APPALACHES
capital

"And remember, 'Patience, Patience,' is the watchword of a sage, not to-day nor yet to-morrow can complete a perfect age."

- "The Old Astronomer" by Sarah Williams (1868)

Dear Client of Appalaches Capital,

Appalaches Core LO finished the 4th quarter up 3.9% after all fees and expenses. This compares with the S&P 500's return of 11.7%, and the SOFR Index return of 1.3% in the 4th quarter. This was our first quarter investing client assets under the strategy, and therefore the total return for 2023 is also 3.9%.

Markets have been favorable to our positions so far – we have indeed surpassed the return that could be earned on cash – but we have also lagged the broad market. This is simply due to our low exposure throughout the quarter to U.S. equities and risk assets in general. Our portfolio beta[1] measured over the quarter was 0.21.

The quarter began in the midst of a drawdown in equities as rates began to climb to levels not seen in decades. In fact, 30-year treasury yields briefly touched 5%. After the October FOMC meeting, treasury yields began their rapid descent which in turn acted as a catalyst for a significant rally in equities. This is easily observed.

However, this rally has been rather violent, in my opinion. The S&P 500 finished the quarter with *nine straight* weeks of gains. There has been no pause, and it seems as though caution is being thrown to the wind with investors chasing the year-end "Santa Rally" to make up for their poor performance in 2022 and the prior three quarters of 2023. As investors fervently bid asset prices higher, this became more dramatic. Highly speculative names once thought to have been killed in 2022 are once again rising from the ashes. Lower interest rates are positive for valuations, but this seems to be overdone. I believe that it is more prudent to wait for better opportunities than to follow the crowd.

[1] Ex-post beta of portfolio as measured against S&P 500 using daily returns. Backward looking. For illustrative purposes only. Please read our disclosures regarding measured returns and risk metrics.

Portfolio Commentary

At the end of the quarter, we had a rather large cash position and less than a third of our capital was allocated towards U.S. equities. At first glance, this may appear as a very bearish expectation for equity prices going forward. However, I do not, nor does anyone else in my opinion, know exactly where the indices may trade in a year from now. I also do not currently find the market excessively overvalued. On the other hand, I broadly do not see many interesting opportunities at today's valuations and find that cash is an excellent alternative while waiting for the interesting opportunities to become apparent.

Our goal is to generate attractive *risk-adjusted returns over an entire market cycle*. This goal has two parts. To generate attractive risk-adjusted returns, my focus must inherently be on attractive absolute returns and valuations. Given the broad mandate of the firm, this means that cash and other securities will from time to time offer more attractive return profiles than equities. The second part, of course, is that our returns should be measured over an entire market cycle. We are unlikely to outperform during significant sprints upward like we saw within indices in the quarter. We should, however, be able to capitalize on favorable valuations when securities must inevitably take the elevator down. This is difficult, if not impossible, to anticipate. Instead, my aim is to manage the portfolio so that we can continue to be flexible even if it means forgoing short-term gains. I find this tradeoff to be well worth it.

While you are welcome to benchmark our performance against whichever suitable indices you may choose, please know that I do not manage our capital with respect to how they are currently behaving in any given quarter or year. I believe that this leads to the pressure to buy securities at unattractive valuations to keep up with the herd, regardless of the expected forward returns. It is paramount to be patient even if it is sometimes difficult to do so.

As dour as that may sound, I am very excited to see which opportunities are revealed in 2024. Our large cash position, while currently unexciting, brings with it the optionality to make great investments as these opportunities become available.

Being Flexible Where Others Are Not

During the quarter, our two best performing positions were also our largest equity positions, namely Vestis (VSTS) and Safety Insurance (SAFT). I still believe that both trade at a discount to their underlying intrinsic values (though less so now after a great quarter), and their respective reasons for why are more similar than you may think.

Many securities may seem cheap at any given moment, but many of these also have fundamental or economic problems with their underlying businesses. A non-economic factor of undervaluation, on the other hand, has nothing to do with the underlying business and is instead driven by the actions of large, institutional investors. You see, the vast majority of investors in the investment industry have significant restrictions on what they can and cannot do. They may be forced to sell (or buy) en masse because of these restrictions. I find that building conviction in an idea is much easier when you are being paid to be

more flexible than others, and not necessarily smarter than others. In the many months before I was able to invest capital on your behalf, I worked to develop systems that would greatly improve our chances of identifying potentially mispriced securities where the mispricing is driven by non-economic reasons. Safety Insurance and Vestis were both identified because of these systems in place.

Safety Insurance Group, Inc. is a P&C insurer that serves private and commercial customers in Massachusetts, Maine, and New Hampshire. Their primary offering is private passenger and commercial auto insurance, as well as homeowners insurance. Their average combined ratio over the last decade has been 97%, and a slightly better 96% over the last twenty years[2]. For the uninitiated, this means that for every dollar that Safety earns in premiums, the company only pays out 97 cents in claims and expenses, on average. Furthermore, this means that Safety is a profitable underwriter, which is uncommon in the industry. The average P&C company typically has a combined ratio of around 100[3], forgoing underwriting profits while trying to make up for it on the backend from their investment returns.

Safety does not typically increase reserves for prior loss years, and nearly all of their investment portfolio is invested in fixed-income securities with low duration. It is clear that Safety operates in a very conservative manner. Safety's returns have historically shown little correlation with the rest of the market, and most of our return from the position was generated while the market was declining in late October.

How could then, a small, risk-averse, and boring property and casualty insurer be so interesting? Upon further research, the events that drove this opportunity did not happen in the weeks preceding the quarter, but rather all the way back in March.

During the regional banking crisis, banks like SVB, Signature, and First Republic saw their share prices rapidly decline. This decline bled over into the rest of the regional banks, and then the financial sector more broadly. As a result, mutual funds who focused on small-cap financials had terrible performance stemming from their regional bank holdings. As is typical in investment management, investors began to redeem, which forced the managers of these funds to liquidate all of their positions. As a small-cap financial, our internal estimates show that Safety was a part of this unlucky group of securities and was heavily sold despite not being directly impacted by the regional bank failures.

Companies that were only tangentially affected by the crisis and widely covered by the investment industry, such as Visa and Mastercard, saw their share prices rebound relatively quickly. Companies that were directly affected, like other regional banks, have still not seen their share prices recover as of today. On the other hand, insurance companies, and specifically smaller insurance companies, were not directly affected but also did not see their share prices immediately rise in the aftermath. The aforementioned combined ratio was particularly high for the industry this year, as claims for damages were being paid out on inflated costs relative to premiums collected years ago. However, this is just part of the insurance cycle.

[2] According to company filings pulled from www.edgar.gov and as calculated by Appalaches Capital, LLC.
[3] According to industry data pulled from www.statista.com and as calculated by Appalaches Capital, LLC.

Insurance is a unique and specialized industry. Most generalists avoid financials due to their idiosyncrasies, which means that the market participants driving the bid and ask over the long run are specialists. However, as detailed above, the specialists who covered financials were washed out of these names and had no capital to correct any mispricing. This is nearly a textbook definition of a fire sale. It is my opinion that, because of this, we had the opportunity to purchase shares in Safety for less than 10 times normalized earnings several months after its liquidity event. An improvement in sentiment surrounding P&C insurers and rate increases have helped bring some interest back to Safety, but I still think the shares are undervalued as of today.

Vestis Corporation supplies workplace uniforms and supplies to various industries across the United States and Canada. Auto shops, factories, retailers, and other customers contract Vestis to deliver, pick-up, and launder uniforms and other supplies on a recurring basis. This is an industry that has been around for decades but has historically been made up of local family-controlled operators. The industry is highly fragmented, where the top three firms (Cintas, Vestis, and UniFirst) control around 25% of the market[4]. Vestis is recession-resistant and earns high returns on incremental invested capital due to its route-based business model. Adding additional stops on each route comes with no additional fixed costs, and additional sales per stop are highly margin accretive. Because uniforms can be a form of corporate branding and identity, uniform services also have high retention rates in their customer base. These tend to be great businesses.

Unless you contract with Aramark, or regularly look at recent spin-offs, you may not have heard of Vestis. The company in its current form has only existed for a short time. At the end of September, Vestis was spun out from Aramark as an independent company. Aramark provides food services and food facility management to large entities, like hospitals and universities. Its uniform services segment (now Vestis) was generally unrelated to the rest of the business and did not share many synergies according to management. As a result, it was never a true focus of Aramark to really spend time growing or to properly invest in the business. Aramark decided that Vestis would be better off as an independent company with separate management. The new management team has excellent experience, with some directors and officers having prior roles with the industry leader, Cintas.

As is typical of spin-offs, shares of Vestis declined quickly after its spin from Aramark. Investors who owned Aramark received the shares of Vestis, a uniform services business that had little to do with their intended food service holding. For a myriad of reasons, a large number of investors sold their Vestis shares due to neglect or constraint. This effect of idiosyncratic price action is well-documented[5], and I believe this is why we were able to purchase shares of Vestis at a significant discount to their intrinsic value. Even so, Vestis still has a lot of "wood to chop" before realizing its full value.

Safety and Vestis are just a small representation of the very best of the ideas that I hope we can continue to pursue. I firmly believe that it is the flexibility and trust that you have afforded me with that will allow us to participate in these situations going forward.

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[4] According to company filings pulled from www.edgar.gov and as calculated by Appalaches Capital, LLC.

[5] Cusatis, Patrick J., James A. Miles, and J. Randall Woolridge. "Restructuring through spinoffs: The stock market evidence." Journal of Financial Economics 33.3 (1993): 293-311.

Closing Thoughts

With our first quarter now complete, I feel great about the road that lies ahead. I plan to begin writing more regularly on the firm's website (and possibly other platforms) in 2024. These will not be related to the portfolio or its performance but will hopefully provide more insight into markets, the investment process, and my beliefs regarding portfolio construction. I especially want to thank you for being among the first to entrust me with your capital. As I build the business, if there is anything I could do to better serve you, please let me know. I would also appreciate it if you would share this with anyone you know who may be interested in our concentrated, absolute value, and long-only approach.

Thank you for your relationship,

Jake Keys

Founder and Managing Member

Top 5 Holdings as of the Quarter Ended December 31, 2023 *in alphabetical order*	
Alphabet Inc.	GOOG/GOOGL
Cash and Short-Term Treasury ETF	USD, SGOV
Markel Group Inc.	MKL
Safety Insurance Group, Inc.	SAFT
Vestis Corporation	VSTS

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Measured Performance and Risk Metrics

Performance figures and risk metrics provided in this letter are calculated by the custodian. Any return amounts that are reported within this letter are estimated by the Firm on an unaudited basis and are subject to revision. The Firm's returns are calculated net of a 1.0% annual management fee and reflect a client's performance who would have joined the Firm on its inception date. Information on the methodology used to calculate the performance information is available upon request. Actual individual investor returns will vary based on the timing of their initial investment and the impacts of additions and withdrawals from their account. Performance results are reported to the nearest tenth of one percent. Past performance figures are no guarantee of future results. Future investments will be made under different economic and market conditions than those that prevailed during past periods. Asset allocation and portfolio diversification cannot ensure or guarantee better performance and cannot eliminate the risk of investment losses. The Firm will furnish a list of all recommendations made by the Firm within the immediately preceding period of one (1) year upon request.

Any risk metrics referenced in this letter are backward looking in nature and may not be representative of the current portfolios of the Firm's clients. Risk metrics discussed in this letter are for informational purposes only and are not intended to reflect any recommendation of their use. The Firm asserts that the reader is solely liable for their interpretation and use of any information contained in this document.

Index returns referenced in this letter include the S&P 500 and SOFR Index. The Firm's returns are likely to differ from those of any referenced index. These returns are calculated from the respective provider's websites, www.spglobal.com for the S&P500, and www.newyorkfed.org for the SOFR Index, and include the reinvestment of all dividends and/or distributions.