



July 20, 2021

Dear Partner,

The performance of the Kinsman Oak Equity Fund was +2.7% for the second quarter of 2021, net of all fees and expenses¹ compared to the benchmarks set forth below.

Performance (%)	Q2 2021	YTD 2020
Kinsman Oak Equity Fund	2.7	6.4
S&P 500 Index	8.6	16.8
Russell 2000 Index	4.3	17.3
TSX Composite Index	10.2	21.2

COMMENT ON PERFORMANCE

The Fund increased in value by mid-single digits year-to-date. The Fund's gainers (Alphabet, Facebook, Colliers) were offset by its detractors (Gentex, Turning Point Brands, BWX Technologies) and combined for a slightly positive gain this quarter. Reported Q1 earnings and full year guidance for our positions generally exceeded consensus expectations.

Many companies we track beat earnings and raised guidance only to trade down shortly thereafter. We wonder how much optimism is truly baked into stock prices with both valuations and earnings expectations at all-time highs. None of the Fund's positions have been significant detractors to performance on a year-to-date basis.

MARKET COMMENTARY

We continue to believe tail risks to both the upside and downside remain extraordinarily fat. Churning continues beneath the surface and single stock volatility is higher than broad index returns may suggest. This year can be characterized by rolling corrections and factor rotations, primarily driven by yields and inflation expectations, with the underlying trend moving higher. It's easy to get whipsawed.

The actual strength of the U.S. economy remains difficult to gauge. Government stimulus programs and central bank emergency measures are still obfuscating traditional economic analysis. Headline figures suggest a robust recovery is underway, but we wonder exactly how much of that is artificial. What would consumer spending figures be without stimulus checks? What would the labour force participation rate look like without additional unemployment benefits? What would happen to the housing market if MBS purchases were scaled back? More importantly, so long as these measures continue, does it even matter?

Vaccine rollouts have largely been completed across North America but federal government and central bank "emergency measures" remain intact with no end in sight. We find it interesting, and somewhat amusing, that jawboning about a potential rate hike two years from now is considered hawkish.

¹ Individual performance may vary depending on Class of units held and subscription date.

Investor Sentiment Remains Euphoric

Citi Research maintains a proprietary Panic/Euphoria Model that charts the market's 12-month forward return versus investor sentiment dating back to 1987. Not surprisingly, these two factors are inversely correlated. Any sentiment indicator below -0.17 is considered panic territory and anything above +0.38 is considered euphoria. This week Citi Research's Panic/Euphoria model hit 1.06 (Appendix A).

Exuberance is pervasive and extends well beyond equity markets. For starters, many meme stocks mounted a noteworthy comeback. We can't think of another instance of widespread bubbles inflating, collapsing, and then re-inflating again with such vigor so shortly thereafter. Perhaps the upcoming Robinhood IPO will sound the alarm bell at the 'Meme Stock Top' in hindsight.

Real estate has gone parabolic partly due to input costs and partly due to supply shortages. Enthusiasm surrounding cryptocurrencies has waned somewhat but those along with NFTs are still wildly popular. Junk bonds have a negative real yield for the first time ever (HYG yields 3.5% vs. 5.4% inflation).

The market feels predominantly psychological at this juncture. A scenario where excessive liquidity is never withdrawn or reduced, earnings growth continues, and inflation pressures abate is a fine needle to thread. Historically, breadth narrows before tops occur, so we will be monitoring potential risks closely.

Labour Market Shortages

Labour shortages continue to be widely cited especially in the restaurant and hospitality industries. For instance, a McDonald's in Florida reportedly paid job applicants \$50 to show up to the interview.² Other fast-food chains are offering referral bonuses to employees and increasing hourly wages.³ Even large companies like Disney are having difficulty enticing individuals back to work and reportedly offered \$1,000 signing bonuses to recruit new housekeepers and kitchen staff at its theme parks.⁴

The number of job openings continuously hits record highs, but unemployment remains elevated.^{5,6,7} While these instances may seem anecdotal, we could continue to list numerous other examples. Many management teams we have spoken to tell us these are real problems, and the severity varies by state.

We are inclined to believe that this is one of the unintended consequences of offering overly generous supplemental unemployment benefits. Investors assume wage inflation translates to CPI inflation in a rather linear fashion. The line of thinking is as follows: a business experiences increased cost pressures and will push those incremental costs onto their end customers, causing inflation.

However, the process is more complicated. Businesses are typically unable to pass along large enough price hikes to completely offset rising wages, resulting in some degree of margin degradation. Rational decision makers will stomach increased costs so long as contribution margins from incremental volume remains positive. But if costs continue rising, there comes a point at which each new sale is unprofitable from a unit economic perspective. Under this scenario, sacrificing potential revenue growth is the best option for maximizing dollar profits.

² <https://www.businessinsider.com/mcdonalds-pays-50-for-job-interviews-highlighting-hiring-struggles-2021-4>

³ <https://www.dailymail.co.uk/news/article-9742549/McDonalds-offers-500-bonus-new-staff-Wendys-gives-100-Chipotle-increase-pay.html>

⁴ <https://www.bloomberg.com/news/articles/2021-06-25/disney-offers-1-000-signing-bonuses-nine-months-after-layoffs>

⁵ <https://www.cnbc.com/2021/06/08/job-openings-set-new-record-of-9point3-million-amid-economic-reopening.html>

⁶ <https://www.piiie.com/research/piie-charts/jobs-are-plentiful-unemployment-remains-high>

⁷ <https://fas.org/sgp/crs/misc/R46554.pdf>

Ultimately, fewer sales combined with margin degradation create headwinds for real GDP growth. Fiscal spending measures, as well-intentioned as they may be, create short-term tailwinds but knock-on consequences stifle sustainable economic growth. Everybody seems to be focused on the first order effects from wage and commodity inflation, but we feel concerns from second order effects such as disappointing economic growth will come into focus. Bizarre labour market conditions are another reason why ascertaining true economic health is difficult.

RECALIBRATING

Long duration technology stocks that were trounced last quarter reversed most of that underperformance as yields plummeted (Appendix B). We previously discussed our belief that secular inflation was far from a foregone conclusion. Anything was possible but having that much conviction seemed premature. The overcrowded reflation trade unwound rather quickly, as things tend to do when participants overwhelmingly clamour towards one side of the boat (Appendix C).

Right now, we view the market to be in a period of recalibration of sorts, where the consensus will likely meet somewhere in between the two extremes until the future becomes clearer. Yields are basically the fulcrum underpinning factor rotations and underlying market structure dictates a lot of price action too.

Disruptor Tech Has Become Very, Very Expensive Again (Briefly Only Very Expensive)

While many tech stocks experienced significant selloffs during the first quarter, almost none of them would have been considered cheap even if you bottom-ticked the lows. Software investors will tout business quality, disruption, exponential growth, network effects, and Wright's Law until your ears fall off. But the reality is the hurdle that needs to be cleared in order to justify 20-50x EV/Sales is almost unfathomable even if your business becomes a government guaranteed monopoly.

Investors point to the FAANGM stocks as if companies of a similar calibre grow on trees. For every Amazon there is a wasteland of other companies that had promising growth prospects all the way to zero. Simply put, they are exceedingly rare. It is also worth noting Facebook went public at ~11.5x EV/Sales and promptly declined by more than half to a trough valuation of ~5.5x EV/Sales, while growing revenues by 55% and generating a profit at the same time. Investors buying shares of "ultra-high growth disruptors" are doing so at far worse starting valuations than the FAANGM stocks ten years ago that it makes any comparison between these two groups plainly absurd, even if we ignore the difference in business quality.

"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes which is very hard. And that assumes you pay no taxes on your dividends which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at \$64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?" – Scott McNealy, CEO, Sun Microsystems, April 2002⁸ (Appendix D)

⁸ A Talk with Scott McNealy – Bloomberg Businessweek (<https://www.bloomberg.com/news/articles/2002-03-31/a-talk-with-scott-mcnealy>)

Value Buying Opportunity

On the flip side, value stocks experienced significant drawdowns during the second quarter, and we believe many are oversold. The reflation trade unwound to the point where sentiment has swung too far in the opposite direction. We took the opportunity to add shares of cheap stocks that we feel possess favourable risk-return characteristics. We would rather have a strong FCF yield setting a floor under our stock prices at this point in the market cycle than an implied floor derived from perceived business quality or unrealistic terminal value growth rates.

PORTFOLIO UPDATE

The Fund held sixteen long positions and no short positions as of the end of the second quarter. Net exposure averaged ~75% over the past three months. The long book ended the quarter 80% net invested. Going forward, new long positions and any increases in existing positions will be offset by building out the short side of our portfolio.

LONG POSITIONS

The breakdown of the Fund's sixteen long positions are as follows: thirteen are U.S. listed and three 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.

Turning Point Brands (TPB) – Long Position

TPB continues to be a volatile stock, but business execution has been admirable since we first initiated our position. The company has put forth consecutive beat and raise quarters, announced a few tuck-in acquisitions, and recently promoted a new CFO. We view these developments as positives for the stock. We believe TPB remains undervalued at ~14x FY22 EPS and ~10x FY22 EBITDA.

Gentex Corporation (GNTX) – Long Position

In our view, concerns about chip shortages have been weighing on GNTX. Auto manufacturers will experience bottlenecks in new vehicle production if they cannot procure critical components. But we continue to believe these business disruptions are a temporary problem that is more than priced into the stock today. Inventory depletion among auto retailers persists which will eventually have to get fixed one way or another (Appendix E). We believe ~13x FY22 EPS ex-cash is simply too cheap for a high-quality industrial company with 32% EBITDA margins, minimal maintenance capex, and a pristine balance sheet.

Facebook (FB) – Long Position

Our thesis on Facebook is largely playing out. The company overwhelmingly beat Q1 earnings estimates, and the growth outlook continues to look positive from here. Falling yields also benefitted the stock price as well. We continue to believe Facebook is attractively valued at ~12x FY22 EBITDA given its deep economic moat and underrated growth prospects.

SHORT POSITIONS

We have been exceedingly patient deploying the Fund's initial seed capital on the long side of our portfolio. Going forward, any additional increase in long exposure will be met with offsetting short exposure so we can maintain a relatively stable net exposure over time. Individual position sizes as a percentage of NAV will always be much smaller in our short book than our long book.

LOOKING AHEAD

Investor sentiment remains firmly in euphoric territory and there are obvious pockets of gross overvaluation across certain asset classes and sectors. We continue to see opportunity on a stock-specific basis and will accumulate shares while being cognizant that the broader market appears to be very stretched. We feel many of our more off-the-beaten-path ideas should compound healthy returns over the next few years regardless of what happens from a macroeconomic perspective.

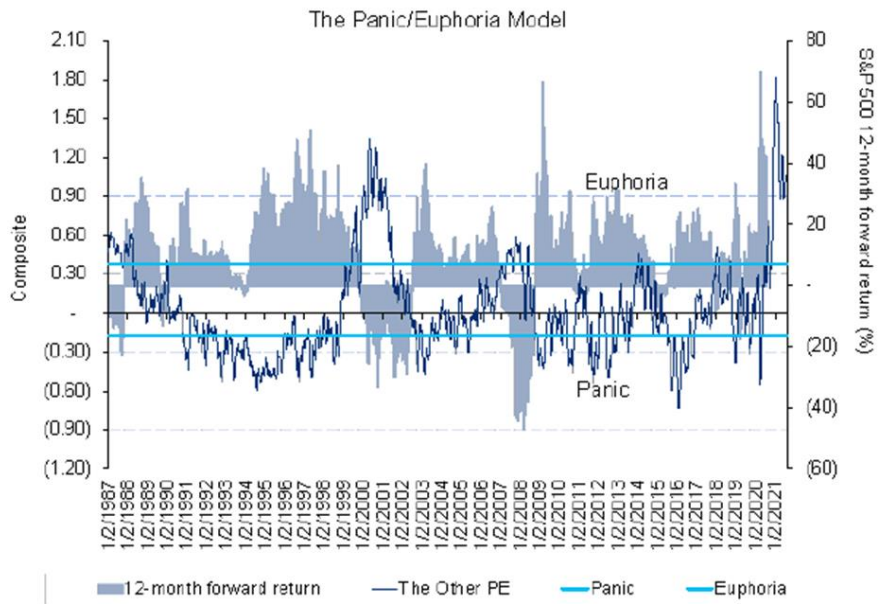
Sincerely,

A. Agostino

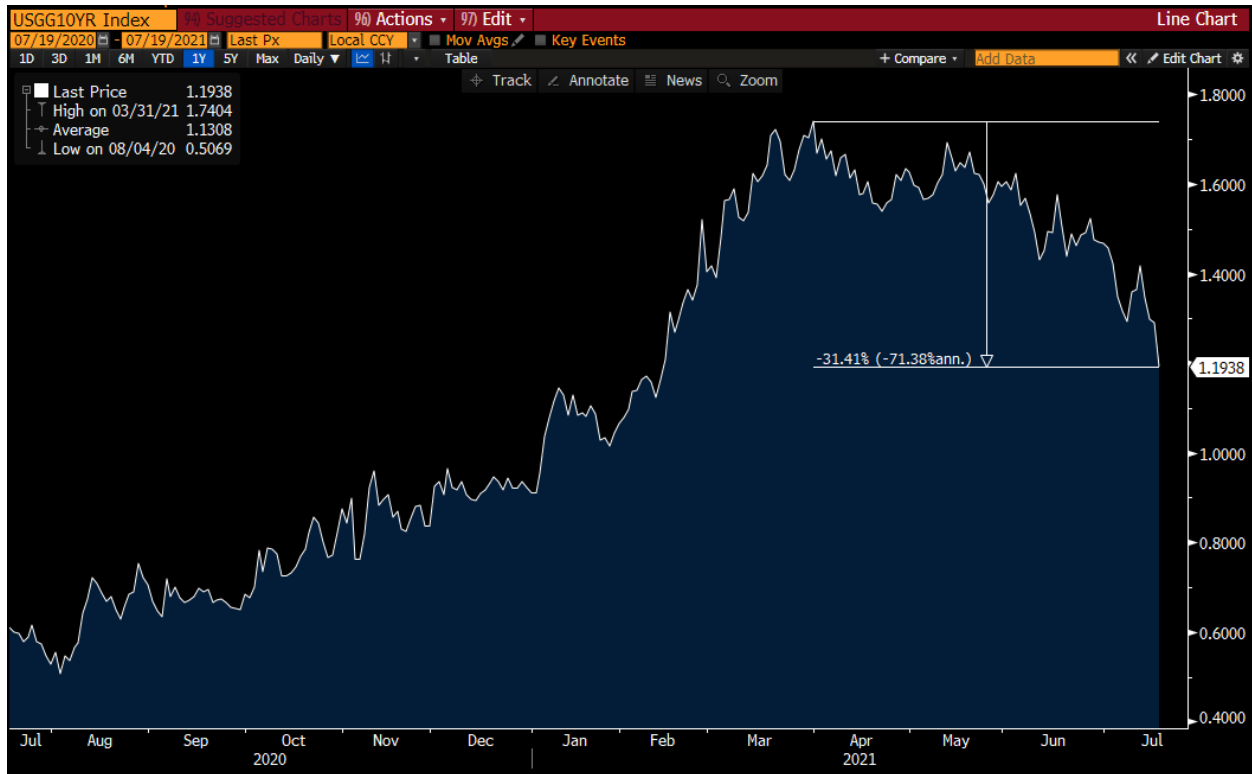
Alexander Agostino

APPENDIX

Appendix A:



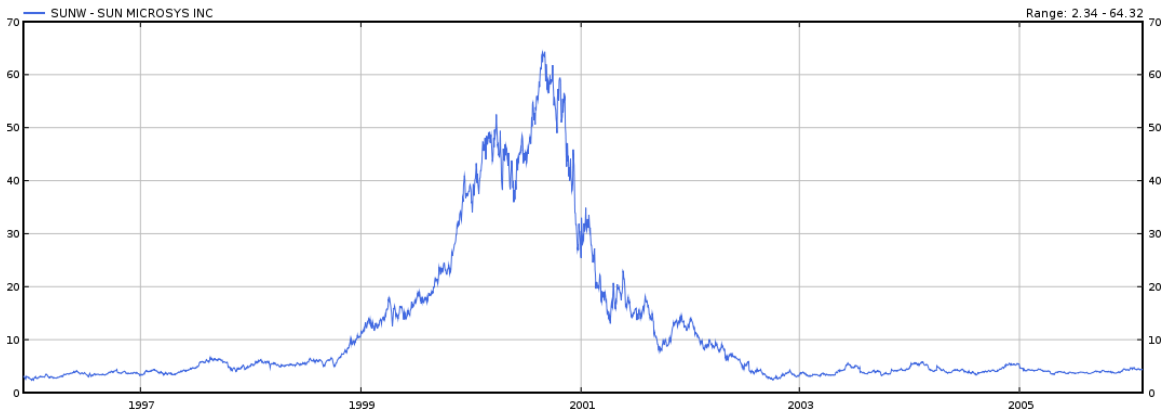
Appendix B:



Appendix C:



Appendix D:



Source: The Felder Report
 (<https://thefelderreport.com/2017/10/26/what-were-you-thinking/>)

Appendix E:

Inventory - New Vehicles	FY19	FY20	1Q21	%
ABG - Asbury Automotive	802.6	640.0	527.5	-34.3%
AN - AutoNation	2,490.8	1,761.9	1,363.6	-45.3%
LAD - Lithia Motors	1,704.1	1,556.6	1,432.4	-15.9%
PAG - Penske Automotive Group	2,346.2	1,810.9	1,671.2	-28.8%
SAH - Sonic Automotive	983.1	648.4	602.7	-38.7%

Source: Company Filings

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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