



October 2022

	Merion Road Small Cap Fund	IWM (Russell 2000)	Barclay Hedge Fund Index		MRCM Long Only Large Cap	SPY (S&P 500)
Annualized Since Inception	18.8%	7.3%	4.5%	Annualized Since Inception	7.2%	7.9%
Q3 2022	(11.5%)	(2.1%)	(2.0%)	Q3 2022	(6.4%)	(4.9%)
2022 YTD	(13.9%)	(25.1%)	(11.5%)	2022 YTD	(36.1%)	(23.9%)
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.

This was a disappointing quarter. I feel the pain both as an investment manager with the desire to do well for my clients, and as an investor in the fund. Maintaining an even keel when emotions are running high is a critical determinant of long-term success. Our investment horizon naturally shrinks when facing losses. While this urge makes sense from an emotional standpoint, it is not necessarily in our best interest. Rather we should extend our investment horizon exactly when others shorten theirs.

The Long Only portfolio fell a bit over 6%. Portfolio returns continued to get dragged down by some of our core holdings in large-cap technology like Alphabet (“GOOG”). The market positioning and long-term opportunity set for these companies has not changed. Current prices obviously reflect increased macro-economic risks and risk-free rates/premium. But it’s hard to argue that these risks are not reflected in the price or that GOOG should be disproportionately hurt by rising rates when it is trading at a mid-teen multiple of free cash flow. In any case, GOOG is a secular winner when we look beyond a few months or years. Or take Ferguson (“FERG”) which continues to languish at its lows. Earnings over the next twelve months will likely be lower than the past twelve months. But investing in a moat-y business in a fragmented industry with a strong balance sheet/free cash flow profile should work well over the course of a cycle.

Peloton (“PTON”) is quite a different story. You may recall from my Q1 letter that I initiated a position in the stock given the potential for a new CEO to leverage the company’s passionate and engaged userbase. The investment had meaningful upside potential (multiples of the then trading price), but also presented real downside risk; as such, I kept our exposure to just a few percentage points of the portfolio. Fast forward six months and underlying trends like churn, engagement, and new users weakened dramatically. I sold our shares as the likelihood for the company to achieve financial success has become increasingly remote.

I am actively looking for new ideas and started dipping my toe in Six Flags (“SIX”). SIX is another turnaround situation. Unlike PTON, SIX is backed by hard assets and has a history of stable earnings. New

management is looking to grow EBITDA to \$700mm vs. the \$525mm range over the past several years, covid aside. Their strategy is to effectively reduce traffic and increase price, while prioritizing capital spend on high return projects. Results have admittedly been mixed so far. But even assuming no benefit from the new initiatives, the company is trading at a reasonable valuation of 11x EBIT.

The Long Short portfolio had its worst quarter since inception in what was a benign period for the Russell, despite significant volatility. I maintained a relatively constant beta exposure of ~0.30 so this was not a function of trying to time the market and getting caught off-sides. Our positions simply did not perform as expected. This is reflected in the alpha (stock performance irrespective of the market) of negative 11.5%. Up until this point, my worse quarterly performance from an alpha perspective was negative 4.9% in Q4 2020; interestingly enough, the Russell was up over 30% during that period and I just had a hard time keeping up.

The question is what happened and what do I have to do to prevent a reoccurrence. Our short positions benefitted returns by almost 2%, a more than acceptable outcome given our exposure. The long book, on the other hand, accounted for a 13% loss. Positions where I believe the market is entirely too bearish, and I have been holding or adding, represented 7%. I do not want to entirely dismiss these mark-to-market losses as assets are fungible. But it would be a mistake to conflate errors with idiosyncratic movements over relatively short horizons. Given our focus on small cap names, it does not take a lot of selling or buying pressure to move a stock. The largest detractor in this bucket was Westwood Holdings (“WHG”), which fell 30%. It’s easy to understand why WHG would face pressure in a tough economic backdrop, but at an EV/AUM of just 0.2% valuation is strikingly low. Small asset managers have routinely been acquired at a median of 1.0% of AUM. Our prior holding, Manning & Napier, has agreed to be acquired at 0.9% of AUM and Pzena management announced in July that they would take the company private at an EV of 1.7% of AUM. In either case, I anticipate a meaningful increase in both margins and earnings once WHG closes on their acquisition of Salient.

The remaining 6% of losses on the long side relate to positions where I got it wrong. Our largest loss came from a position that I have held since covid. I erred in owning a cyclical company that would be disadvantaged during a sustained slowdown (lacks the balance sheet or business quality to take advantage of opportunities that may arise). It was a painful reminder of anchoring bias and the need to constantly look at the portfolio with a fresh set of eyes. On the positive side, these detractors were partially offset by our position in BBQ Holdings which was acquired for \$17.25 vs the Q2 close price of \$10.42.

During the quarter I initiated a position in America’s Car-Mart (“CRMT”). CRMT is a used auto retailer and financing company serving low-end consumers. Given their focus on rural areas with limited public transportation, CRMT offers an essential service – a way for poor credit quality customers to get to work. As you might expect, loan charge-offs have averaged 25% annually and typically occur when a customer loses their job or the car breaks down. To offset this risk, CRMT charges a hefty 16% annual rate.

You might wonder why I would buy this given the economic sensitivity of the low-end consumer and falling auto prices. Should unemployment pick-up we will likely see increasing loss incidence rates. And with falling auto prices it would be logical to assume that their upfront margins would compress and loss recovery rates would fall.

Over the past two decades CRMT loss reserves peaked two times to the 32-35% range. In both of these periods CRMT loss expenses exceeded actual charge-offs of 30-33% as the company had to increase their balance sheet reserves. The good news is that, today, balance sheet reserves are already at the high end

of the range at 22.4%. Even considering those previous catch-ups, CRMT has been profitable in every year over this time frame. Of course, it is entirely possible that we enter another period of high charge-offs. But these are relatively short-term loans (42 months on average) where the majority of defaults occur within the first twelve months. Given the quick turnaround, CRMT has the opportunity to adjust its underwriting standards in real time. As of last quarter loan's delinquent 30 days or more stood at 3.6%, slightly below the long-term average. Furthermore, in April of this year the company financed half of their loans via a non-recourse securitization. Not only does this diversify their funding sources, but it also helps ringfence some risks to the enterprise.

Regarding used auto prices, deflation is not necessarily bad for the company. CRMT's customer is extremely price sensitive. Given the recent lack of supply and run-up in prices, CRMT took the strategic decision to sacrifice on upfront margin to get people on the road. Additionally, some customers were simply priced out of the market. While it is possible that falling prices will hurt near-term margins as the company works through old inventory, long-term lower prices are preferable.

CRMT has a strong history of creating shareholder wealth through organic growth and capital returns. This is no surprise as management and directors own 12% of the company. Over the last decade they have shrunk shares outstanding by 32% while increasing tangible book value by 150% (tangible book value per share has increased 270%). Their unique approach to auto sales and loan generation has allowed the company to generate ROEs in the mid-teens. We can buy this company today at just 0.85x TBV (i.e. 17% "normalized" annual returns exclusive of multiple expansion), an attractive entry point when we look out beyond the immediate term.

Sincerely,

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

Aaron Sallen

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