 2020
<b>Kinsman Oak Equity Fund</b>	<b>3.7</b>	<b>3.7</b>
S&P 500 Index	6.2	6.2
Russell 2000 Index	12.7	12.7
TSX Composite Index	9.5	9.5

## COMMENT ON PERFORMANCE

The Fund increased in value by low-single digits as of the end of the first quarter. The strong performance experienced by the major indexes year-to-date can be largely attributed to the energy and financial sectors, of which the Fund has no exposure (Appendix A). None of the Fund's positions have been significant detractors to performance and the cash position averaged ~30% over the past few months.

Reported FY 2020 earnings benefitted the Fund's underlying holdings and guidance/commentary was broadly constructive to our investment theses. Our long-term outlook remains relatively unchanged. There was one notable exception, however, and we have since exited the position without incurring a loss.

The Russell 2000 is becoming an increasingly *un-benchmark-able* index as its largest weights throughout the quarter included stocks like Plug Power, GameStop, and other questionable constituents. We believe the index's construction currently provides a distorted and biased barometer of small-cap performance. Our watch list is riddled with small-to-mid-cap stocks significantly below all-time highs.

## MARKET COMMENTARY

Financial markets have remained eventful, and the signal-to-noise ratio continues to trend in a more erratic direction. Two major themes have dominated headlines and asset prices lately. First, at a macro level, rising ten-year Treasury yields have seemingly spurred a rotation from growth to value. Second, at a security-specific level, short squeezes and family office/fund collapses have caused extraordinary volatility.

While headlines imply retail trading activity ignited parabolic moves, we suspect institutional players had a much larger impact. We wonder how many other family offices with ~\$10-15 billion in assets under management are quietly levered up more than 5x across multiple prime brokers. The Robinhood fiasco certainly poses interesting ethical and moral questions about the role it played in gamifying markets, but we doubt its users were solely responsible for multi-billion-dollar changes in market capitalization by purchasing out of the money call options. We will learn more in the coming months once the dust settles.

<sup>1</sup> Individual performance may vary depending on Class of units held and subscription date.

## **Sentiment Check**

Broadly speaking, speculative excesses and elevated investor sentiment from last year have trended higher so far this year but we are beginning to see early signs of waning euphoria. Anecdotally, we sense unfettered bright-eyed and bushy-tailed optimism transforming into angst and nihilism. Animal spirits are notoriously fickle though, and the mood may shift drastically before we even hit the publish button.

For instance, SPAC gross issuance proceeds were ~\$83.3 billion in 2020 which is almost double the amount raised in the previous ten years combined (~\$47.8 billion). Gross proceeds year-to-date are already more than the entirety of 2020 and total ~\$100 billion as of March 31, 2021. According to Bloomberg, SPAC listings have recently slowed to a crawl and deals have been postponed as the insatiable hunger for new listings has cooled.

Most stocks in our short squeeze / greater fool bubble basket referenced in the annual letter are much lower than they were when we last published, but the majority still have positive returns year-to-date. Again, this suggests sentiment remains elevated, but the froth may be dissipating. Numerous post-merger SPAC transactions have also come under heavy scrutiny and are significantly below their all-time highs. Investors piling into these vehicles at the top were quickly disillusioned. On top of that, many high-flying stocks popular with retail investors experienced significant drawdowns as interest rates moved higher.

## **The Bond Market, Rising Yields, and P/E Multiple Rethink**

Rising yields caught fixed income investors flat-footed and dealt a swift blow to the Treasuries market. Losses were concentrated on the long end of the yield curve as the 30-year Treasury experienced a total return loss of 15.7% this quarter. For reference, this is the worst quarterly performance since 1976. Investment grade corporate bonds were down 4.7% and junk bonds were up 4%. Rising rates were trouble for long-duration risk-free assets, but stronger economic data and a rebound in the energy sector reduced junk bond default risk, more than offsetting the impact of interest rate changes.

We wonder if rising yields and inflation expectations will cause a P/E multiple rethink. Valuation multiple compression occurs during inflationary bouts despite the widespread belief that equities are the place to be invested during these times. Sell side price targets are a function of two things: earnings and multiples. Generally, these analysts do a decent job projecting earnings which is where most of their time and effort is spent. But common practice is taking last year's multiple and applying it to this year's earnings. Projecting EPS trajectory is easier than selecting the correct multiple.

## **Fundamental vs. Valuation Risk**

We are always conscientious of risks posed to our Fund's holdings and try to evaluate potential opportunities in the context of whether we are being adequately compensated to take on additional risk. Two main types of risk exist: fundamental risk (a specific business fails to execute/perform adequately enough to meet investors' expectations) and valuation risk (investors ascribe a lower multiple to future cash flow streams). Balance over a cycle is key, but sometimes leaning into one over the other is advantageous.

At this juncture we also know two things to be true. The economy is rebounding from historic lows and valuation multiples are more expensive now than at pretty much any other point in history. For this reason, we believe skewing the Fund's risk profile towards fundamental risk and reducing valuation risk will provide better risk-adjusted returns for the foreseeable future.

## CARNAGE BENEATH THE SURFACE

Analyzing returns in a vacuum at an index level would paint a very misleading picture of the moving parts beneath the surface. Factor rotations throughout the first quarter have been volatile and violent, to say the least, and plenty of stocks on our watch list remain significantly below all-time highs.

### Long Duration Tech Disguised as “Tech is Eating the World”

Expensive software companies trounced the market most of last year. The narrative justifying this extreme outperformance was *tech is eating the world*. The pandemic pulled forward years of behavioural changes on the adoption curve for many businesses. On the surface, this explanation sounds plausible enough. Certain stocks deserved to be higher than where they started the year, but the harder question is calculating exactly how much higher. Many went through the stratosphere to the point where valuations made little, if any, sense.

We believe this quarter unveiled the real reason behind last year’s price action. In essence, these ultra-long duration tech stocks were simply a function of interest rates more than anything else. Technology is just as much eating the world today as it was at the beginning of the year yet, from mid-February to late March, these stocks were clobbered.

Internally we track a basket of *TAM narrative bubble* stocks referenced in our annual letter. Yields rose ~50 basis points in six weeks (Appendix B), and stocks in this group experienced an average drawdown between 30-40%. The implied duration of this basket is shockingly high. At the trough, many ultra-long duration tech stocks in this basket were up less than the median stock in our *re-opening euphoria basket* from the beginning of 2020 to Q1 2021 lows. Perhaps both baskets were just duration plays the whole time.

### The Great Inflation Debate

The most consensus trade in the market right now is the shift to secular inflation driven by fiscal spending and the beginning of a commodity super-cycle. Short-term inflation is virtually guaranteed. Every company we track mentions it, there are supply chain disruptions all over the place, and year-over-year comparisons will be easiest in April and May. Headline inflation numbers will be high, and we suggest using month-over-month figures or two-year figures to filter out some of the noise.

We believe it is premature to conclude that an era of secular inflation is upon us. The change in commodity spot prices is largely driven by temporary supply constraints rather than structural shortages. Almost every commodities futures curve is in backwardation which suggests this elevated market tightness will dissipate over time. The big question is whether elevated demand in the future can offset easing supply interruptions and result in sustained higher prices. Further, one year from now inflation comparisons will be from a much higher base so it is conceivable to think inflation can sink below 2% again. Our base case scenario is that the market is underestimating short-term inflation and overestimating long-term inflation.

The strong performance in energy and financials can be partially explained without a secular inflation or a commodity super-cycle narrative. Rising spot oil prices were certainly a tremendous tailwind for the energy sector this quarter. But perhaps the recent rotation has more to do with rates than investors are willing to admit. If the performance in technology stocks last year was essentially a long duration play, this sector rotation could simply be the reverse of that. As yields rose, investors rushed from ultra-long duration assets into ultra-short duration assets. Energy and financials are the ultimate short duration sectors.

## **PORTFOLIO UPDATE**

The Fund held seventeen long positions and no short positions as of the end of the first quarter. Net exposure averaged ~70% over the past three months.

## **LONG POSITIONS**

The breakdown of the Fund's seventeen long positions are as follows: fifteen are U.S. listed and two are Canadian listed. The top ten holdings are two third of the Fund's net asset value, excluding cash. The Fund does not have any exposure to biotech, financials, or energy. In hindsight, we could have added energy exposure when the sector was considered un-investable but we generally dislike investing in businesses whose fate is predominantly dictated by a commodity price and out of their own control.

### **BWX Technologies (BWXT) – Long Position**

The Fund has owned shares of BWX Technologies for quite some time despite the stock going nowhere until the last two weeks of the quarter. We initially prepared our write-up when the discount to intrinsic value was much larger but, after some internal deliberation, we still decided to include our notes on the company because we feel the business is incredibly unique and would be of interest to our partners.

At a high level, the investment thesis for owning the stock boils down to 1) the base business is undervalued and 2) shareholders have a free option on BWXT's nuclear medicine business. We don't want to get too into the weeds but will provide a general overview below.

### The Base Business

BWXT operates three business segments but derives the majority of revenues/earnings from its Nuclear Operations Group (NOG). This segment is the monopoly manufacturer and supplier of naval nuclear propulsion systems for the U.S. Navy's submarine and aircraft carrier fleets. The company faces no direct or indirect competition from other entities, no substitutes exist, and the U.S. Navy cannot perform these functions internally. BWXT is the only game in town.

The other two business segments – the Nuclear Power Group (NPG) and the Nuclear Services Group (NSG) – are less valuable by comparison. The former provides services to Canadian nuclear power plants (CANDU reactors) and commercial services for other power production facilities. The latter primarily provides nuclear materials processing and site remediation services to the U.S. government.

The NOG segment possesses growth tailwinds as the U.S. government appears committed to building out their nuclear submarine and carrier fleets. BWXT will be a beneficiary of what will likely become a multi-decade fleet build. The company has already undergone a large capex cycle over the past two years preparing for growth and that spending will roll off in 2022. The free cash flow and margin profile of the business will improve quickly going forward.

We believe the BWXT deserves at least a market multiple based on its low double digit earnings growth trajectory and its impenetrable competitive moat alone. On top of that, as re-investment needs diminish, the company will have more capital allocation options at its disposal to further drive shareholder value creation. We anticipate a combination of share buybacks and strategic M&A.

## Nuclear Medicine Potential

The medical isotopes division has considerable potential upside, in our opinion. BWXT entered the market by acquiring Sotera Health's Nordion Medical Isotope business in 2018. Radioisotopes, specifically molybdenum-99 (Mo-99) and technetium-99 (Tc-99), are primarily used for diagnostic purposes. Mo-99 decays into Tc-99 which is then injected into patients and used in 80% of nuclear medicine procedures.

Medical facilities purchase generators that contain Mo-99 which decays into Tc-99 on site shortly before use. A few companies supply these generators, and the end products are relatively commoditized. Instead, the economic moat comes from how the main input material (Mo-99) is obtained. We believe BWXT has developed a highly scalable and proprietary production method for sourcing Mo-99. This differentiated technological process virtually guarantees a structural cost advantage over competitors. Further, national security considerations could allow them to take monopolistic market share.

Mo-99 is a by-product from the nuclear fission process which is where most of the supply currently comes from. Uranium (U-235) is the main input. The traditional method of production poses two drawbacks. First, the process itself is incredibly wasteful. Of all the U-235 used, only 7% becomes Mo-99 and the remaining 93% is essentially nuclear waste with no alternative use. Second, the U.S. government is the only supplier of U-235. The first drawback ensures an expensive production/disposal process, and the second creates a potential tail risk event should the government decide to stop supplying U-235.

BWXT has developed a unique approach to Mo-99 production that does not rely on nuclear fission or uranium at all for that matter. Their alternative process involves the use of a commodity industrial metal called molybdenum. Molybdenum (most commonly Mo-98) undergoes a neutron capture process, and the output is a combination of various Mo particles (Mo-96, Mo-97, Mo-98, Mo-99, Mo-100). The next step is filtering out the Mo-99 and putting only those particles into the generators sold to medical facilities.

Neutron capture solves both traditional method drawbacks. Even if BWXT's competitors received U-235 for free, the incremental production and disposal costs are so excessive that it results in a structural cost disadvantage. Waste from the neutron capture process becomes inert within weeks and is not even considered industrial grade waste at time of disposal, whereas traditional method produces nuclear waste.

U-235 is a highly controlled substance for obvious reasons. The U.S. government has previously indicated that if Mo-99 can be supplied to the market via alternative methods, they would seriously consider reducing or eliminating the supply of U-235 for national security and non-proliferation reasons. A blue-sky scenario like this could allow BWXT to effectively take enormous market share. Only one other company called NorthStar Medical Radioisotopes is attempting to use a similar neutron capture approach but is experiencing production challenges.

According to BWXT's Q3 2019 investor briefing, the North American TAM is estimated to be approximately \$1 billion (comprised of ~\$160 million for Tc-99 generators plus ~\$840 million for Tc-99 cold kits). Worldwide TAM is roughly \$2.5 billion (~\$400 million plus ~\$2.1 billion). We believe BWXT stands a reasonable chance at being one of the few players to capture meaningful North American market share in the coming years. Expanding globally will take longer but can certainly happen as well.

BWXT expects commercialization to begin at some point in 2022. The company needs to obtain FDA approval before sales can ramp which is expected to take between six to nine months. No human trials are required because Mo-99 is an existing product which leads us to believe regulatory pushback at this point is unlikely. The company has indicated they can scale enough production capacity to supply the entire North American market almost immediately after commercialization commences.

## **SPDR Gold Trust (GLD) – Closed Long Position**

We initiated a position in GLD last summer to hedge against potential currency debasement. Our long-term thesis hasn't changed much since then. The United States continues to run enormous fiscal deficits and we believe the Fed will eventually have to choose between the dollar and the stock market.

We chose to close our GLD position for two reasons. First, gold is inversely correlated to real yields in the short run and behaves like a long duration asset in that regard (Appendix E). The precious metal is correlated to M2 money supply growth only over long periods of time. Second, we are exploring more asymmetric and creative ways to profit from debasement rather than owning the physical metal.

## **SHORT POSITIONS**

In our annual letter we discussed how the current market environment has become inhospitable to short sellers. While that has largely remained true, we are beginning to see a shift towards more normalized price action. For example, the Goldman Sachs Non-Profitable Tech Index (GSCBNPTC) is ~25% below February highs and the Goldman Sachs Most Shorted Rolling Index (GSCBMSAL) is ~11% below January highs. Many stocks with dubious operating histories and questionable accounting practices have come under intense fire after blow-off tops.

The pockets of market froth we previously highlighted have significantly underperformed the broader market. It is easy to say that we could have been short these stocks with the benefit of hindsight. But the truth is that it was impossible to know when these baskets would have topped, and we could have been short during the face-ripping rally throughout the first six weeks of the year only to be stopped out of these positions close to the peak. This is part of what makes short selling so challenging. Timing and risk management can often be more important than the fundamental calls.

We have a long list of potential short opportunities. Post-merger SPACs alone will likely be a graveyard for years. On top of that, the pandemic has accelerated certain secularly declining industries, many companies have incurred an inordinate amount of incremental debt, and overly optimistic forward assumptions will reverse course. Suffice it to say, we believe there will be no shortage of good ideas.

## **LOOKING AHEAD**

Markets continue to be priced for perfection in an imperfect world. In a weird way, the new normal is like the old normal. We are back to an environment with high uncertainty, low prospective returns, elevated risk appetite, and the perception that clear skies lie ahead. We see numerous long-term headwinds for equity indexes broadly speaking, making stock selection a more important component for future returns.

Sincerely,



Alexander Agostino

## APPENDIX

### Appendix A: S&P 500 Price Return by Sector (Q1 2021)

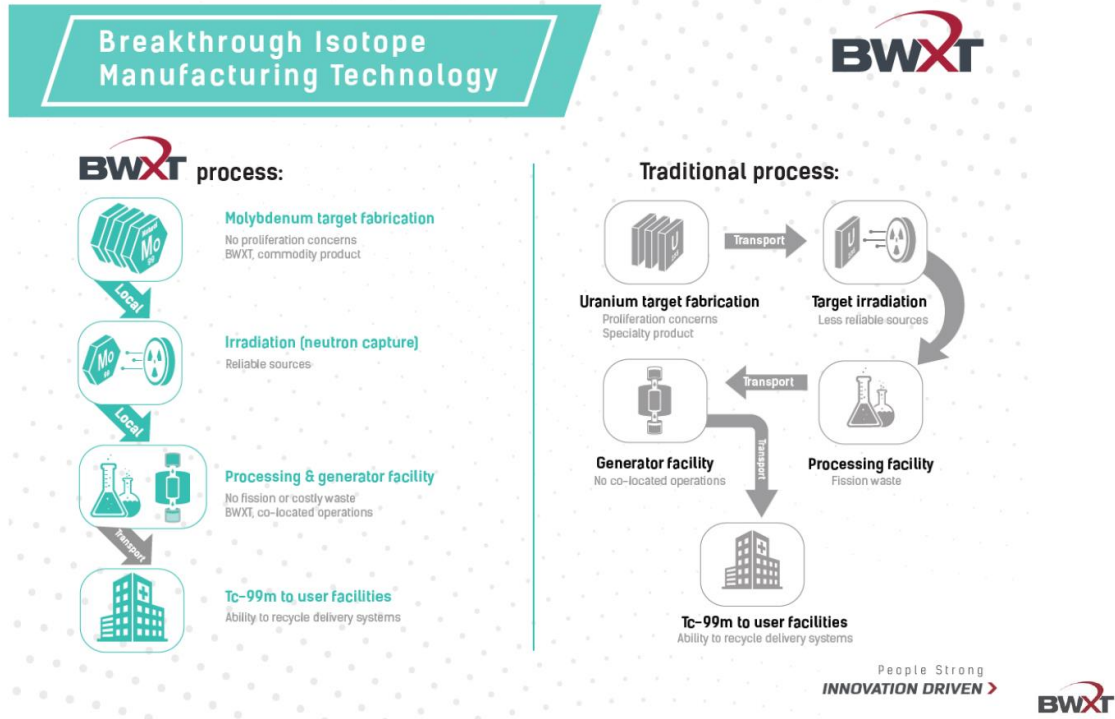


Source: Bloomberg

### Appendix B: U.S. Government Bonds 10 Year Treasury Yield



## Appendix C: BWXT Summary of Mo-99 Process Comparison (2019)



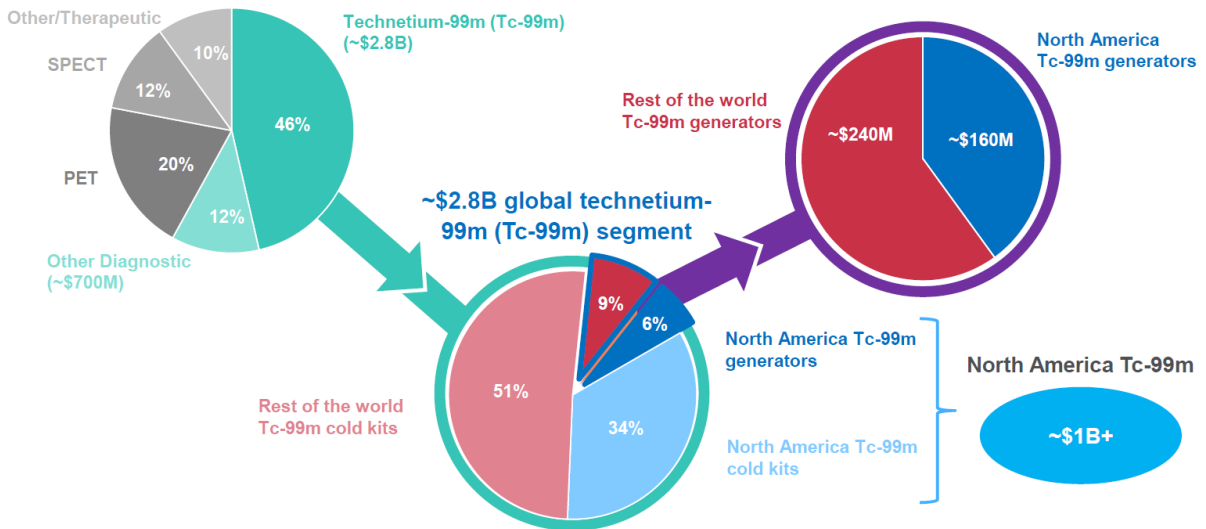
Source: BWXT 2019 Mo-99 Topical Meeting

## Appendix D: BWXT Medical Isotope Estimated TAM (2019)

### > Medical Radioisotopes – Global Technetium-99m Generator Segment

~\$6.1B Global Radiopharmaceutical Segment

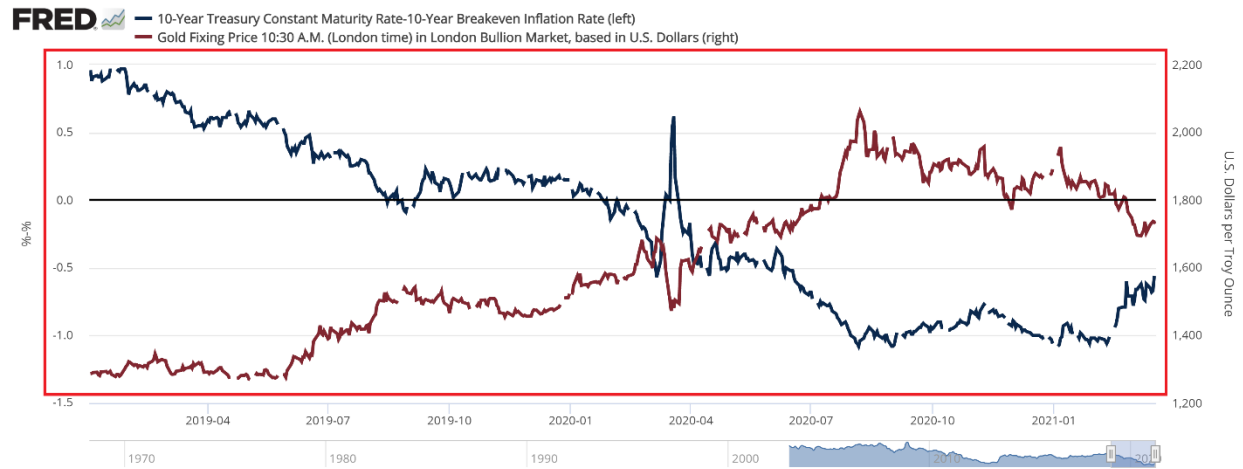
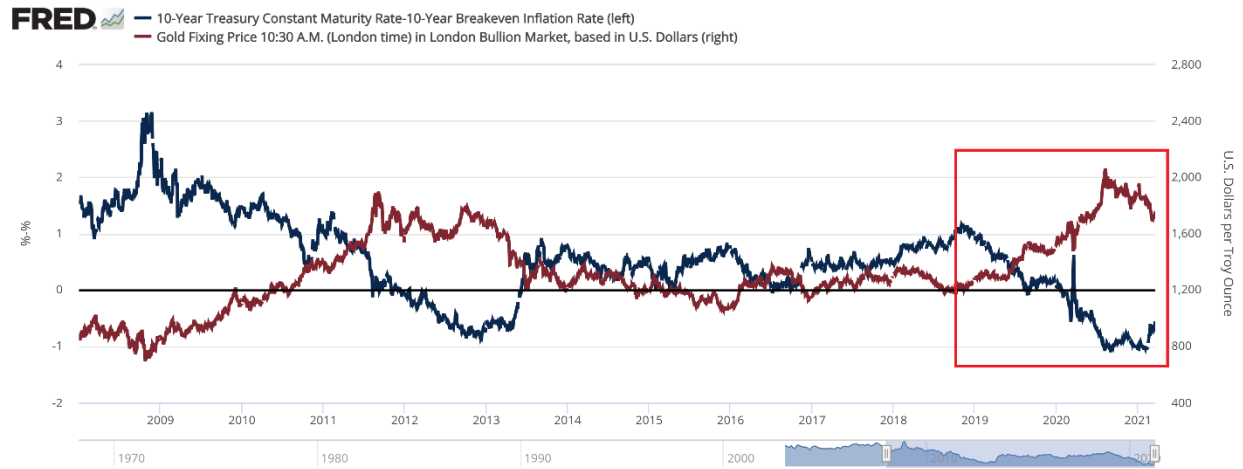
~\$400M+ Global Technetium-99m Generator Segment



Source: BWXT 3Q19 Investor Briefing



## Appendix E: Gold Spot vs. Real Rates



Sources: Board of Governors; St. Louis Fed; IBA

fred.stlouisfed.org

## **LEGAL INFORMATION AND DISCLOSURES**

*This commentary is intended for informational purposes only and should not be construed as a solicitation for investment in the Kinsman Oak Equity Fund. The Fund may only be purchased by accredited investors with a high risk tolerance seeking long-term capital gains. Read the Offering Memorandum in full before making any investment decisions. Prospective investors should inform themselves as to the legal requirements for the purchase of shares.*

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