APPALACHES
capital

“The idea that the future is unpredictable is undermined every day by the ease with which the past is explained.”

- Daniel Kahneman, *Thinking, Fast and Slow*

Dear Client of Appalaches Capital,

Appalaches Core LO finished the 1st quarter up 4.1% after all fees and expenses. This compares with the S&P 500’s return of 10.6%, and the SOFR Index return of 1.3% in the 1st quarter.

Our returns were very similar to the previous quarter on an absolute basis, and so were our exposures. While we have again lagged the broad market, we have also generated returns in excess of what would be expected based on traditional quantitative measures of risk.

The quarter was more or less a continuation of the rapid ascent of equity prices seen in the closing months of last year. While declining rates acted as the driver for the rally in the 4th quarter, interest rates have reversed their course for the time being, rising across the curve. The indices have not followed their traditional inverse path but have instead continued to rise following positive revisions in earnings estimates. At the beginning of the year, if you had told me that the number of rate cuts expected for 2024 would be halved, I would not have expected the indices to repeat their stellar performance. Yet here we are.

Artificial Intelligence has been the topic du jour as of late. NVIDIA’s share price nearly doubled from the beginning to the end of the quarter. This is no small feat for a company that started the year with a market capitalization that was already over one trillion dollars. Given their current standing in the competitive environment, this is still within the bounds of reason even as dramatic as the move has been. They are effectively the only supplier of the proverbial “picks and shovels” in town. The laws of competition would suggest that this will eventually change, although I am not the expert to determine when this will be the case. We will instead benefit from any productivity gains from AI through better insurance underwriting, auto parts inventory management, research and development, and targeted advertising. Capitalism is not a zero-sum game. There will be a plethora of winners if new advancements in AI do proliferate throughout the economy. Investors are becoming excited in anticipation of the next step-change in productivity, and consequently, expectations have been revised significantly upward in industries such as semiconductors and datacenters.

Even still, valuations appear rich. Multiple arguments have been made as to why it shouldn't yet matter. One of which that I have seen repeatedly is what I would call "Bubble Math." The logic is generally as follows:

We may be in the early innings of a bubble; valuations are creeping higher. However, valuations are not yet as high as they were at the peak of previous bubbles. Therefore, we are still buying at a discount to fair value.

Personally, I do not subscribe to this way of thinking. While I do believe that it is important to understand how other investors may value our investments, I do not think that benchmarking this fair value against extremes will ever do us much good. Even so, the appetite for risk and speculation does seem to be high, but it is not clear to me that we are in fact in "bubble" territory. I, along with all other investors, will also not be able to determine with certainty the path that the market may take. Instead, I can only judge our set of opportunities on an individual basis: company by company and situation by situation. I believe it is better to remain disciplined and wait for opportunities that are attractive on an absolute basis rather than buying with the hope of selling into peak mania.

Unfortunately, this way of thinking has not been very popular as of late. Momentum strategies, where investors simply buy stocks that have gone up and sell those that have gone down, have had historically exceptional performance over the last 6 months. Being patient is currently being punished. However, we will stay the course and continue to find opportunities where we can.

Portfolio Commentary

We finished the quarter with a large cash balance, which was slightly less than what we started the year with. We initiated new positions, sized up existing ones, but also realized gains in others. This resulted in a realized portfolio beta of 0.22 which, as mentioned previously, is very similar to the exposure we realized in our previous quarter.[1]

This is now the second letter in which I have mentioned our portfolio's beta. The measure is not perfect, nor is it widely accepted within circles of fundamental investors as a truly reflective risk metric. However, by its calculation, it does suggest how determinant the market's performance is of our returns and conversely how big of an effect stock selection has on our returns. Six months is much too short of a time period to judge these returns, but on a (highly) premature basis, we appear to be executing on our objective and have generated excess returns relative to our exposures.

This conflicts with our apparent underperformance relative to the indices. I will reiterate that the portfolio is not managed against a benchmark, but using a benchmark as a tool does tell us how efficient we have been with our risk and how much return was left on the table. In effect, it has not been faulty selection

[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.

that has led to our lower returns—our results suggest that our security selection has so far been successful; it is more so that I have not taken enough risk. While not ideal, this is much better than the alternative of trailing the market due to poor selection but having full exposure.

Part of this is due to the limited number of opportunities we have had. The amount of adverse volatility in the market and the number of bargains available tend to be highly correlated. And so far, the market has only gone in one direction: up and to the right. To illustrate the point, take the following anecdotal example. As I have mentioned before, we have systematic processes in place that help identify potentially good opportunities. Speaking very generally, one of these processes looks at selling patterns and is typically able to calculate an associated metric for 3,000 to 3,500 securities over a quarter (roughly the size of the Wilshire 5000 with some additional ADRs and OTC securities). This past quarter, only 600 securities had any value for this metric, none of which were significant. The current amount of stress in the market is incredibly low.

I have very quickly learned that there will be times such as these when good ideas are hard to come by. Yet, there are things within my control that could have been done better. Specifically, my decisions regarding position sizing have been overly cautious given our goals. Based on the average weight of our holdings, even having 20 good ideas would have resulted in an excess balance of cash. Clearly, this must change. Going forward, I aim to size our positions to a moderately greater size consistent with our objective of having a portfolio of 12-20 holdings. I am not arguing that our position sizing should have been multiples larger (as hindsight would suggest) because we cannot know the exact path of the future. Instead, any changes in sizing will be slight but noticeable. Our process is working so far; I just need to better maximize what we can get out of it.

Vestis: Some Thoughts on Turnover and Our Process

Last quarter, I wrote to you about one of our largest positions, **Vestis Corporation (VSTS)**. At the time, it was one of my highest conviction ideas. I was convinced that this was a situation in which we were likely to have an edge, that the company was likely of above average quality, and that the shares were also likely to be trading at a discount to fair value. I hoped this would be a company that we could hold in the portfolio for years as it progressed in its transformation. However, in early February, after the company announced its quarterly earnings, it became clear to me that my initial assessment of the company's quality and intrinsic value was likely wrong based on the incremental information being given. I decided to cut the position entirely.

I mentioned in my initial comments that Vestis had a lot of "wood to chop" before it would realize its full value as a standalone company. Unfortunately, it does not seem as though any wood is being chopped. Management has set targets for the company's progression over the next several years, but the guidance they have given for this year falls short of the pace required to meet long-term targets. This was not new information; management clearly communicated that the targets would have a delayed cadence in their progress. However, what was more concerning, was that the communication revolving around guidance for *this year* shifted from a story of gradual progress throughout the year to a story of significant progress in the back half of the year. Communication from management regarding pricing actions also moderated significantly, shifting from value-based price increases to "surgical" price increases. Put more simply, it

seemed as though the can was being kicked even further down the road. Additionally, the COO (who had experience with their competitor Cintas) resigned for personal reasons. However, management did not confirm that these reasons were not due to disagreements with the company when asked about it on the call. In these situations, there is also often a line in the associated 8-K that confirms that “personal reasons” do not mean “disagreements.” In this case, it was absent.

The suggested discord among executives and lack of visibility into their strategy is troubling. Without the urgency to execute on these targets, management’s ability to deleverage will be hampered. Without progress in deleveraging, Vestis will not be able to acquire regional competitors or organically invest to keep up with Cintas or even UniFirst. I wish them the best but no longer feel comfortable sticking around.

While my initial assumptions now seem likely to be incorrect, we were still able to recognize a substantial gain in our Vestis holdings.

That is probably an unusual statement to read. Not because it does not happen to other investors (i.e. profiting from an investment or trade despite an incorrect thesis), but rather that most will not be candid enough to say so. On the other hand, I believe that it is much more productive to honestly assess our *process* with humility and not just our returns. Fortunately, I think Vestis highlights the resilient design of our process.

As I have mentioned before, our process revolves around three main ideas: 1) finding areas where we are reasonably likely to have an edge, 2) buying businesses that are likely to be of high quality going forward, and 3) buying the associated shares at a discount to our estimates of their fair value.

You may notice that I use the term “likely” to describe the analysis. This is intentional. Investors, even great ones, cannot know the future and must instead make probabilistic judgements. Ben Graham, widely known as the father of value investing, coined the term “margin of safety” to address this issue in valuation. Buying at a discount to an estimate of fair value decreases the odds of overpaying even if the future is different from what was initially anticipated. Our process extends this idea to other functions of our analysis:

- Buying shares in companies that are of high quality and can earn excess returns on their capital over a long duration reduces the risk that comes from potentially paying a high price. However, the pressures of capitalism can cause quick and dramatic shifts in a company’s ability to earn exceptional returns. Investors can have a good idea of what the returns of the business are likely to be but cannot be certain.

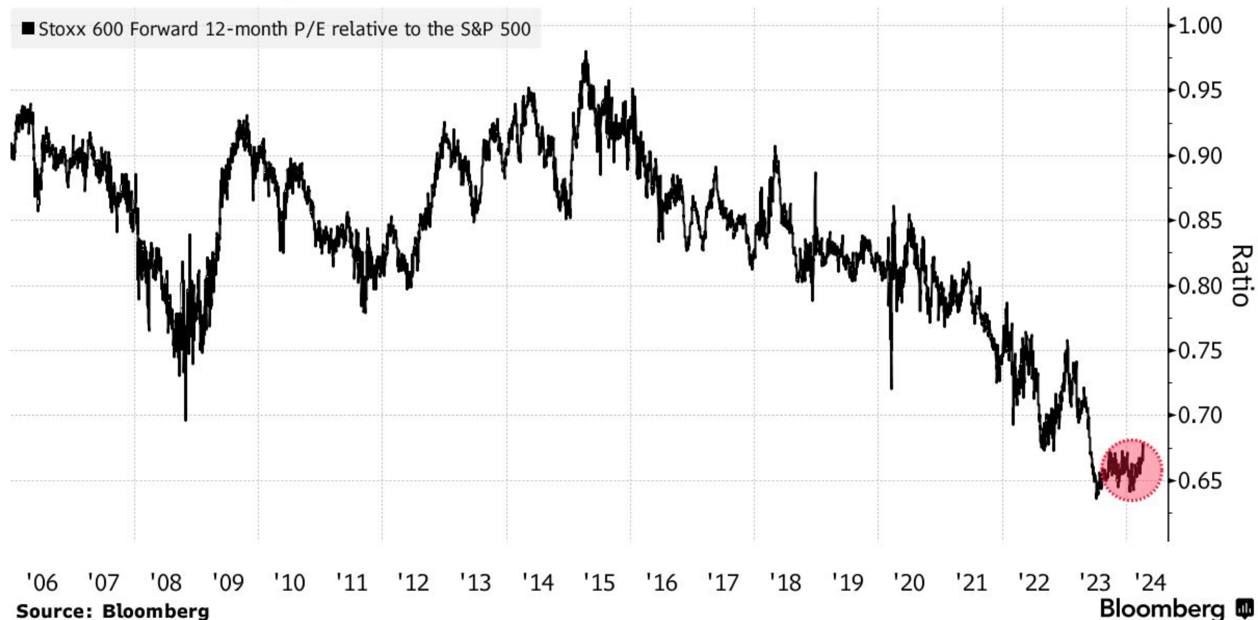
- Additionally, only buying when we are reasonably likely to have an edge increases the odds that we can generate excess returns through our stock selection. However, markets are competitive, and while we can identify situations where we may have advantages, we again cannot be certain.

Context, Quality, and Value. These requirements together create a high bar. However, if I happen to be wrong in my assessment in one area, the outcome of the investment is still likely to be acceptable. This builds a margin of safety into not just our valuation, but our entire process. Taking Vestis as an example, I made the best judgement that I could with the information given at the time. The future unfolded differently than I expected, and my initial estimates of Vestis' quality were too high. Still, we purchased shares at a steep discount to fair value and had the confidence to do so because it was reasonable to assume that we had an edge. This resulted in a favorable outcome despite some unexpected variance.

Additionally, I think I should address the brevity of the holding period. While I hope to hold most of our investments for as long as possible, this is an ideal, not a prescription. The facts underlying our holdings will change over time, as will their quoted values. To maximize our returns in these competitive markets, it is a necessity that I have humility and adjust my views accordingly. This is quite a lengthy post-mortem for a quarterly update, but I hope that it is illustrative of the investment process.

Fishing on the Other Side of the Pond

Lately, I have had a difficult time finding interesting opportunities in the U.S. that meet our standards. I have instead decided to spend more time looking into situations occurring abroad in European markets, where the valuation gap to the U.S. is significant:



Much of Europe has stagnated over the past year, so part of this discount is warranted. However, some companies, such as Syensqo (SYENS) and Pluxee N.V. (PLX) are multinationals with worldwide geographic breadths that are not reliant on a strong local economy.

Syensqo is a high-margin specialty chemicals producer with wide ranging end markets and operating segments. The company spun out from Solvay in December, effectively splitting the legacy organization into commoditized and specialty chemicals. Specialty chemicals producers typically carry moderate pricing power due to high switching costs although volumes are subject to the specific end markets that they are exposed to. Syensqo has some of the best margins in the industry and also one of the broadest end market portfolios. The company has a top-3 position in 90% of its markets based on sales.[2]

With spin-offs, theory would say that there is some forced selling into the initial days of trading. This suggests that an advantage could exist for those who are ready to provide liquidity, although in the case of Syensqo, there also could have been an advantage for those who took the time to read the filings.

Most professionals rely on data providers such as Bloomberg, CapitalIQ, or FactSet to collect a company's financials. These data providers typically have the numbers correct, but there can occasionally be large discrepancies in unique situations. In the case of Syensqo, for weeks after the company had begun trading, these data providers had net debt listed to be in excess of €4-5 billion. The true net debt is closer to just €1 billion. This €3 billion gap is quite significant for a company that at the time had a market capitalization of less than €9 billion. We were of course not the only lucky ones to notice this (that would be naïve to assume so) but the time that it took for this to be corrected does suggest a lack of investor attention. Given the context of the spin and stale data, it's reasonable to assume that there was an advantage to be had in this situation.

In terms of valuation, Syensqo trades at a low multiple both relative to peers and on an absolute basis. Part of this is due to the cyclical nature of the chemicals industry, however, I believe the discount is sufficient to overcome any cyclical headwinds. Additionally, many of Syensqo's peers are calling for a stabilization in volumes this year after significant destocking during 2023. Cyclical pressures may very well continue, but it seems as though we are getting closer to seeing them finally subside. Despite some gains, I still see Syensqo as trading significantly below fair value.

Pluxee N.V. is a provider of a specialized and closed-network payments system for customers and merchants. The network is employee benefits focused and initially started with meal and food vouchers. Pluxee maintains a network of employers and merchants and issues prepaid cards for employees to use based on some predefined employer benefit (food stipends, lodging, transportation, medical care, etc.) Pluxee collects a fee from both sides of the network, which has averaged a total 4.2% of volume issued historically. In addition, due to the prepaid nature of the network, Pluxee generates a substantial float which earns additional interest income. The employer benefits come with substantial tax savings for both the employer and the employee, which drives the bulk of the demand for Pluxee's services. Additionally,

[2] According to company filings and as calculated by Appalaches Capital, LLC.

these benefits are operationally difficult to facilitate without the help of Pluxee or another competitor due to stringent regulatory requirements.[3]

The industry has been subject to good returns, but with higher interest rates and broadening tax-exemptions, both profitability and demand for these services have increased. Pluxee earns high returns on capital and benefits from strong barriers to entry (I estimate that the business earns 20% returns on incremental invested capital from payment fees alone). The industry is an oligopoly, but truly defaults to a duopoly between Pluxee and Edenred. Edenred is the #1 player in the space but has recently come under regulatory review for bid rigging in their Italian markets. I view Pluxee as having an attractive valuation with more head room to grow into as an independently focused unit. At our initial purchase, Pluxee traded at around a 7-8% NTM FCF yield depending on how the float is accounted for.

Like Syensqo, Pluxee is also a spin-off. There is a growing debate as to whether or not spin-offs still provide sources of good returns. That is a fair concern. Markets change and adapt; it's unlikely that investors would still do well to blindly buy every spin-off like once before. Some, however, still seem to be mispriced for no other good reason. If you look carefully, you can still see signs of the herded selling in less liquid spins. Take Pluxee for example. On February 7, the shares traded down nearly 10% in the opening seconds of the day. By 9:20 (20 minutes into the European session), the discount had been snapped up almost in its entirety. Was there a negative overnight headline? No. Was there any negative news with competitors or the industry? No. It was just that the shares had finally cleared overnight and were available for sale in European retail accounts. A large number sold the newfound holding at their first chance without any hesitation. Spin-offs may no longer be the surefire sources of outperformance that they once were, but that does not mean that they are without their unique and opportunistic quirks.

The Availability Heuristic in Today's Market

The quote on the first page of this letter is from Daniel Kahneman, behavioral economist, and author of *Thinking, Fast and Slow*. He died on March 27, and while I had never read his books, his theories were pervasive enough such that they still had an impact on my scholastic and independent studies through their influence on behavioral finance as a whole. I decided that now was as good a time as ever to read his work, and I found that it was incredibly applicable to today's market.

Among other ideas, Kahneman discusses what is known as the "Availability Heuristic" in great length throughout the book. When faced with a difficult question, individuals have a tendency to substitute an easier question in its place that is often answered by some instinctual thought process, or *heuristic*. *Availability* refers to the tendency to rely on the ease at which examples come to mind when asked to estimate the frequency or severity of an event. Generally speaking, individuals are more likely to overestimate a given metric when they can easily remember related examples and are conversely more likely to underestimate when anecdotes are difficult to come up with. Kahneman's research suggests that this is a systematic error committed by both the broad population and experts alike. In his book,

[3] According to company filings and as calculated by Appalaches Capital, LLC.

Kahneman also discusses the impact of media coverage on availability and the population as a whole: consistent and repetitive news coverage has significant influence on availability in decision-making.

This brings us back to Artificial Intelligence. Truly, I am unsure of whether there has been an hour that has gone by in the last three months where it has not been mentioned on the financial news networks. Many companies that have no real exposure to the technology are finding ways to incorporate the idea into their communications with investors. Stock prices whipsaw violently on any headline that suggests whispers of AI and the enterprise's products, good or bad. While its measurement can be difficult, there do seem to be significant effects of the availability heuristic concerning AI and the market.

Take one of our largest holdings, **Alphabet Inc. (GOOGL)**, for example. The following question is highly difficult to answer: "*How will AI affect Google's dominance in Search over the next ten years?*" Still, analysts and investors everywhere are compelled to come up with an answer. Arguably, investors are instead substituting a much easier question: "*How is Google performing in the AI development race right now?*" Google's Gemini (Bard) project has very publicly had its own unique struggles. On February 26, Alphabet's share price declined over 4% after a debacle involving its generative AI and "woke" culture. The shares continued to slide over the week and into the next as every broadcaster, columnist, and other talking-head questioned whether the company had lost its way. By March 6, the shares had fallen nearly 10% on what I would argue is a non-event. We increased our holdings on the way down.

Google may be a step behind in AI development, but these bumps should be expected when dealing with technological frontiers. Furthermore, it hasn't seemed to have an effect on Search up to this point. Search-threatening generative AI projects have been around for well over a year now. Yet, Google's global market share in Search has not been subject to anymore fluctuation than it has over the last decade. Not to mention the fact that Google has latent margin expansion opportunities through cost cutting which seem to be ignored. The shares were trading at a discount to a reasonable estimate of fair value, the business is of great quality, and there were reasons to believe that there could be a behavior-driven mispricing. Is Google having its Kodak moment? I am willing to bet otherwise.

Now, when investors think of having an edge, most would immediately think of the informational advantages that come from intensive research. This does exist, but it becomes incredibly difficult to gather the incremental information necessary to gain differentiated insight in larger, more liquid, and more competitive areas of the market. But I'd argue that this isn't the only source of edge. As I mentioned in the previous letter, sometimes being flexible and taking advantage of structural characteristics of a market can provide an edge. As I am suggesting now, sometimes taking advantage of the behavior of the crowd can provide an edge. Behavioral advantages are difficult to quantify; I will forgive you if you think that it's fuzzy thinking. However, systematic mistakes in thinking do occur, and I believe that we will occasionally be fortunate enough to spot them.

Closing Thoughts

Our first six months have flown by, and over these six months, being risk-aware has not yet shown its value. However, in the long-run, I would argue that being risk-aware trumps being risk-agnostic every time. I encourage you to review our returns from a similar perspective. It is our job to remain patient and wait for our best opportunities which are yet to come. I look forward to better maximizing our rewards as these opportunities do begin to appear.

Just as I wrote last time, 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 return, and long-only approach.

Thank you for your relationship,

Jake Keys

Founder and Managing Member

Top 5 Holdings as of the Quarter Ended March 31, 2024 *in alphabetical order*	
Alphabet Inc.	GOOG/GOOGL
AutoZone, Inc.	AZO
Cash and Short-Term Treasury ETF	USD, SGOV
Safety Insurance Group, Inc.	SAFT
Syensqo	SYENS

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