



## April 2022

	Merion Road Small Cap Fund	IWM (Russell 2000)	Barclay Hedge Fund Index		MRCM Long Only Large Cap	SPY (S&P 500)
<b>Annualized Since Inception</b>	<b>24.4%</b>	<b>11.9%</b>	<b>6.5%</b>	<b>Annualized Since Inception</b>	<b>15.6%</b>	<b>14.7 %</b>
<b>Q1 2022</b>	<b>3.4%</b>	<b>(7.5%)</b>	<b>(3.0%)</b>	<b>Q1 2022</b>	<b>(14.3%)</b>	<b>(4.6%)</b>
<b>2022 YTD</b>	<b>3.4%</b>	<b>(7.5%)</b>	<b>(3.0%)</b>	<b>2022 YTD</b>	<b>(14.3%)</b>	<b>(4.6%)</b>
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. Returns for the Merion Road Small Cap Fund for the period prior to fund launch (01/13/22) reflect a basket of SMAs.

The Long Only strategy was down 14.3% in Q1. This is roughly comparable to our loss in Q1 2020 during the covid sell-off. The obvious difference between the two periods is our relative (under)performance versus the broader market. While I am disappointed in these results, it bears reminding that my job is to focus on generating attractive risk-adjusted returns over many years, not a few months.

Another difference between these two periods is that I have become incrementally cautious on deploying capital. At the start of the year, I did not view the risk of rising interest rates as a meaningful concern. It appeared that a lot of inflationary pressures were driven by too much demand, a result of excessive money printing, direct stimulus, and low borrowing costs. Furthermore, I believed supply chain bottlenecks would ease as the lingering effects of Covid dissipate. While higher interest rates could lead to multiple contraction, my opinion was that the growth in our company's earnings would ultimately offset this headwind.

From an economic standpoint the war in Ukraine has created hard to solve challenges that are likely to create additional headwinds. Disruptions to the global agricultural/fertilizer and energy sectors have led to increasing prices in many commodities. Absent the removal of sanctions and resumption of Western business activities in Russia, it is hard to see supply revert. In short, prices should remain elevated until there is a meaningful reduction in demand. In a worst-case scenario, we are looking at even higher interest rates, increasing risk-premiums, and reduced earnings generation. When analyzing our portfolio construction, I have to incorporate these factors into my valuation assessment. The net result is that I have pared back on those positions where the majority of value comes in the distant future and have been more conservative in my growth projections. I have also included some commodity exposure into the portfolio (specifically potash, an industry I have loosely followed for several years); valuation appears reasonable for these names and they serve as protection in a low growth / inflationary environment.

By far our largest detractor so far has been Ferguson ("FERG"), accounting for a 4% hit to the portfolio. From a market perspective the stock has sold off along with the rest of the construction industry largely

due to the fear of higher rates / economic uncertainty impacting housing demand. I am not entirely sold on the thesis that new housing starts are going to fall off a cliff as we remain woefully underbuilt (February starts were down 1.9% vs. January but up 7.7% vs. February last year). In any case, 60% of FERG revenue comes from renovation, maintenance, and improvement, an inherently more stable business. Furthermore, 56% of their revenue is non-residential which is less impacted by rates. In the near-term FERG actually benefits from rising commodity costs as it provides a boost to margins.

Last quarter I discussed FERG moving their primary listing to the U.S. as a positive for the stock. While this remains true, I did not appreciate the short-term trading dynamics. European index funds are currently selling their holdings as the stock no longer falls within their mandate. Conversely U.S. index funds will buy the stock after the move is completed and enough time has passed. Analysts estimate that European index funds account for 10% of shares outstanding while U.S. index funds will own 20% of the shares – a 10% net increase in demand. The issue is timing. European indices are selling ahead of the move whereas U.S. indices will not add for another year or so. I would not be surprised if this “artificial” selling pressure has been impacting the market value as well.

Given what I have discussed so far you might be surprised that I built a new position in Peloton (“PTON”). PTON has had a rollercoaster ride in the public markets. Following their 2019 IPO at \$29 the stock rocketed to over \$160 at the peak of the covid hype, before tanking to its current price in the mid-\$20’s. The company has basically checked the box on any negative event you could think of. A few standouts include cutting guidance (May 2021, November 2021, January 2022), major strategic gaffes (overbuilding supply capacity, flip-flopping on price cuts), and poor/misleading communication (raising capital 2 weeks after stating there was no need to raise capital). So why would I own this?

Peloton (the product, not the stock) has a strong brand name, value proposition, and customer loyalty. Despite their woes the company has built an established base of users that should be highly valued. The market is currently telling us that their 2.7mm users are worth \$2,600 per subscriber, or just 7.5x subscription gross profit. Simplistically this assumes  $1/7.5x = 13\%$  annual attrition which is more draconian than current levels of ~10% (of course giving no credit for future growth).

The biggest fear is that churn will increase as the “covid cohort” cancels their accounts. While this risk is hard to disprove near-term, it fails to consider that PTON had over 700k subscribers (25% of its current base) prior to covid. I would have to assume that these are “die-hard” Peloton users; even if churn increases for the rest of the subs, this cohort will likely persist. A similar, albeit less clear, argument can be made for the 1.1mm subscribers who have joined in the last twelve months, well after peak covid. Usage metrics provide a good insight into future churn. Last quarter subscribers worked out on average 16 times per month – while this is down from the covid peak of 26, it is well above the December 2019 quarter at 13.

PTON has done an admirable job of providing additional services to keep their users engaged. This is predominately seen in the expansion of class offerings to include non-cycling workouts like running, strength, yoga, and meditation. The company can monetize these services by providing additional products like Tread, the recently released Guide, and apparel. More importantly, however, these products improve the value proposition of classes and make users stickier.

The company has recently brought on Barry McCarthy to serve as the new CEO. Mr. McCarthy was previously the CFO of Spotify (arguably the best music streaming product) and CFO of Netflix (the best video streaming product). He seems like the perfect person to capitalize on PTON’s established position

as the go to streaming fitness company. He has already begun to test new pricing models including a no fee hardware / more expensive subscription model. While this would increase the upfront cost of a new subscriber and extend the payback period, it has the potential to expand the overall market and create a higher lifetime value per customer. It is entirely too early to determine if this will be rolled out beyond test markets, but it is encouraging to see the company think outside the box. Mr. McCarthy was granted the right to acquire 8mm shares of PTON at \$38.77.

Our Long Short portfolio has performed well despite the market turbulence and ended the quarter up 3.4%. Our long holdings generally reported strong earnings and bounced back from a weak Q4. Our hedges and alpha shorts also provided positive contribution.

During the quarter I added to Sportsman's Warehouse ("SPWH"). SPWH is an outdoor sporting goods retailer with about half of their revenue coming from hunting & shooting products (guns, ammo). I initiated our position back in December following their failed merger with Great Outdoors on the grounds of anti-trust concerns. It appeared that the stock was being sold off indiscriminately by merger arbitrageurs and valuation seemed attractive, particularly after adjusting for the receipt of a \$55mm termination payment and unwind of excess inventory.

While the dust has largely settled from an investor base perspective, SPWH remains attractively priced with a few upcoming catalysts. Fundamentally the company is well positioned. Following the tragic Parkland school shooting two large competitors to SPWH, Dicks Sporting Goods and Walmart, made the decision to exit the category; their absence makes the competitive landscape for SPWH a lot more favorable than in prior years. Furthermore, it is no surprise that gun and ammo sales during covid experienced tremendous growth. Unlike prior cycles, however, this wave saw an increase in new gun buyers rather than purchases by existing owners. SPWH estimates that over the past 18 months the industry created 12mm new firearm owners; using a prior base of 100mm, this implies an increase to their addressable market of 12%. The company is executing on many other internal initiatives including store expansion, omni-channel growth (e-comm up to 15% of revenues), loyalty programs (at 3mm members) and new co-branded credit cards.

The biggest question this year was what SPWH would do with its excess capital. In March the company announced that they would spend \$75mm over the next 12 months repurchasing stock; at the current price that amounts to 15% of the market cap. The company should benefit from a further unwind of capital as inventory/sq. foot reverts to normalized levels. Lastly, I expect strong financials, despite the pull-back in gun sales, as the company executes on their standalone organic growth strategy.

Sincerely,

A handwritten signature in black ink, appearing to read "Aaron Sallen". The signature is fluid and cursive, with a long horizontal stroke at the end.

Aaron Sallen

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