APPALACHES
capital

"Uncertainty is not an absence of order — it is the natural state of anyone paying attention."

- John Kenneth Galbraith

Dear Client of Appalaches Capital,

Appalaches Core LO finished the 1st quarter with a loss of 2.2% after all fees and expenses. This compares with the S&P 500's loss of 4.4%, the equal-weighted S&P 500's return of 0.5%, and the SOFR Index return of 0.9% in the 1st quarter. When annualized since inception, the portfolio has achieved a net return of 10.2% per annum.

We are always confronted with uncertainty, and this quarter has been no different. Part of the challenge is determining which uncertainty is important, and which uncertainty is just uncomfortable. The current conflict in Iran may last for much longer than the currently indicated timeline, but I am not so sure that any of our businesses are so fragile that we need to lose much sleep over prevailing oil prices. Similarly, artificial intelligence is creating new products and services that seem to circumvent the intangible value of legacy providers, but I am not so sure that the value lies solely in the products themselves. It is very easy to only look at situations as they exist today, but it is important to remember that they are all just one long chain of actions and reactions, eventually returning to some level of balance. The world may see tremendous change over five years, but that does not mean that the businesses of the world will not also change to suit the environment.

For any given asset, the **only** thing we can say for certain today is the *current market price*. In our often-chaotic world, anything can happen, both good and bad. We should expect both to occur over a long enough time. It makes sense then that, all else equal, lower prices should make us more excited to invest and that higher prices should make us less enthusiastic.

That was the prescriptive action we took this quarter, investing in some businesses that went on sale and selling others that had greatly appreciated or were otherwise no longer good deals. Some of our new investments continued to get cheaper, and so we continued to add to our holdings. Consider it an investment of short-term performance for long-term gains.

Portfolio Commentary

I think it would be fair to expect our portfolio to move out of step with the broader market, both for better and for worse. Typically, this would provide a relative benefit in down markets and may seem a little disappointing in up markets. While this can be another source of traditional discomfort for many equity investors, it is another source of opportunity for us. Many of our investments are in businesses that have persistently moved to the beat of their own drum. Others have been short-term misfits. Investing in these opportunities creates a stronger, more resilient portfolio, and finds value in areas that others are more inclined to overlook due to the uncertainty of relative performance. Since near-term relative performance is not a focus of ours, we will continue to lean into that idiosyncrasy.

In the case of meaningful uncertainty, we sold our shares in Canadian National following their poor outlook for the coming year. Typically, weak guidance for the year would not be cause for concern – some year-to-year variance in results should be expected, and a year's time is too short to be a meaningful reflection of the business. However, this case was different. By all measures, we seem to be exiting a prolonged freight recession with rejection rates in the trucking market increasing, capacity decreasing, and spot rates finally gaining some strength. This should make this a particularly attractive market for rail, since an expensive trucking market makes cheap rail look all the more attractive. Our other railroad holding, Canadian Pacific, was much more optimistic and guided towards some attractive growth in volumes and profits, as did other railroads to varying extents. Canadian National, on the other hand, projected flat volumes and similarly flat profitability. I still believe that it has a great asset in its network, but it seems as though the management team is not realizing its full potential. For that reason, there are better places for our capital, and the great team at Canadian Pacific makes the decision easy.

At the time of writing this letter, we have also sold our stake in ASML. As you may recall, we sold our stake in Lam Research at the end of last year due to significant price appreciation and have now disposed of our shares in ASML for similar reasons. From our purchase to our sale, the stock price had appreciated just over two-fold while analyst earnings estimates for the next few years have risen around 50% to a more reasonable level. It seems to me that we would need ASML to nearly triple their earnings over the next five years to receive a satisfactory return, assuming a reasonable valuation on those earnings. It is possible for this to happen since EUV orders are rising quickly, but uncertainty does not seem to be on our side at this price. Higher prices have a way of turning uncomfortable uncertainties into meaningful uncertainties.

We made a few new investments during the more tumultuous periods over the quarter. One of the market's current preoccupations is the tension between being an artificial intelligence winner and loser. Our initial investment in Alphabet was when the company was thought to be an AI loser, and now the company is thought to be amongst the leaders in the space. Similarly, our new investments this quarter each seem to be thought of as having competitive headwinds from AI. The remainder of this letter will be devoted to our largest new investments, Mastercard and Visa, along with the sources of uncertainty that presented us with the opportunity.

Regulatory Uncertainty: The Credit Card Competition Act

In prior letters, most of the investment pitches I have shared with you have included an exposition of the company and its advantages, and a short acknowledgement of the ongoing debate that provided us with the opportunity to invest. In the case of **Visa (V)** and **Mastercard (MA)**, I am going to take an alternative approach since they are well known, and it is easy to see how they are great businesses. Instead, I am aiming to share the current points of contention and how an investor might become more comfortable with the uncertainty involved.

Initially, our investment was made after the Credit Card Competition Act (CCCA) was reintroduced in January of this year. Effectively, Senators Durbin and Marshall are seeking to introduce manufactured competition to the payment rails ecosystem to limit the fees charged by Visa and Mastercard. Among the proposals, the bill mandates that large, card-issuing banks offer other unaffiliated networks for credit card transaction routing. This dual-network routing protocol would in theory allow merchants to choose to route transactions over whichever network had the lower interchange fee, which would result in fee compression (assuming no other frictions). The current model makes it such that transactions are routed solely via the branded network that the card issuer chooses, which is nearly always Visa or Mastercard. Senator Durbin passed a similar piece of legislation in 2010, named the Durbin Amendment, which was attached to the Dodd-Frank Act passed in the same year. The Durbin Amendment, however, enforced dual-routing protocols over debit transactions and additionally introduced interchange fee caps.

I believe that part of the political appeal is rooted in a misunderstanding of how the card networks operate. Or at least, a convenient obfuscation of the economics behind the transaction fees. Interchange fees are around 2-3% depending on the transaction, and the networks are indeed the governing authorities that set these rates. However, most of this fee is passed on to the other participants in the model, namely the acquiring bank and the issuing bank. These fees help incentivize credit-based transactions by compensating the bank who in turn incentivizes the customer with card rewards or points. While Visa and Mastercard are demonized, because they are the ones who collect the interchange fees, they are not the ultimate beneficiary of the fees. On average, they keep somewhere between 0.12-0.15% of the total transaction – a tiny fee to operate the network that saves merchants from the cost of managing cash transactions.

The card networks were not given their competitive positions from artificially imposed advantages. Visa and Mastercard control such a large market share (around 90% globally, ex-China) because they offer a structurally cost-effective alternative to cash payments, while further conferring their cost advantages to the ecosystem of merchants, acquirers, issuers, and customers through low fees.[1] Jamie Dimon stated in his 2024 letter to JP Morgan shareholders that, “the cost of processing cash, even for the largest retailers, is probably more than 4% of the payment.” Visa and Mastercard are clearly much more efficient for the ecosystem than cash and are able to increasingly reduce frictions as they scale.

At the end of the day, we are left with two separate questions with regard to the CCCA. First, will it even be enacted? This is the third time in three years that the bill has been proposed, and in both prior instances

[1] According to company filings and as calculated by Appalaches Capital.

it did not make the floor for a vote after heavy opposition from the banking industry. I think it is unlikely that the act will ultimately benefit consumers (although that is not necessarily disqualifying in Washington). Fifteen years later, the original Durbin Amendment is largely considered to have failed in lowering costs for consumers. Most of the reduced interchange fees benefited large retailers, who did not pass these savings on to the consumers in the form of lower prices. Free checking accounts, once funded with debit interchange fees, are also much less prevalent today than they once were. Banking is highly competitive, and fees exist to cover the cost of service. Whether it is debit or credit, the idea that a commoditized industry with ample capital would be able to collect significant economic rents over the long run is misguided. In my opinion, the CCCA would be poor policy that accomplishes little, and I would imagine that the failure to be passed so far illustrates a similar belief among lawmakers.

Second, what is the likely impact to the card networks in the event that the bill is actually enacted? Luckily, the Durbin Amendment illustrates some historical precedent as well. While debit cards have had multiple routing networks for fifteen years, Visa and Mastercard have maintained their strong grip on the market. Although the interoperability requirements initially resulted in the two seeing some temporary share losses, they actually resumed taking share in the period following.[2] Even with their routing exclusivity being breached by forcing network interoperability, Visa and Mastercard still offer the best proposition to the ecosystem by sharing the advantages of their scale with merchants and issuers. Having the largest network allows them to have the lowest costs, provide the most comprehensive transaction security, and continue to innovate with new payment methods. As a centralized authority, they also act as a collective bargaining intermediary between the thousands of banks and merchants. The fact that they have such a commanding market share is a structural feature of scaled intangible markets.

In summary, I think the likelihood of the CCCA passing is low, and the likelihood of any long-term headwinds to the card networks is similarly low. If it is any consolation, both networks have diversified beyond the domestic market – less than a fifth of Visa's credit transaction volumes come from the United States, and less than a sixth of Mastercard's credit transaction volumes. Many international markets already have fee caps in place and are generally growing much more quickly.

Technological Uncertainty: Agentic Commerce

When it rains, it pours. A few weeks after the renewed interest in the CCCA, an article was published that hypothesized a fictional future where several business models would be obsolete within the next few years following the rise of agentic AI. For reasons that perhaps say more about the current market mood than the article's merit, this piece was shared enough that it was even being discussed on financial news networks, like Bloomberg and CNBC, and the companies mentioned were selling off on the threat of fictitious obsolescence. Of course, Mastercard and Visa were both mentioned under the reasoning that AI agents would route transactions to cheaper networks using cryptocurrencies and stablecoins.

Setting that specific argument aside for now, both card networks have had to contend with emergent technologies over the past several years. First, it was the threat of the alternative card networks discussed above, next the threat of real time Account-to-Account (A2A) payments, then decentralized blockchain

[2] According to company filings and data from The Federal Reserve Payments Studies.

networks, and now agentic commerce. They have innovated to deal with the current threats each time successfully, and I think the tailwinds are still on their side.

So, why is the agentic commerce threat not very potent? For one, it inaccurately ascribes costs and benefits. Interchange fees are borne by the merchant, and AI agents would be acting on behalf of consumers. Blockchain is immutable, meaning that transactions would not be easily reversed. This is a cost to the consumer by way of more costly fraud, and the benefits of cheaper interchange would not accrue to the customer (the Durbin Amendment's consequences say as much). It makes little sense to think that customer agents would choose the network that benefits the merchant and adds costs for the customer.

This is not to say that agentic commerce is not on the horizon. It seems reasonable to me that agentic solutions could exist to automate certain transactions in cases of managing orders between multiple vendors, transactions that are recurring in nature, or transactions that are small enough to prioritize convenience over cost. However, why should we believe that Mastercard and Visa would not also capture this volume? Both already have agentic protocols in place and ready to be utilized. MasterCard's Agent Pay suite has tools that allows AI agents to make purchases on behalf of consumers in a secure, transparent, and rules-based protocol using the security and fraud protection of the underlying MasterCard network. Visa has created their own Trusted Agent Protocol (TAP) which authorizes agents in a similar way, meaning that both networks own the standards of agentic commerce. If you believe that agentic commerce will reduce transaction friction, as I think is likely, then it seems reasonable to think that Visa and Mastercard are actually the beneficiaries of the technological change.

More broadly speaking, the market sometimes seems to only account for what is known today: the business as it exists currently, and the ever-present uncertainty of the future. Great businesses are not built on the specific products or services they provide, but the advantages that working with them provides. Visa and Mastercard own card networks, yet the organizations themselves are not limited to only being card networks. They are scaled, centralized authorities in the most fragmented financial network in the world. That will always have its value.

Closing Thoughts

It is my belief that if we are prepared to deal with the uncertain environment ahead of us, we will be well compensated. No one has a crystal ball, but I believe that partnering with great businesses led by proactive management teams will allow us to navigate the environment with a bit more confidence. As I mentioned in the introduction, I am aiming to move the portfolio to a position where we are more exposed to idiosyncratic businesses and cycles. It is better to own more of what is good and unique than what is average and abundant.

And in more personal news, I got married this past March. Wish us well!

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,

Jake Keys

Founder and Managing Member

Top 5 Holdings as of the Quarter Ended March 31, 2026 *in alphabetical order*	
Arch Capital Group Ltd.	ACGL
AutoZone, Inc.	AZO
Cash and Short-Term Treasury ETF	USD, SGOV
CME Group Inc.	CME
Progressive Corporation	PGR

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