Executive Summary

Performance in the 2nd quarter was behind the OS's benchmark and behind the S&P 500. There were a number of securities with significantly negative returns. The S&P 500 continues to push higher due to optimism over AI. There is some optimism the Fed can begin to start cutting rates and the economy can avoid a recession. However, that optimism is not widespread as many economically sensitive stocks continue to be weak. The OS continues to maintain the viewpoint economic trouble is ahead, but the valuations of some stocks are compelling and have the potential to provide strong returns in years ahead. The allocation within fixed income securities has shifted over the past year to more creditworthy securities.

The Opportunistic Strategy returned -3.4% in the second quarter of 2024, behind its benchmark and behind the S&P 500. The poor performance is the result of significant corrections in a number of stocks. Momentum is still a huge factor in stock market returns for 2024. The Ishares Momentum Factor ETF is up over 24% through the first six months of 2024. Small cap value stocks and international stocks are still lagging and while one can envision a rotation taking place on lower interest rates and a weakening dollar, that has not occurred yet. Small cap value has had a negative return year to date. Its 3 year return is negative while the S&P 500 3 year annualized return is over 10%. That is a large spread. International stocks are performing better this year. The FTSE All Country World Ex US net tax is up 5.5% this year. However, its 3 year annualized return is less than 1%.

If one were to look at a 40 year return chart comparing the Russell 2000 Value and the MSCI All Country World Index ex US to the S&P 500, the performance of the indices has varied greatly at times. The S&P 500 trounced the Russell 200 Value during the late 80's and 90's during the tech bubble. It did even better vs. international stocks over that time period. Then, in the decade of the 2000's, the Russell 2000 Value provided a solid return of over 8% per annum while the S&P 500 had a negative annual return of about 1%. International stocks did better than the S&P 500 this decade but a little over 3% annualized are not strong returns. During the 2010's, the S&P 500 outperformed the Russell 2000 Value but not by a whole lot, both solidly positive during the decade. However, international stocks did lag in performance quite a bit last decade. In this decade a large performance gap is opening up similar to the late 1990's, between the S&P 500 and the Russell 2000 Value, and the MSCI ACWI ex US as well.

As of 6/30/2024	QTD	YTD	1 year	3 year	5 year	Since Inception
OS	-3.4%	2.4%	8.5%	2.9%	13.1%	14.7%
Benchmark	-1.3%	6.0%	12.6%	3.8%	8.0%	8.4%
SPX	4.3%	15.3%	24.6%	10.0%	15.0%	14.5%

Inception: 9/1/2020

While not necessarily the case with international stocks, when small cap value stocks have gone through a period of meaningful underperformance, they have tended to snap back with solid return years. But value stocks are sensitive to domestic economic conditions so any potential snap back could be delayed by a faltering US economy. Nevertheless, the risk vs. reward for some value-oriented stocks looks strong if one has a 2 or 3 year horizon.

The equity portion of the OS will be the primary determinant of returns every quarter but fixed income can impact returns as well. The fixed income in the OS is a mix with some high quality bonds in the mix but high yield is still the largest allocation at 46% of fixed income. Within high yield, spreads are tight making the asset class less attractive. A perhaps bigger problem with high yield is the manner in which corporations and lenders are conducting business these days. That behavior is to the detriment of investors that are not large institutional lenders. In the 2nd quarter, two 1st lien bond holdings (1st lien is usually the strongest most protected bonds) fell significantly because of management behavior. EchoStar Corporation has a complex debt structure. While many issues are very risky, within that there were Hughes Satellite 1st lien bonds backed by meaningful cash flow and assets. EchoStar did have the right to dividend up a lot of cash held at Hughes and chose to do so, stripping the company of a meaningful cash backstop. While the extent of the dividend is questionable, the new onerous lease charge Hughes has to pay EchoStar really pushed bondholders over the edge and bondholders are now retaining legal advice to opine on some of these tactics being utilized by EchoStar that have weakened the protections of SATS bonds considerably.

Another example of a company with a complex debt structure is Lumen Technologies. While much of Lumen's debt is very risky, within Lumen existed some 1st lien Level 3 debt backed by very good assets. Lumen went through a debt restructuring where it offered to exchange about 670 million of the 750 million holding of one particular 1st lien issue backed by strong collateral. This process has stripped collateral protection for the remaining 80 million, so this bond too is in legal crosshairs.

High yield is not that attractive an asset class at the moment and when corporate shuffling of assets increases risk for all but the top institutional players, it means the OS will probably remain with a high yield allocation less than 50% of the fixed income allocation. At one point, high yield was close to 100% of the fixed income allocation.

While fixed income is relevant, equity still dominates the return profile of the OS. Some of the largest detractors this quarter in the advancers and decliners table definitely have snap back potential. Daqo New Energy is a stock that holds a 72% interest in Daqo's Chinese polysilicon entity. 72% of the China valuation is US $3.9 billion. However, the stock trades at a valuation of US $1 billion. There is a polysilicon glut and Chinese companies are poor allocators of capital. Geopolitics also need to be considered but in this case the risk vs reward outweighs those factors. This company has no debt, actually its US valuation is ½ the cash value on the balance sheet. Just to trade at cash value, the stock would need to rise 100%. Another potential catalyst is in July of 2024, Daqo gets some extra freedom from Chinese stock market restrictions that can allow it to start closing the arbitrage gap. Management has bought back stock before, so historical precedent shows this is not just a shell company illusion. They have bought back stock to close the arbitrage gap and likely will do so again. Another catalyst is that Daqo is a survivor. It is one of the lowest cost producers of polysilicon in the world. While it won't make money in the current environment, there is a good chance it can at least breakeven. That is better than many. Loss making companies can't exist forever. The Chinese government is starting to take notice of the excess capacity that exists in many sectors and needs to address this problem within the Chinese economy. The operating leverage this company has to an improving polysilicon price is massive. It is unlikely polysilicon will stay at these prices for multiple years.

Hooker Furniture is a microcap furniture company. Perhaps to my detriment in this momentum driven market, I have consistently not shied away from investing in good companies with incredible balance sheets that are operating in a difficult business environment. Furniture sales are down significantly from previous years as the existing home sales market is weak. But Hooker still can make decent money in a tough environment, has a really strong balance sheet and has consistently paid a dividend for a long period of time. That dividend is close to 7%. While its multiple to 2024 earnings is very high, this company has a lot of leverage to improving furniture sales. If interest rates drop meaningfully in the next year, the existing home sales market will have a pent up demand rebound and furniture sales will bounce back.

Advancers/Decliners	2024 2Q Return
Hitachi, Ltd.	23.5%
Impinj, Inc.	22.1%
Kyndryl Holdings, Inc	20.9%
Hewlett Packard Ent. Co	20.3%
Daqo New Energy Co	<48.2%>
Hooker Furniture Co	<38.7%>
Xperi Inc	<32.2%>
Intel Corp.	<29.6%>
Canadian Solar Inc.	<25.4%>
Brunswick Corp.	<24.3%>
Suzano SA	<19.7%>
ThyssenKrupp AG	<18.9%>

Xperi Inc has a number of technology assets that are in the media/entertainment area. DTS, Tivo, HD Radio, among others. It receives a lot of licensing revenue. My interest in Xperi was not based on revenue growth, I actually thought and still think they will not meet projected growth targets. However, Xperi trades with a 70% Gross Profit Margin, the dollar amount of which is larger than the Enterprise Value of the company. Gross Profit dollars to Enterprise Value is a metric I look at. This company can lower its cost base dramatically and be a highly profitable licensing company. Sure enough, it has been battling an activist. The hope here is the activist involvement forces management to address its excessive cost position much sooner than they otherwise would.

Intel is becoming a volatile stock. Nothing has changed my thesis with Intel. They are spending too much on capex but government subsidies and deals like the Apollo and Brookfield deals lower that burden. We are about six months away from a strong Intel product cycle that will last for years. Its manufacturing ability will catch TSM and Samsung and that will allow Intel to put out really competitive products. While it would be nice to have had Falcon Shores taped out and ready a little earlier, it won't be long before Intel will have competitive AI chips. CUDA and some other benefits Nvidia has now, like access to the best memory, will not be long-term moats. The AI chip market is heading for real competition in a year or 2. Also, improved chips from Intel will drive data center and PC sales in years ahead. Whether Intel can generate the customer base for its improved manufacturing assets is definitely still a wildcard but I think the risk vs. reward is good.

Canadian Solar continues to be impacted by the downdraft in solar stocks. This is a sum of parts company with Recurrent Energy and its stake in CSI solar being the 2 main assets. Blackrock just completed its 500 million preferred which on an as converted basis in a couple years would value Canadian Solar's interest in Recurrent at US $2 billion. CSIQ trades for less than $US 1 billion. This does not even include the CSI solar stake which at current valuation is worth US $2.9 billion. This type of stock when sentiment turns can just surge ahead. Tough to predict when sentiment will change but the battery storage division continues to book a lot of new business. Electricity demand for AI data centers can drive solar demand.

Brunswick Corporation is the leading marine company in the United States. Its Mercury Engines make up almost 50% of new boat sales. It has a number of other boating assets, from parts and accessories to full

manufacturing of boats and even a rental company. Its position in the industry is extremely strong but the boating industry is going through a downturn, so Brunswick is suffering. This is a small holding that the OS might add to.

Suzano stock dropped significantly on its plan to try to acquire International Paper with only debt. That fell through as Suzano was not willing to pay as much as International Paper would want but the stock has not recovered from its drop. Investors fear another debt financed large acquisition is in the cards. It is a risk although it was nice to see Suzano back away from paying too much for International Paper. That shows some discipline. It will be nice to see the extra cash flow start coming from Cerrado, its large capital expenditure expansion project that is starting to ramp up now. Suzano is undervalued when one considers how competitive its pulp assets are. Its margins are exceptional. When margins are as strong as this, concerns over a heavy debt load shouldn't be a red flag for investors. Hopefully, some money will be allocated to share repurchases in the near future now that a heavy capex cycle is over.

ThyssenKrupp is a German industrial with a number of assets. Focus tends to be on its steel assets which are important but not the whole story. The European economy is weak and China is exporting lots of steel abroad. The European market is not as well protected as the US market so global excess steel capacity will drive down prices in Europe. ThyssenKrupp also doesn't have the most competitive steel assets so investors are concerned steel will be loss making in years ahead. However, its other divisions are doing okay. Investors are not believing management will deliver on its massive APEX cost savings program. I believe management will. If so, earnings will be strong regardless of if the steel division can turn around. ThyssenKrupp has a net cash position of 4 billion euro and trades at a market cap of 2.5 billion euro. It does have a large pension liability but the annual funding cost of that is not too onerous. There are other assets like upwards of a $500 million stake in the sold elevator company. In addition, the company has lots of room to generate cash from working capital. Working capital is too high even though it has a materials distribution division. There is plenty of room to restructure here without running into trouble. Just a little investor patience is needed.

Hitachi was one of the largest advances last quarter as well as this quarter. Optimism over its digital Lumada business and its grid infrastructure business has led to investors pushing the stock higher. Those are good assets but have been well-known for a while and they can help generate solid growth but nothing spectacular. Nevertheless, Hitachi was recently upgraded even at close to 30x earnings for an industrial company. A large percentage of Hitachi was recently sold. The only reason a small holding is being kept is one has to give some respect to momentum in this market.

Impinj was also one of the best performers last quarter and is again this quarter. Impinj is a good company with a great secular growth story. Its only concern is valuation but the OS's approach has been to trim Impinj vs sell outright.

Kyndryl Holdings is benefitting from optimism it has now established itself as a profitable IT services company with a credible growth story. The optimism investors have now for the stock was telegraphed a couple years ago when the stock was in the low teen's. An investor just needed a little bit of patience to have a strong return here. At one point, the OS had a very large negative return in Kyndryl when the position was established in the low teen's. It now trades in the mid 20's. It is just another example that sentiment can create extreme volatility in smaller companies, especially ones that don't a very solid current earnings footing.

Hewlett Packard Enterprise is rallying over AI server optimism. It has some strong server assets that have been developed over the years. It has a solid liquid cooling offering. HPE is one of the few stocks left that has leverage to the AI story but doesn't trade at extreme valuations.

Looking ahead, the US fiscal deficit, at almost 7% of GDP, is helping to sustain the economy. And as inflation is cooling, real personal income levels are growing despite a slowdown in the jobs market. There is enough consumer purchasing power to keep consumption growing. In addition, infrastructure investment from government incentives and also the technology boom can help offset other slowing investment categories to keep investment growing. While that dynamic is a possibility, the OS base is still the economy slips into a recession later this year. Affordability challenges will lead to an increased savings rate that will hurt consumption. Investment is set to cool as well, as technology spending is getting ahead of demand. If the US economy does fall into a recession there is not fiscal stimulus around the corner to help pull it out. The deficit is too large in a growth year. That will mean the Fed is the only way to stimulate the economy. It is not unreasonable to assume fed rate cuts will be a lot faster than projected next year. Significant rate cuts could be the catalyst to generate bullish sentiment in small-cap and international stocks. The US dollar is being held up by decent US growth combined with high real interest rates. If the Fed does cut interest rates quite a bit, with large twin deficits, there isn't a whole lot of support for the dollar. A weak dollar almost always leads to good international returns.

The OS is positioned for that type of reversal. Cash has been worked down in the OS and even more so in early July. While I still maintain a pessimistic view about our economy this fall, there are some compelling small cap value stocks that I think can provide strong returns over the next couple years even if the next 6 months are volatile. New positions have been established in small cap stocks that largely have had meaningful corrections this year. Sentiment is still weak for small-cap and international stocks and a recession won't help sentiment, so I expect the second half of 2024 to be a bit of a grind before sentiment improves in 2025.

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