



January 2022

	MRCM Long Short Small Cap	IWM (Russell 2000)	Barclay Hedge Fund Index		MRCM Long Only Large Cap	SPY (S&P 500)
Annualized Since Inception	24.9%	14.0%	7.4%	Annualized Since Inception	21.2%	17.0%
Q4 2021	(1.3%)	2.0%	1.2%	Q4 2021	7.5%	11.1%
2021	42.5%	14.5%	10.0%	2021	20.4%	28.7%
2020	29.5%	20.0%	11.0%	2020	54.3%	18.3%
2019	17.9%	25.4%	10.6%	2019	25.2%	31.2%
2018	15.7%	(11.1%)	(5.2%)	2018	(6.0%)	(4.6%)
2017	35.7%	14.6%	10.3%	Dec 18 - Dec 31	0.1%	(0.5%)
2016 (Jul-Dec)	1.3%	18.7%	5.4%			

Note: All returns are net of management and performance fees. Past performance is not indicative of future results.

The large cap portfolio returned 20% for the year. While this is a strong result on an absolute basis, it lagged the S&P.

One of our largest contributors was Ferguson (“FERG”). The company was busy from a strategic perspective, having divested its non-core UK business, created a dual stock listing, and initiated a \$1bn share buyback program. They are currently preparing to move their primary stock listing from the UK to the US. This should lead to their inclusion in the S&P 500 index and improved trading liquidity – both good things for the stock. FERG has also executed well fundamentally. Organic growth over the last few quarters has been in the low 20% to which the company has augmented their usual barrage of smaller acquisitions. While the uplift in construction activity has surely been a boon to the topline, FERG has continued gaining share within the industry. To this point, in a time when securing product is difficult, they have been able to leverage their relationships with over 45,000 global suppliers. Margins have been particularly strong given the dramatic increase in commodity prices; though this may turn from tailwind to headwind over the next several quarters, the company anticipates offsetting much of this through scale benefits and other internal initiatives.

The largest detractor for the year was our position in Activision (“ATVI”). ATVI took multiple legs down during the year as they became the defendants of a sexual harassment lawsuit and faced a wave of incriminating press from journalists. To make matters worse, it became apparent that ATVI was struggling in their response to the crisis at hand. While I find such actions truly deplorable, my job as an investor is to assess the situation and determine whether or not the company’s valuation accurately reflects these associated risks. Unfortunately, I miscalculated the impact that these factors would have on the company. My initial rationale was that sexual harassment lawsuits are not uncommon and would be settled with compensation – given ATVI’s size and balance sheet, this would not be a crippling event. Furthermore, with a deep catalog of proven games, ATVI’s earnings stream is predictable and less reliant on new hits.

What I did not properly consider was that the company’s true asset is not its catalog but rather its employee base. Video games are a form of art and need creative developers to build stories that draw

users in and keep them engaged. Whether it is brand new content or an iteration of a previously successful title, the quality of the work, and therefore bench of developers / creators, matters. It is clear that the culture at ATVI was unhealthy. Changing that will not be easy. It will make it difficult for the company to attract new talent and retain key employees. From a financial perspective this could lead to delays in game production and perhaps less successful products. I exited our position given these risks.

The small cap portfolio increased 42% for the year, our best since inception. The largest contributor was one of our smaller investments from 2020, Leatt (“LEAT”), that was up 340% during the year and is up over 10x since our initial purchases. LEAT is a niche provider of safety accessories for moto-cross and downhill biking enthusiasts. When I initiated the position, I saw an off the radar company that was poised for a step-change in revenue and earnings growth. Additional product price points, new product releases (the company now touts being a head-to-toe company), and expanded category reach (initially they were just a moto company) all served as upside optionality. Given covid tailwinds and the company’s attractive valuation, I thought our downside was limited. Potential catalysts included increasing shareholder recognition and an uplisting / index inclusion. While there were a few red flags, as is often the case amongst nano-cap stocks, these were overcome by management’s transparency, the historic lack of dilution, and a strong margin profile at just \$30mm LTM revenue.

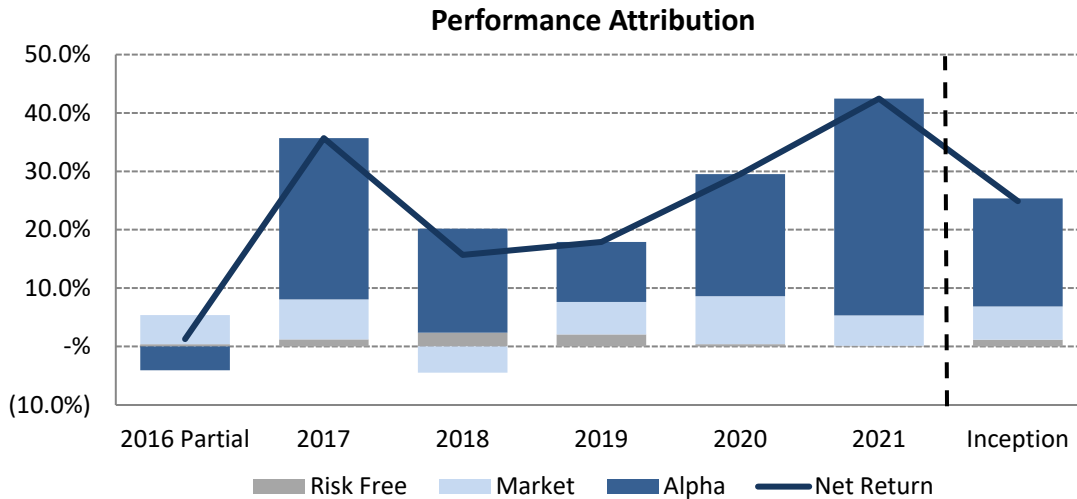
LEAT has executed superbly over the past 6 quarters with LTM revenue more than doubling to \$62mm with a corresponding increase in margins. Importantly a large part of these gains has been driven by company specific performance. LEAT is trading at about 1.8x 2021 revenue and 7x EBITDA. These are attractive levels given comparable outdoor valuations and the company’s normalized growth trajectory.

Our biggest single-name detractor for the period was Lensar (“LNSR”). Not much is new from a fundamental perspective. Revenue has rebounded from the covid lows and the company is nearing the launch of ALLY, its joint phacoemulsification and laser system for cataract surgery. Frankly the stock just has little investor appetite given its small size and negative cashflow profile. I anticipate this changing should ALLY prove to be a success. Even if ALLY fails to gain steam, eliminating the incremental investment expenses would dramatically change the earnings profile of the core business.

At the risk of sounding arrogant, I will say that we left some money on the table (we were flat since June). I’ve talked a lot in the past about our largest position, Rocky Brands (“RCKY”), but once again feel that an update is due. In November the company whiffed on earnings sending the stock down 22% and it continued to trade weak through the end of year. Revenue came in below expectations, not due to a lack of demand but rather a lack of supply. This failure appears to be mostly self-inflicted as RCKY just couldn’t ship boots out of their distribution center. Transitioning the acquired business into their facility got pushed towards the busy season and the company couldn’t handle the increased throughput. This led to all sorts of scary things like an earnings loss and significant draw on their credit facility.

Whenever I see a big surprise like this, I like to ask myself if it will matter in a year or two. Assuming the company does not face any liquidity issues I think the answer is a resounding no. Underlying demand remains strong with order growth up mid-30% QoQ for the combined business. Customers have largely maintained orders as other manufacturers have been unable to deliver due to global supply chains. From here the question moves onto what RCKY is doing to address the foot fault. Improvements have already been made at their Ohio facility and they are in the process of bringing the new Reno distribution center online. Q4 will likely be sloppy and things will probably not be perfect in Q1 either. Nonetheless, my fundamental thesis remains intact.

As I have included in the past several years, the chart below provides performance attribution of the portfolio. Over the past 5.5 years we have gained nearly 25% per year. 1% has come from the risk-free rate and almost 6% from the market (the Russell is up 14% during this period but our portfolio has had a beta of 0.41). The remaining 18% of returns have come from good stock picking.



This year has gotten off to an interesting start with a noticeable decline in most indices and surge in volatility. We have lived through a handful of periods in the last decade alone where declining prices drive narratives. Frankly, it might take a minute or two to recall exactly what all of the risks were that dominated so much brain power at the time. Instead of focusing on what the market is doing, we must turn our attention to the quality of the businesses that we own and the price we are paying for them. In this regard, I feel good about our portfolio and am not terribly concerned about their longer-term outlook.

I hope everyone has a happy and healthy 2022!

Sincerely,

Aaron Sallen

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