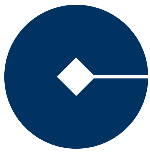

CENTERSTONE INVESTORS

LET THEM EAT CAKE?

SEPTEMBER 30, 2021

DEAR FELLOW PARTNERS & FRIENDS,

The third quarter was a period of consolidation, especially for companies exposed to the normalization of economic activity. It is not surprising to see this ebb and flow, as the COVID-19 storm slowly–excruciatingly slowly–drifts off into the horizon. I was reminded of the importance of patience this summer as I was in the backyard. New to the Connecticut countryside, I am a little nervous about going outside at night. It is dark and we have bears as neighbors! The upside is that stargazing is on a whole other level. This August perched above a full moon were Saturn and Jupiter. As I studied the rings of Saturn in amazement, I wondered about the astrological meaning of the planet. Wouldn't you know it, Saturn signifies hard work, discipline and above all–patience. While our stocks continue to find their way through the labyrinth of COVID-19, it was a timely reminder that change will eventually come, even if slowly.

Patience is especially required when investing in cyclical and emerging market companies, such as those found in the Centerstone portfolios. The increased weighting of these holdings is a function of our fundamental bottom-up research process and the strong performance of these investments since last March. The stock prices of many of these investments took a healthy breather last quarter. After a strong run since last March, the MSCI Emerging Markets Index retreated this past quarter. The Centerstone Investors Fund (CENTX) and the Centerstone International Fund (CINTX) have exposures of approximately 14% and 19%, respectively to this segment of the market and were thus impacted. Since the Funds have minimal overlap with a typical index or fund, the difference between our Funds' performance and that of others can be magnified at times. The past three months are a good example of this phenomenon, as the post-COVID-19 rebound narratives gave way to the narratives of the Delta variant—goods inflation and product shortages.

We believe the reason emerging markets retreated this past quarter is quite straightforward. With vaccination rates well behind the developed world, the economies are in a constant stop-and-start pattern based on domestic infection rates. Europe similarly lagged the US for a while, but with vaccination rates doubling every month it only took a few months to catch up. Much of the emerging world is following the same pattern, whether we look at Asia or Latin America. At the current rate of progress, we believe the vaccination rates should catch up to that in the US and Europe in mere months.

In our view, a "new normal" is right around the corner which drives our confidence that the Funds are well-positioned for the years to come. It is never enjoyable to give back performance, but divergent performance comes with investing differently. In our experience, we believe the key to successful investing is remaining patient through the gyrations at the bottom of the cycle. If all goes well, we think the ride should become smoother in time.

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The upside to this environment—at least for the research-obsessed like ourselves—is that there has been plenty of new companies to research and analyze. While some headlines, like those relating to the meme stocks, purely provide ongoing entertainment, others are creating fear and volatility, such as China's crackdown on its capital markets and the possibility of credit contagion in its highly leveraged economy. And of course, the ongoing inflation debate. Consequently, we find ourselves with plenty of research to do.

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Inflation & Debt

After the early inflation flag we raised in our first quarter commentary titled *Value Investing Canceled?*, the debate has settled on whether the massive policy interventions will result in a lasting or transitory inflation pickup. We believe this debate is a diversion from what will be the more lasting effects of the government borrowing binge.

Government debt-financed spending is not "good" or "bad," it is either "productive" or "nonproductive." What matters is how borrowed money is spent and importantly how many more hands it flows through. In COVID-19 terms, it depends on the "infection" rate. Productive debt-financed spending has a higher rate. Nonproductive spending has a lower one.

For example, let's say a government borrows money to build a highway to connect two towns. One could imagine that someone would build a gas station in between the towns. Maybe a restaurant next to it. Someone else would build a store next to that. Maybe some housing to be near these new jobs. That original money borrowed and spent by the government would have multiplied into many more dollars and therefore the value of the economy (GDP) would permanently increase. The additional taxes on this increased GDP could service the debt and the economy's increase could exceed that of the money that was borrowed. This, in a nutshell, is why the construction of interstate highway systems in both the US and China drove strong economic growth. Both were a productive use of debt.

Now imagine the borrowed money is instead used to buy chocolate cake for everyone in one of the two towns for an entire year. Chocolate cake production would go up and there would be some more workers needed or maybe some robots. But the cost of the additional ingredients would consume most of the new money and labor would take its piece as well.

"The increase in prices we are observing–from commodity prices to shipping costs to wages–is not a monetary phenomenon but rather a cluster of supply/demand imbalances caused by a global supply chain shock."

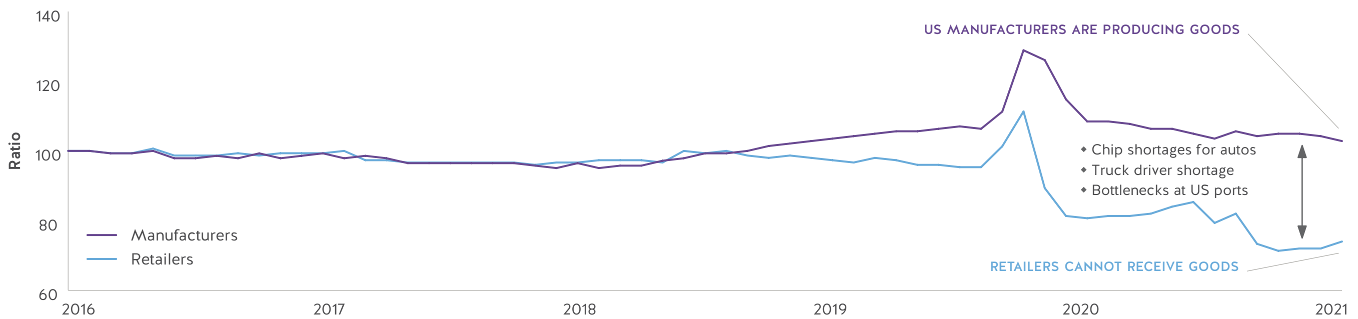
Taxes on the remaining cake factory income would pay the interest on the debt. But next year, as the borrowed money was used up, cake production would go back to normal, and the factory's value would remain unchanged from the year before. The government's debts would be higher, but the economy's value (GDP) would, after being boosted for that year, revert to its previous state. The money in the system would not multiply much because it was literally eaten. This weakness in the economy would then compel the government to borrow more money the next year so that cake production and GDP would stay at the higher level—this would go on and on. Government debt would go up, but without a multiplier effect, the economy's growth rate (its yearly percentage growth rate) would decrease, ultimately to nearly zero. Does this sound at all familiar? This is referred to as a "debt trap" and many economies in the real world, not just the US, are entangled in it. This is the difference between productive and nonproductive spending.

As most of the recent government stimulus has been nonproductive spending, we believe it is not affecting prices. Stimulus checks mostly just substituted for wage income. The increase in prices we are observing—from commodity prices to shipping costs to wages—is not a monetary phenomenon but rather a cluster of supply/demand imbalances caused by a global supply chain shock. Not too different from what you would see in a wartime situation. Consequently, we believe the debate over inflation is misplaced. Within the next 12 months, inflation rates will likely begin to soften as the supply chain sorts itself out. This will explain why, despite rising CPI numbers, government bond yields probably already peaked. Much more importantly for now though, hopefully there are some adults in the room who understand this underlying dynamic and the futility of debt-financed consumption stimulus before we choke on chocolate cakes. There is no reason to keep going in circles.

Accelerated Changes

As these macro issues continue to capture the attention of market participants, the work at Centerstone continues to focus on fundamental bottom-up analysis. On balance, the companies in both Funds continue to make improvements in their cost and competitive positions. Over time it should become increasingly evident that events of the past 18 months drove accelerated change at many businesses. We are already starting to see the initial signs of those changes.

INVENTORY IMBALANCES



Past performance is no guarantee of future results
Source: Federal Reserve Economic Data (FRED); Inventories to Sales Ratio
Note: Values indexed to 100

For instance, Fraport[1] is planning to permanently reduce its ongoing expenses by several hundred million euros. Fraport is a German-listed airport services business. It has been impacted by the pandemic which has led to a significant decrease in travel globally, impacting its worldwide operations. Management's response was immediately to reduce costs through the reduction of headcount via natural attrition, expiration of temporary contracts and active implementation of headcount reductions. As of the end of the first half 2021, management had already achieved much of their goal, including a headcount reduction of 20% of their workforce. Management's commitment to make a large portion of the cost reductions permanent and sustainable, mainly in their Retail & Real Estate and Ground Handling businesses, will help improve profitability as travel normalizes to pre-pandemic levels.

Another example is how ISS[2] has reduced its exposure to money-losing contracts. ISS is a Denmark-domiciled market leader in cleaning and integrated facility services. It provides these services at its customers' sites. For instance, the daily cleaning of facilities or the daily management of catering services at a customer's site. The pandemic has changed how some businesses use their sites or facilities. For many businesses, it has become more important to maintain their facilities or sites in a cost-effective manner. We believe more businesses will decide to outsource their facilities management to providers who specialize in these services, such as ISS. Some specific services have become more important to businesses. There has been an increase in demand for cleaning services to manage COVID-19. ISS is a market leader in cleaning services and has been providing deep-cleaning and other services to improve hygiene at customer sites. It is focusing on contracts and services where it can provide value to customers and is exiting less profitable contracts or business units.

> *"On balance, the companies in both Funds continue to make improvements in their cost and competitive positions."*

Yet another example is how Mekonomen[3] has rapidly increased efficiencies from recent acquisitions in a more compressed timeframe. Mekonomen is the leading provider of automotive aftermarket parts in Denmark, Norway, and Sweden and is a market leader in Poland. The pandemic has put pressure on supply chains. The company has leveraged its scale and sophisticated distribution network and has gained market share in Denmark and Poland and has maintained its market share in its other markets. To mitigate the impact from COVID-19, it initiated efficiency improvements and cost-saving actions throughout its operations, but particularly in Sweden and Norway. It reduced its workforce, reduced marketing activities and took

1 2.95% position in the Centerstone Investors Fund and 6.19% position in the Centerstone International Fund as of June 30, 2021
2 2.92% position in the Centerstone Investors Fund and 4.57% position in the Centerstone International Fund as of June 30, 2021
3 1.61% position in the Centerstone Investors Fund and 2.29% position in the Centerstone International Fund as of June 30, 2021

other actions to streamline its operations. Approximately one-third of these efficiency improvements and cost savings actions are expected to be permanent. These actions have already improved its profitability and we expect profitability to continue to improve as business trends back to normal.

The common thread is that many of our businesses have a great deal more operating leverage than before COVID-19 and should, in theory, out-earn their previous peak earnings even at lower revenues. This sets up the potential for even higher earnings as business trends back to normal.

Thank you for your trust and interest in Centerstone.

Sincerely,

Abhay Deshpande, CFA
CHIEF INVESTMENT OFFICER

Important Risk Information and Disclosure:

The MSCI Emerging Markets Index captures large and mid cap representation across 27 Emerging Markets (EM) countries. With 1,407 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The commentary represents the opinion of Centerstone Investors as of September 2021 and is subject to change based on market and other conditions. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Any statistics contained here have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any fund or security.

An investment in the Funds entails risk including possible loss of principal. There can be no assurance that the Funds will achieve their investment objective.

Past performance is no guarantee of future results.

The value of the Funds portfolio holdings may fluctuate in response to events specific to the companies or markets in which the Funds invest, as well as economic, political, or social events in the United States or abroad. The impact of the coronavirus (COVID-19), and other epidemics and pandemics that may arise in the future, could affect the economies of many nations, individual companies and the market in general in ways that cannot necessarily be foreseen at the present time.

Value investing involves buying stocks that are out of favor and/or undervalued in comparison to their peers or their prospects for growth. Our value strategy may not meet its investment objective and you could lose money by investing in the Centerstone Funds. Value investing involves the risk that such securities may not reach their expected market value, causing the Funds to underperform other equity funds that use different investing styles.

Investments in foreign securities could subject the Funds to greater risks including, currency fluctuation, economic conditions, and different governmental and accounting standards. Foreign common stocks and currency strategies will subject the Funds to currency trading risks that include market risk, credit risk and country risk. There can be no assurance that the Funds' hedging strategy will reduce risk or that hedging transactions will be either available or cost effective. The Funds use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments.

Domestic economic growth and market conditions, interest rate levels, and political events are among the factors affecting the securities markets in which the Funds invest.

Large-cap company risk is the risk that established companies may be unable to respond quickly to new competitive challenges such as changes in consumer tastes or innovative smaller competitors. Investments in lesser-known, small and medium capitalization companies may be more vulnerable than larger, more established organizations. Securities in small and mid-cap companies may be more volatile and less liquid than the securities of companies with larger market capitalizations.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Centerstone Funds. This and other important information about the Funds are contained in the prospectus, which can be obtained by calling 877.314.9006. The prospectus should be read carefully before investing. For further information about the Centerstone Funds, please call 877.314.9006. The Centerstone Funds are distributed by Northern Lights Distributors, LLC, Member FINRA/SIPC. Centerstone Investors, LLC is not affiliated with Northern Lights Distributors, LLC.