CENTERSTONE INVESTORS

RECESSION THREAT?

JUNE 30, 2022

DEAR FELLOW PARTNERS & FRIENDS,

If there is a recession coming, it will be one of the most predicted recessions in history. There are valid reasons to back the consensus view because the Federal Reserve's track record at inducing a "soft landing" is not good. It was arguably successful just once, in 1994. On the flip side, the stock market has also wrongly anticipated recessions. The stock market crash of 1987 comes to mind. In between these are numerous environments in which stock market indices fell around 30% and some true wipeouts such as 2008/2009 occurred. From observation, severe declines such as the Global Financial Crisis have been accompanied by a banking crisis and the good news is that there is no such crisis risk at the moment.

If that logic holds, I would expect to see continued market volatility as the path resolves, but at the same time, it is hard for me to see a worst-case scenario. It may come in handy to remember that if stocks continue to gyrate. Market commentary is usually the bleakest at the bottom and that is also the best time not to do anything. As illustrated on the next page, there were plenty of scary headlines over the years yet in hindsight it paid to ignore them.

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Recessions are part of the landscape as are "bear markets." From my experience, there is not much that can be done about them in the moment. And predicting duration or severity is just as pointless. This is why we have such a strict focus on valuation, balance sheets, business durability and management strength. We believe these attributes can help ensure that the companies outlast recessions while low valuations can help mitigate impairment risks. Although there are few safe harbors in a devastating bear market, I have found that this approach at least leads us intact and into calmer waters.

Is Inflation Cyclical or Secular?

I can see both sides of the debate, but it seems odd to me that we can be worried about the exact opposite things at the same time. It is our view, that the greatest threat until just a year ago was debt deflation, meaning a cascading effect of asset deflation as the system de-levered due to contracting demand and an overloaded public and private balance sheet. We now believe the greatest threat is secular price inflation caused by spiraling wages and supply bottlenecks. It is funny that both threats share the same root cause—market intervention. The Federal Reserve began its long journey of intervention in the late 1990s with the bailout of LTCM and the Federal Government joined the game with a big splash during COVID. I cannot imagine what they will do next, but it would be nice if they just did not do anything so the economy could just detox for a while. I know, wishful thinking...

Alive and Well

These are the environments in which I am grateful to be a stock picker and a value investor, as our preference is for companies largely driven by internal factors, rather than external ones. It is not that our companies are immune from macroeconomic challenges, but they are managed with the understanding that such challenges exist and are unpredictable. It is because the world is unpredictable that we emphasize balance sheet strength, business model durability and shareholder-oriented management teams. This combination is usually sufficient to pull our companies through most external shocks.

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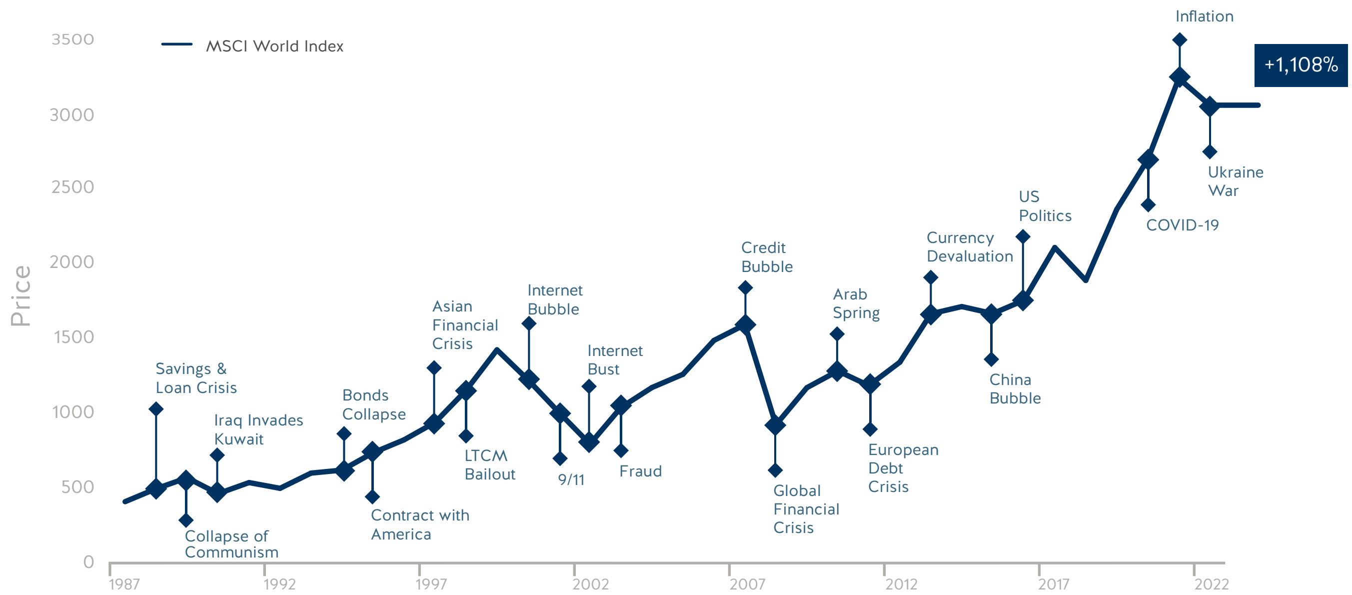
A REASONABLE RETURN OVER TIME BUT WITH FREQUENT PERIODS OF VOLATILITY



Past performance is no guarantee of future results. Investors cannot invest in an index.
Source: Bloomberg

While mayhem ensued again this quarter, one of our top holdings, CDK Global[1], was acquired. CDK Global is the leading provider of dealer management systems to franchise auto dealerships. Management has been focused on unlocking shareholder value for the past few years. In November 2020, CDK sold its international business for 15x the CDK international business segment's adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA). This past April, CDK announced that it entered into a definitive agreement to be acquired by Brookfield Business Partners for $54.87 per share. This represents a 30% premium to CDK Global's closing price on February 18, 2022, which was the last trading day before rumors of a potential sale emerged.

On theme, another long-term holding, FirstGroup[2], received a takeover offer and speculation of buyout interest surrounded another portfolio company, Ubisoft[3]. At this rate, nearly 20% of the portfolios have been subject to M&A over the past two years, all of which occurred within our range of estimated intrinsic value. As opposed to the popular opinion that value investing is "dead," our experience has been the opposite—it is alive and well.

When market environments are good and valuations are high, we spend some of our time researching high-quality companies we would love to own at the right price. These companies are added to our watchlist or "wish list" with the hope that one day Mr. Market will offer them up for an attractive price. He did just that last quarter and we initiated three new equity positions and two new high yield positions at attractive valuations.

Regardless of how markets behave, our style of investing and our focus on fundamental bottom-up analysis remain

> *"As opposed to the popular opinion that value investing is 'dead,' our experience has been the opposite–it is alive and well."*

1 2.57% position in the Centerstone Investors as of March 31, 2022
2 0.65% position in the Centerstone Investors Fund and 2.52% position in the Centerstone International Fund as of March 31, 2022
3 2.32% position in the Centerstone Investors Fund and 2.85% position in the Centerstone International Fund as of March 31, 2022

consistent. Irrespective of the market or macro backdrop, we look for businesses that have solid balance sheets, durable business models and shareholder-friendly management teams that can live through any market environment. We believe our portfolios will drive strong long-term performance as our holdings demonstrate these attributes.

Thank you for your support and interest. We hope you have a safe and healthy summer.

Sincerely,

Abhay Deshpande, CFA
CHIEF INVESTMENT OFFICER