

APPALACHES

capital

“All of humanity's problems stem from man's inability to sit quietly in a room alone.”

- Blaise Pascal

Dear Client of Appalaches Capital,

Appalaches Core LO finished the 4th quarter with a gain of 1.7% after all fees and expenses. This compares with the S&P 500's return of 2.6%, the equal-weighted S&P 500's return of 1.2%, and the SOFR Index return of 1.0% in the 4th quarter. Year to date, Appalaches Core LO has achieved a net return of 16.5%. When annualized since inception, the portfolio has achieved a net return of 12.5% per annum.

Our results were favorable this year. The portfolio realized a beta of 0.46 according to our custodian. From an academic perspective, this means that roughly 6.1 points of our 16.5% return was alpha. Or, if you prefer a more direct explanation: we generated returns greater than would be expected based on our portfolio's exposure to the market. Had you instead formed a portfolio with similar exposure using index and money market funds, your return would have instead been around 10.4%. That six-point advantage came from our stock picking and advantageous temperament – a good result on a *relative* basis.

Of course, our goal is to achieve exceptional *absolute* returns over a sufficiently long period; it will not be of much use to me or you if we end a five-year period with a smaller loss than an index fund. This is not to say that there will not be years where we will be underwater; those are inevitable, and *fortunately* so. If investors ran no risk of having such results, there would not be the same level of opportunity for those who are willing to bear that uncertainty. Still, it is necessary to be patient and selective in the investments we choose to make to ensure we are well compensated for our risks over the long run.

Comparing short-term performance with a long-term attitude may seem contradictory. However, achieving exceptional absolute returns will require being efficient with the risks we choose to take and finding opportunities to generate excess returns. Over time, a relative advantage, when compounded, should convey a satisfactory absolute result. Using betas and alphas is just a crude way to track our progress over short periods of time, even while the real result takes much longer.

Portfolio Commentary

We made some very minor adjustments to the portfolio in the fourth quarter, but none are worth discussing at the moment. (Take the inactivity as a sign that things are going well.)

We still have ample cash waiting to be put to work. The fact that these reserves are holding back our returns in the interim is not lost on me. Being efficient with three quarters of your capital is nice, but not as nice as being efficient with all of it. I am actively working on finding good spots where we will be well compensated. We have roughly the same number of investments as we did at the end of last year, but a higher weighting on average. If you recall, this was something that I thought needed to be better on my end, and I have no regrets in terms of sizing investments this year.

Portfolio Construction

As it stands, we own the shares of twelve companies, each with steep competitive advantages. Twelve, I am finding, can be a good number. It is not so low that any one poor investment would prove detrimental to our long-term performance, nor is it so high that the success of our good ideas would fail to register on the scale. Our ideal portfolio would not have much difference in concentration – topping out at around fifteen or so concentrated investments in unique, independent businesses. (Unique and independent being the key words, because while we have twelve investments currently, two of those are Canadian railroads.) So, why not fifteen today? There are certainly more than fifteen companies that meet our quality hurdle after all. However, it is difficult to find enough that are undervalued at any one point in time. Earning acceptable returns requires buying at acceptable prices. Buying at acceptable prices requires patience.

This patience is not only limited to new investments but also reinvesting in what we already know best. Our current portfolio is already a good collection of businesses, and given enough of a discount, we would surely invest more. A traditional investment heuristic is to avoid “watering the weeds and cutting the flowers” (or to not buy more of your losers while selling your winners), but I prefer the imagery of watering your flowers when they need it and keeping the weeds out of the yard entirely. Rebalancing a portfolio of high-quality companies is an act of reallocating to those with more attractive prices.

Imagine a portfolio of companies that will each grow their intrinsic value per share at a rate of exactly 10% per annum over ten years. I can assure you that the market return will not be a smooth 10% annualized rate compounded daily, but rather very lumpy. If the stock prices of some of these businesses double after a year, then the market has undoubtedly pulled forward some of the future value creation. While if some fall 20, 30, or 40%, then there is future value being deferred to be realized in a later period. Of course, intrinsic value does not grow as smoothly as this example suggests, but it should be more predictable than stock prices. Going back to our ideal 15-investment portfolio, our ideal level of activity would be simply leaning into these accruals and deferrals while not making large changes. It should be the case that as we approach this ideal portfolio, our turnover will likewise approach a state of inactivity.

“No Alpha in Large Caps”

Interestingly, we generated our good result with our largest contributors being large-cap stocks, like Alphabet and ASML. Traditionally, many investors and academics have thought that the stocks of larger companies are priced more efficiently – that is, it is harder to generate the alpha outlined above in these kinds of stocks. It is true that these stocks are more closely followed by analysts and investors than their smaller counterparts. It is rather highly unlikely that any one individual will (legally) come across information that is unbeknownst to the rest of the market. However, this does not mean that they cannot also be mispriced at times. Their share prices can swing just as wildly.

Take Alphabet and ASML, for instance. Over the course of the year, Alphabet’s share price ranged anywhere from ~\$140 to ~\$328, despite being covered by over 50 analysts and being one of the largest companies in the world. ASML’s share price similarly varied anywhere from ~\$575 to ~\$1,140, despite being the largest company in Europe. Did their intrinsic values fluctuate this much over the course of the year? I would find that unlikely.

If it is not an informational gap, then what is it? It is my opinion that academic models of market efficiency oversimplify the mechanics of the market. Most of the time, the market is explained as an all-knowing oracle, ingesting information and spitting out perfectly aligned prices. In reality, markets are made up of individuals acting on that same information. But information is not the only input. Investors are constantly grappling with external influences and incentives that go beyond solely maximizing returns. They have constraints. They have operational quirks. At the end of the day, information coming into the market’s ecosystem is not observed in a dissociative manner. There are layers and filters that it passes through before making its way into prices.

Take Alphabet, for example. Another manager this past year also had the company as one of their largest investments. Now that the dust has settled, he recently wrote to his clients about the institutional pressures he faced owning the stock over the last couple of years. In particular, a client wrote to the manager saying that under no circumstances should they own the stock. Think of all the managers who received similar warnings, and worse yet, those who listened! It is not unreasonable to say that the stocks of larger companies are more likely to be subject to these external impedances. Alphabet is a high-profile company with a new headline written about it each day. On the other hand, you do not hear much about a company like Eagle Materials on CNBC, nor do you have a strong and decisive consensus from which to anchor yourself. The market for large-cap stocks may be more informationally efficient, but that does not mean they are necessarily totally efficient. We will continue to look for quality, value, and missteps wherever they can be found.

Long-termism

This year ended on a positive note, but it certainly did not start on one. Extraordinary tariffs announced in April threatened to topple economic growth and the global hegemony of the United States, and with valuations being as high as they were, many market indices swiftly entered steep drawdowns. At one point, the S&P 500 was down over 20% from its previous high. The outlook was bleak. Risks were abundant while optimism was in short supply.

Now, I was not much of an investor during the Great Financial Crisis, but I do know that the world survived. The various systemic instabilities and poor incentives were amended, and long-term economic growth continued. Similarly, the market crash in 2020 was significant and jarring while everyday life came to a complete halt. And still, our innovative healthcare systems provided support as the world adapted, again returning to long-term economic growth. We have seen pandemics, broad insolvencies, bank runs, trade wars, nuclear bombs, civil wars, draughts, floods, volcanic winters, and yet, nearly every measure of global prosperity has continued its march higher over the long run.

Often, in chaotic moments, the shortsighted nature of investors results in them mistaking that good run for luck. How else could we have made it this far? Former crises only look similar to the current ones, and the solutions that worked previously are unlikely to come to their rescue today. The only reasons things did end up working out were due to the specific circumstances of the time. It appears as though we have all just benefitted from a miraculous series of coin flips. But this is not the case. Society is adaptive. New adversities are analyzed, understood, and dealt with – even if it does take some time. New medical treatments are developed and utilized, policies are rescinded and updated, ruins are rebuilt and reimagined. We have collectively continued to work towards the common goal of creating a better future. From 1800 to today, GDP per capita in real terms has consistently grown at an annualized rate of nearly 1.5% per year in the United States, despite the many moments where it felt as though the sky was falling.¹

In the face of this long-term record of capitalism and innovation, it is difficult to find many scenarios in which it is worthwhile to bet against it. That is why we chose to lean into the volatility earlier this year, being given the chance to buy great businesses at a discounted price. It was not clear when the headwinds of uncertain trade policy would abate, but it was clear that it was reversible, and that there were dislocations between market prices and fair values. (As a reminder, our cash holdings are not a reflection of pessimism, but instead patience for acceptable opportunities.)

The long-term record also shows just how crucial it is for successful companies to continue to create irreplaceable value. Those which do will be rewarded, and those which do not will eventually be replaced by another solution. This overarching attitude of “long-termism” is important not only in our attitudes towards investing, but also our analysis. Myopia leads many investors to get caught up in short-term issues and noisy quarterly data, causing them to lose sight of the long-term value of their holdings. Likewise, many others forget to ask the right questions while things are going well and are surprised to find their holdings underperform when their value proposition erodes. Not every business that generates a

¹ Data from Our World in Data and as calculated by Appalaches Capital.

profit is necessarily generating value for their customers. However, in the long run, this is non-negotiable for any business that will stick around.

An attitude of “long-termism” also influences how we think about business quality. It does not matter so much to me as to how high a company’s margins are or the absolute level of any specific profitability measure. What is important is the *duration* of economic profitability. In this case, all that matters are the barriers to entry and the durability of the value proposition of the business. Highly profitable businesses are not worth much if these profits only persist for a few years, and in the same vein, modestly profitable businesses can turn out to be wonderful investments if those profits are protected for decades. (The Vulcan Materials and Philip Morris of the world are fine examples.) In that same light, it is incredibly difficult to make accurate predictions about the future. This makes it even more important that the businesses we invest in have durable advantages that can be understood today.

Clearly, “long-termism” is a quality that I wish to have as the cornerstone of every decision we make. There are worse things to obsess over.

Closing Thoughts

This letter marks two full years under our belt, and I am looking forward to many more. I am confident in our performance so far and believe that our process will continue to prove its merit over a full market cycle.

As always, 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, benchmark agnostic, and long-only approach.

Thank you for your relationship,

A handwritten signature in black ink, appearing to read "Jake Keys", with a long horizontal flourish extending to the right.

Jake Keys
Founder and Managing Member

Top 5 Holdings as of the Quarter Ended December 31, 2025	
<i>in alphabetical order</i>	
Alphabet Inc.	GOOG/GOOGL
Arch Capital Group Ltd.	ACGL
AutoZone, Inc.	AZO
Cash and Short-Term Treasury ETF	USD, SGOV
Progressive Corporation	PGR

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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.