The MD Sass Concentrated Value ("CV") strategy was up +5.7%, net of fees, in the second quarter of 2021, vs. +5.2% for both the Russell 1000 Value ("R1V") and Russell 3000 Value ("R3V") indices.

From inception (January 2019) through the second quarter of 2021, CV had an annualized return of +27.4% net of fees, vs. +18.3% and +18.5% for the R1V and R3V indices, respectively.

If you ask most investors what the most important driver of stock returns are, the majority are likely to cite "earnings growth". Intuitively this makes sense, but it is important to also weigh the fact that not all earnings growth is created equal. A company that requires $100M of capital to grow earnings 10% per year is worth less than an identical company that requires only $20M per year to accomplish the same level of growth. The latter has higher returns on invested capital (ROIC), retains a higher percentage of earnings and, likewise, justifies a premium multiple. Generally, high ROIC companies operate very good businesses – to achieve above average returns, a company must have some sort of competitive advantage and/or value proposition that justifies outsized returns. However, great businesses with high ROIC do not necessarily translate into great stocks. It is the future direction of ROIC that will matter more than the absolute level today. To illustrate, from 2014-2019, *LKQ* **(LKQ)**'s EPS grew from $1.28 to $2.07 or an earnings CAGR of 10.1% vs. 6.9% for S&P 500 earnings, yet LKQ stock returned 27.0% vs. 56.9% for the S&P 500. We believe a big reason for the stock's underperformance despite superior earnings growth was LKQ's need to pour more and more capital into the business (in the form of M&A) at lower returns to drive growth. LKQ's ROIC shrank from nearly 10% in 2013 to just 6.3% in 2019 and its forward P/E dropped from 18x in 2014 down to 10x in 2019. The market's willingness to pay a premium multiple for LKQ vanished as the company's incremental returns on invested capital continued to fall.

Conversely, businesses that require less capital intensity to drive incremental growth have generally proven to be very good investments. *Charter Communications* **(CHTR)** had a ROIC of just 2.2% in 2015 but that more than doubled to 5.4% by 2020. During this period, CHTR's revenues grew more than 5x, in large part due to acquisitions, yet capital expenditures grew less than 3.5x. Unsurprisingly, CHTR significantly outperformed the market from the beginning of 2015 thru 2020 and was up +259% during the period vs. +82.4% for the S&P 500.

It may be hard to believe, but there was a protracted period when the beloved *Microsoft* **(MSFT)** underperformed the market. From 2007-2012, MSFT returned -10.6% vs. +0.6% for the S&P 500 despite growing EPS from $1.27 to $2.68 over that time, a 13% earnings CAGR, significantly ahead of the S&P 500's +1.7% earnings growth rate (MSFT's fiscal year ends June 30th so the comparison to calendar year S&P 500 earnings is a little bit of apples and oranges but the divergence in earnings growth is notable even adjusting for the fiscal year end differences). Of note, MSFT's ROIC at the end of fiscal year 2012 was 21.7%, down from 36.6% in fiscal 2007. While MSFT was clearly a great company with high ROIC and relatively strong earnings growth, the stock languished as incremental ROIC returns on capital deteriorated. This demonstrates the point that great companies don't always make great stocks. In a 2006 article entitled *Balancing ROIC and Growth to Build Value*, McKinsey argued that improving returns on invested capital creates more value than growth except when ROIC is already high. Assuming a 9% weighted average cost of capital, McKinsey estimated that a 100 bps increase in ROIC would drive nearly 3x as much value creation vs a 100 bps faster growth rate for a given company that has a baseline ROIC of 12%.

Although we seek investments where we expect sustained, long-term earnings growth, we are very focused on incremental ROIC as well. We don't mind buying companies that have relatively poor ROIC today if we believe that it will improve in the future. Conversely, we try to avoid "great" companies with high ROICs that are likely to face deteriorating incremental returns. An example of this is *CACI International* **(CACI)**, a stock we purchased in the second quarter. Although we are attracted to CACI's potential earnings growth over the next few years, we believe CACI's ROIC can grow from 7.6% in 2020 to 11% by 2023. If this happens, we believe the market will pay a higher multiple of earnings to the extent the company requires less capital to sustain earnings growth. We also bought shares of *Walker & Dunlop* **(WD)** in the quarter, and we expect its ROE to increase from 17.2% in 2019 to approximately 22% in 2023 concurrent with an acceleration in adjusted earnings per share. We discuss CACI and WD in greater detail later in this memo.

Q4 PORTFOLIO REVIEW

The biggest contributors to performance in Q2 were *Google* **(GOOGL)**, LKQ Corp. (LKQ) and *Liberty Broadband* **(LBRDK)** which collectively contributed approximately 229 bps to performance.

GOOGL was up 18.4% in the quarter as Q1 earnings materially surpassed consensus expectations for the fourth consecutive quarter. The preceding discussion about improving ROIC is highly relevant to GOOGL whose ROIC improved to over 17% in Q1, up from 14% in 2019. Q1 earnings were up 30% vs. Q1 2019 while operating expenses per employee were down 9% which drove margins up nearly 700 bps from Q1 2019 to Q1 2021. We believe that GOOGL's margins will continue to surprise to the upside as the company leverages its large investments in Google Cloud Platform (GCP). In 2020, GCP generated revenues of over $13B but $5.6B of EBIT losses. Interestingly, Amazon's AWS did $12.2B of sales in 2016 with 25% EBIT margins. We believe this demonstrates the opportunity for GCP to ultimately generate meaningful margin expansion on its sizable (and rapidly growing) revenue base as it leverages its large investment in salespeople and infrastructure. We believe today's stock price reflects virtually no value for GCP, Waymo (the self-driving unit of GOOGL) or "Other Bets" assuming the "core" Google business of YouTube, Search and Play are worth 25x this year's EBIT.

LKQ was up 16.3% in the quarter as the company executed flawlessly on its turnaround plan despite an anemic demand environment. Q1 EPS of $0.95 significantly beat the consensus estimate of $0.63 as EBITDA grew 40% organically yr/yr and margins improved 440 bps. ROIC improved 300 bps to 11.2% as net income grew on a lower capital base. The demand backdrop is improving as passenger car miles driven is now above pre-COVID levels which should support further upside surprises. The growth in collisions appears to be far surpassing the growth in miles driven as evidenced by *Progressive* **(PGR)**'s Q2 earnings which showed personal auto incurred accident frequency growth of 47% year over year. LKQ's auto aftermarket business is sensitive to changes in accidents and benefits from growth in auto collisions.

LBRDK, a tracking stock that is levered to the performance of CHTR, was up 15.7% in Q2. Support for the stock was likely buoyed by the resurgence in "work from home" stocks as the Delta variant raised concerns about the economic recovery and "return to normal". Additionally, management's comments about the longer-term positive EBITDA impact from its foray into Mobile was above consensus expectations. "I think this will be a $1 billion EBITDA business within four years and potentially much more," said Greg Maffei, Liberty Broadband's CEO, at an investor conference in May. Charter's mobile business generated an EBITDA loss of $400M in 2020. Maffei's comment implies that Mobile can add more than $3/share in free cash flow (FCF) to CHTR over the next 4 years on a base of $30/share in 2020. We believe CHTR can earn $48 in FCF/share in 2023

and with LBRDK trading at a 19% discount to our estimated NAV, it affords investors the opportunity to own CHTR at a "look through" valuation of just under 12x FCF.

The biggest detractors to performance in Q2 were *Sony* **(SONY)**, *Bausch & Lomb* **(BHC)** and *East West Bancorp* **(EWBC)**, which collectively hurt performance by 70 basis points.

SONY dropped 8.3% in Q2 as the company delivered an underwhelming first quarter result. Game & Network Services EBIT margins were weaker than expected at just 5% vs. 9.1% in the previous quarter. Additionally, semiconductor revenues were roughly flat but margins were down over 600 bps due to a much weaker mix. We do not believe one lackluster quarter derails the promising long-term growth prospects for SONY in gaming (new console cycle with the PlayStation 5), semiconductors (image sensor content per phone growing), or music (digital music now more than 50% of the business and leading to accelerated growth). We believe SONY's complexity and conglomerate structure largely explains the discounted valuation on a sum-of-the-parts basis and the stock can compound at a mid-teens IRR holding the multiple constant over the next few years.

Given the forthcoming spin-off if its eyecare business, no news is bad news for an "event driven" name like BHC and investors did not get any further clarity in the quarter on the timing of the spin or potential divestitures in the interim. Although the company continues to recover post-COVID, the growth rate of Xifaxan fell short of expectations largely due to lower prescriptions in the Long Term Care (LTC) channel where COVID-19 continues to have a negative impact. Despite some market weakness, Xifaxan continues to gain share with new prescription share of 86.6% in Q1 2020 compared to 85.2% in Q4 2019. Furthermore, as the loss of exclusivities becomes less of a headwind, we expect BHC's growth will accelerate and ultimately lead to a re-rating of the stock as growth and ROIC improve.

EWBC dropped 2.4% in the quarter as this niche, asset sensitive bank sold off in sympathy with the decline in interest rates. Deteriorating China/U.S. relations likely played a role in the stock's performance in the quarter as well. We continue to believe that EWBC's loan growth will beat investor expectations and that earnings in 2022 and 2023 will be materially higher than consensus expectations.

We initiated new positions in CACI International (CACI) and Walker & Dunlop (WD) in the quarter which we discuss below.

CACI INTERNATIONAL (CACI)

CACI is a service provider to U.S. government agencies offering technology and domain expertise including cloud migration, signals intelligence, application development and technical expertise to support internal agency operations and agency missions. Approximately 50% of revenues are Technology related with the other half being Expertise (or personnel) related. The company has a long track record of growth with a 20-year adjusted EPS CAGR of 16% from fiscal 2001 to fiscal 2021.

In Q1 of 2021, CACI was trading at the lowest relative multiple to the S&P 500 in more than a decade. This was largely due to concerns about the election sweep by the Democrats and the potential for defense budget cuts. However, we struggled to see any correlation between presidential election results and defense spending. In fact, a March 2020 report from Bank of America showed that the defense sector outperformed the S&P 500 in nine of the last ten presidential election years since 1980, with an average return of 19.9% versus 4.8% for the S&P 500.

Although all defense stocks were trading at relatively depressed multiples, we were particularly attracted to CACI for its superior organic growth, strong incremental margins, healthy balance sheet and improving ROIC. Specifically, CACI's focus on providing differentiated technology is the driving force behind CACI's financial performance and attractive long-term outlook. Through a series of acquisitions over the past few years, CACI has developed a strong technology portfolio with expertise in cyber-data analytics, agile software development, counter-unmanned aircraft systems and C4ISR (Command, Control, Communications, Computers, Intelligence, Surveillance and Reconnaissance).

CACI's Technology segment has been growing over 12% the past three quarters and we believe this segment will continue to grow at double digits for the foreseeable future. Despite the fears of defense budget cuts under Biden, the preliminary fiscal '22 budget contemplates healthy growth in areas where CACI has strong capabilities. The cyber budget is +14%, the C4I budget is +7%, and the administration has stated that cybersecurity is a top priority which goes hand in hand with IT modernization and agile software development.

Importantly, Technology segment margins are significantly higher than Expertise, so as Technology grows at a much faster rate, the margin impact is material. At a February 2021 conference the CEO said, "we see technology growing faster than the expertise side of our business, which is a positive for us. It's about 12% year-over-year as I look back on the first half and margins are doing very well in both sectors, but about 300 to 500 bps greater on the technology side."

Assuming the Expertise business stays flat, we believe the overall company can grow revenues 6% organically, EBIT 8% organically, and EPS double digits as the company continues to aggressively buyback stock (earlier this year CACI executed a $500M accelerated buyback program or 8% of its market cap). We believe this growth formula will ultimately drive ROIC from 7.6% in 2020 to over 9% by fiscal 2022. With the stock trading for just 12.6x our 2022 adj. EPS estimate, we think CACI is a compelling investment opportunity.

WALKER & DUNLOP (WD)

WD is one of the leading originators and servicers of multi-family loans in the United States. Multifamily servicing rights are a valuable asset as, unlike single-family servicing rights, they don't have prepayment risk. As of Q1 2021, the servicing portfolio had a weighted average remaining life of 9.2 years with 85% of future servicing fees prepayment protected. Under the stewardship of Willy Walker (who personally owns $150M of stock), the company has generated 17-20% returns on equity and from 2015-2020 has delivered a revenue CAGR of 18% and EPS CAGR of 24%. Since its IPO in 2010, the stock has compounded at 25%, significantly higher than peers and the market. The stock sold off over 10% after Q1 earnings due to transient headwinds which created a window of opportunity to invest in a high-quality business with a long runway of growth ahead of it at a very attractive valuation of just over 12x our estimated 2023 FCF/share.

In December 2020, WD held an Investor Day where they outlined a target of achieving a 20% CAGR in EBITDA thru 2025 by nearly doubling revenues over the same period. Although this sounds aggressive, WD grew at comparable growth rates in the previous five years and achieved most of their prior 5-year targets despite the COVID-19 impact on 2020 results. Between 2015 and 2020, WD nearly doubled its market share of multifamily loan originations from 5.4% to 10.2%. However, WD still has a small share with ample opportunities for continued gains. Small balance loans (SBLs) represent as much as half the market, yet WD conducts very little SBL business. We believe WD will leverage its vast trove of proprietary data (WD services over

$110B of loans with plenty of additional data on non-serviced loans) along with its investments in machine learning and AI to penetrate the SBL market and take share.

The multifamily loan market declined sharply in 2020 due to COVID with total originations down about 17% to $302B. Despite the decline in industry originations, WD grew its originations by over 30%. We believe the cyclical recovery in industry originations will continue to drive strong results at WD. The cyclical recovery will be aided by a significant rise in loan maturities over the next five years that will need to get refinanced and will boost transaction volumes. Between 2016 and 2020, an average of $30B of multifamily loans matured per year or ~10% of total industry volumes. Over the next five years, about $65B of loans will mature per year on average or ~17% of total projected originations. As a share gainer, we believe WD will be an outsized beneficiary of the growth in loan maturities. In Q1 of 2021, for example, 79% of WD's refinancing volume were new loans to WD.

WD grew headcount 20% in 2020 (during a pandemic!) to invest in several promising future growth opportunities. For example, to grow its share of property brokerage sales where WD is the #8 player, it invested in brokerage teams in several large markets including Chicago, San Diego, Miami and Philadelphia. Although WD's property brokerage sales has grown at a 30% CAGR since 2015, we believe there is plenty of opportunity for additional share gains as the revenue-generating teams have yet to bear fruit. WD also invested in its investment management business which currently manages under $1.5B. With mid-teens IRR at its current active real estate funds, we believe WD has very marketable investment strategies with ample room for AUM growth.

WD also invested in personnel to develop an appraisal business. Appraisals is a $3B market and highly fragmented with the largest player garnering just a 5% share. We believe WD is well-positioned to take share in this market given its significant presence in loan originations, property brokerage and loan servicing. We believe the material investments in personnel will lead to an acceleration in revenue growth with strong incremental margins. WD generated 30% EBITDA margins in 2018 and 2019 but "only" 27% margins in Q1 2020. We believe the company can drive margins back to 30% over time as the new hires season.

We believe the recent Supreme Court decision that allowed President Biden to oust Mark Calabria as Head of the FHFA was a significant positive catalyst that was under-appreciated by investors. Calabria favored the idea of reducing the size of Fannie Mae and Freddie Mac (GSEs) and privatizing them. Given the importance of this channel to WD (WD not only originates for the GSEs but also services these loans) any reduced role of the GSEs could negatively impact WD. Biden believes in the importance of the GSEs as a liquidity provider and source of capital for affordable housing and the GSEs roles may increase over the next few years. Likewise, the regulatory backdrop seems favorable to WD.

If WD hits its Investor Day targets we believe it can earn $15/share in FCF by 2025. We believe a company organically growing double-digits with 19%+ ROE should conservatively trade for 16x FCF in which case the stock could more than double by 2025. *CBRE Group* **(CBRE)** and *Jones Lang Lasalle* **(JLL)** trade for over 20x FCF and are arguably inferior businesses.

During the quarter, we sold our investments in *Equity Commonwealth* **(EQC)**, *Duke Realty* **(DRE)** and *Facebook* **(FB)**.

MARKET COMMENTARY

In our Q4 2020 letter we posited that there were pockets of irrational exuberance in the market but that our portfolio should be largely immune to any potential bubble pop as our portfolio companies trade at reasonable valuations with tangible, growing free cash flow. The high growth/high valuation stocks we referenced in our letter are all down considerably off their highs (and down on the year) while the S&P 500 was up 15% YTD as of the end of the second quarter. The De-SPAC index, an index that captures performance of 25 companies that went public via SPAC, is down 28% YTD thru July 15th. Despite the hard landing for many FOMO stocks, it's hard to justify valuations for many of these stocks even at current levels.

We don't focus too much on FOMO and meme stocks but rather on exogenous factors that can negatively impact our portfolio companies. We are cautious about the market in the face of rising inflation concurrent with a slowdown in the rate of change in earnings growth. On July 20th, the CEO of *PPG Industries* **(PPG)** stated that he expects raw material costs could be as much as 20% higher in Q3 2021 vs the prior year, sending a warning shot to investors in specialty chemicals and cyclicals more broadly. We continue to monitor and analyze which of our companies face increasing inflation risk with particular emphasis on our more cyclical investments including *Mohawk* **(MHK)**, *Axalta Coatings* **(AXTA)** and LKQ. In all cases, we believe that either the inflation fears are overblown and/or overly discounted in the stock prices. In the case of MHK, we believe the company has raised prices at least four times this year and PPI flooring data suggest pricing in June was up over 10% vs. last year which should be sufficient to cover inflationary pressures.

Bulls argue that inflationary pressures are transitory and will moderate once supply chain bottlenecks ease and COVID-related stimulus payments come to an end. We take a more conservative underwriting approach and are cautious about inflation being just a transitory issue. Shelter comprises ~30% of the CPI basket and 40% of Core CPI, so it is notable that it has barely contributed to the surge in inflation. There are several potential causes for this including rent relief during COVID. Given the surge in household formations and the lack of housing supply, we believe inflationary pressures could persist longer than expected to the extent shelter inflation accelerates.

The rise of the Delta variant poses additional risks to the global recovery. Forty-four states and territories have seen a greater than 25% increase in COVID-19 cases in the last two weeks, compared to the two weeks before. The U.K. is reporting case numbers that are the highest in six months while more than half of Australia's population is now under lockdown. The market has a wall of worry to climb if COVID cases continue to accelerate, particularly against the backdrop of rising inflation and slowing growth.

With respect to slowing growth, while investors hate to see second derivative declines, we believe current growth rates are unsustainable and a return to a more reasonable base of growth is healthy and a more suitable backdrop for markets broadly. JP Morgan's recent *U.S. Equity Strategy* report sums it up well: "while the second derivatives of macro-cyclical indicators…appear to be cresting, going from exaggerated low levels to seemingly extreme high levels, we believe this does not signal the beginning of a down cycle but rather a transition to a more sustained cycle."

Our earnings forecasts for our portfolio companies are significantly above consensus, providing us with a margin of safety in the event moderating growth negatively impacts our outlook for earnings growth. We estimate that about 45% of our portfolio has a factor bias towards "reopening" themes whereas more than half the portfolio either is neutral or biased towards "stay at home" themes. In sum, we believe the portfolio isn't taking a large factor bet one way or the other on the pace of the re-opening of the global economy.

As of July 19th, our five largest positions were *Raytheon Technologies* **(RTX)**, *Crown Holdings* **(CCK)**, *NRG Energy* **(NRG)**, Axalta Coating Systems (AXTA) and *Qorvo* **(QRVO)**, representing 29% of the total portfolio. Approximately 2% of the portfolio is currently held in cash.

We hope everyone is safe and healthy. Thanks, as always, for your continued support and confidence.

Sincerely,

Ari Sass
President & Portfolio Manager, MD Sass

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