July 21, 2017

Dear Investor,

We're pleased to report a strong second quarter of performance as some of our biggest bets paid off nicely. We added a couple of shorts, harvested some gains to seed a couple new ideas, and we continue to like how we're positioned going into the second half of the year.

The format of the letter is as follows: (1) an overview of S&P 500 performance drivers by sector followed by (2) performance drivers for the Blue Hawk Fund and (3) purchases and sales for the quarter concluding with a (4) manager commentary touching on a variety of subjects.

Market Performance by Sector

Of the 11 sectors in the S&P 500, 9 had positive returns for the quarter. Leading the way was Healthcare (6.65%) followed by Industrials (4.16%), Financials (3.80%), Tech (3.76%) and Materials (2.64%). Notable decliners were Telecom (8.14%) and Energy (7.02%). Earnings growth was stronger than expected in all sectors ex-Telecom, with particular strength in Consumer Discretionary, Energy, Financials, and Industrials. Industries with ties to Construction and E-commerce/Software fared particularly well, including Household Durables, Internet & Direct Marketing, and Machinery. Retailed continued to face pressure, both in Consumer Staples and Discretionary, as well as Telecom Providers and Automobile Manufactures.

(%) denotes quarterly returns

Performance Drivers Blue Hawk Fundamental Growth Q2'17

Within the fund, Consumer Discretionary was the largest contributor in the quarter, contributing almost half of the portfolio's performance. In addition, Information Technology and Industrials contributed positively as well as Healthcare and Financials Services. Dissecting by Industry, Software and Services led the way followed by Entertainment and Leisure, Beverages and Airlines.

Of note, Ryanair was a top contributor and has been a great stock this year. Ryanair is a European low-cost airline and the most innovative airline globally. Led by Michael O'Leary, the company has pioneered many cost saving initiatives including charging for baggage, Wi-Fi, and even attempting to charge for bathroom usage. Although counter-intuitive, these incentives/disincentives allow the airline to maximize the space on the airplane, add more seats, and ultimately pass along the savings to the customer in the form of lower fares - the ultimate value proposition their core customer seeks. *Their goal of charging for bathroom usage was to incentivize passengers to use the bathroom before flying, allowing their airplanes to have less bathrooms and thus more seats. The initiative ended up being nixed for obvious reasons but provides a glimpse into the company's obsessive focus on maintaining their position as the low-cost provider.*

The biggest and only material detractor was Consumer Staples, specifically Food & Staples Retailing. One of our bigger shorts was acquired at a premium, forcing us to cover in the red. Two other shorts in the space declined in concert with the acquisition, which mitigated the negative performance.

Purchases and Sales – Q2'17

Overall, we didn't make any major changes to the portfolio. We leaned into some of the strength in big tech to seed some new ideas. On the long side, we added Sherwin Williams, Hasbro, and Equinix to the portfolio and eliminated Zoetis and CVS. In addition, we initiated a moderate size position in Alibaba, a name on which I've done a lot of work and have become very bullish. The best description of the company is Amazon, Ebay, and Paypal all combined into one. Jack Ma is as impressive a visionary founder as there is today and I don't say that lightly. In a future letter, I plan on writing more about the company.

On the short side, we initiated a few new positions bringing the total number of short positions to 15 representing about 30% of the fund. New positions include a motorcycle company with an aging customer base, an "energy-from-waste" company with a challenged core business, and a big food products company with a large exposure to pet food. Lastly, we covered a position that was acquired in the period, which I touched on above.

Commentary

Growth stocks and tech specifically have received a lot of focus by investors and the media of late due to strong performance. This commentary focuses on why we continue to view these areas as attractive on the long and short side and believe they'll continue to demonstrate a high dispersion of outcomes.

Technological Acceleration

We are amid two massive drivers of change in today's world – the democratization of information and globalization. Before I expound, I need to address one thing and that's reflexive comparisons to the Tech Bubble technological change is mentioned. Let's do a quick comparison of the two time periods. In 2000, the five largest market cap stocks traded at a forward price to earnings ratio of 58x[1] and a Free Cash Flow yield of 1.6%. Today, the five largest tech stocks trade at a forward price to earnings ratio[2] of 23x and a Free Cash Flow yield of 5.6%[3]. The periods are not comparable and in reality, big tech is attractively valued considering its growth profile.

We are at a very interesting point in time. In today's world, we now have at our fingertips access to limitless data and information. The proliferations of smartphones and high-speed internet have fundamentally changed our behavior and it's easy to lose perspective of the magnitude of this change (and future change). But having access to limitless data and information (for free), limitless processing power, and a connection to everyone in the world fundamentally alter the competitive landscape and increase the potential value companies can provide. Below I provide a few observations of the downstream effects of these changes. The list is a small sample and for the sake of brevity not exhaustive.

(1) Buyers have more power than ever. The car buying process is a perfect example to demonstrate this point. Previously, the car buying process involved going to a dealership with little to no information on the real price of a car. Salesman used the opacity of price to their advantage and buyers had no choice but to accept the poor experience. Today, the buyer can go online and get relatively precise data on car cost, MSRP, etc. While the experience still may not be enjoyable, it's become less costly as the information advantage has largely disappeared. This change has occurred across industry after industry. The result is that informational advantages have largely disappeared and buyers have more power than ever.

(2) Brands have become three dimensional. It used to be that companies and brands could largely control their image in a top down almost tyrannical way. The communication channels between corporate and customers were largely one-way streets. The channels were essentially newspaper, television, and advertising. These dynamics allowed these companies to largely control consumer attention and information. The result was that consumers only had access to the what and not the how. Today, with social media and the ubiquity of information, poor customer experiences, product information (such as nutritional information), and other issues that could previously be hidden are much more accessible. Two dimensional brands have now become three dimensional corporate *identities*. The result is "brand" has become the aggregation of the value provided to the customer each and every interaction instead of marketing silos. Brand has been replaced by corporate identity.

(3) Geographic location almost doesn't matter anymore. Unless the good or service is difficult to ship, location has become much less important. Corporate distribution is more complex and reaches further than ever. In this world, the ma and pa stores have a hard time competing and the big get even bigger. Facebook, for example, now touches literally every corner of the world and accomplished this task in what seems like overnight. This interconnected, globalized instantaneous world allows corporations to grow larger than we've ever seen and to do so at lightning speed.

So how do we invest in this environment?

How These Megatrends Affect Our Portfolio

[1] Fiscal Year +2
[2] Fiscal Year +2
[3] As of June 7, 2017 Source: Goldman Sachs

A wise man once said the best businesses are the ones in which you bring two people into a room, they transact and you take a cut from both sides.

The Platform Company is King

In a hyperconnected, globalized world, platforms that connect buyer and seller in an intuitive, easy to use interface have become very attractive. The platform business model exhibits certain traits that are very attractive from an investing standpoint. First, the customer acquisition strategy is self-reinforcing – users attract sellers and more/better products which attracts more users. The model has strong operating leverage – the next dollar of revenue is less expensive to generate than the previous dollar. The business is both sticky and defensible in general due to user generated reviews and a buyer-centric focus. Lastly, there's no fashion risk as platforms are brand and seller agnostic.

A Unique Experience

It's never been easier for customers to switch to substitute products. Whether it's an unhelpful customer service experience, overpricing, or laziness, switching products is a click away. The perception is that retail and hotels could get swallowed up by this change. We believe this view is appropriate for the status quo but overstated for the industries overall. In a world where ultimate value wins out, customer experience is what matter. The retail companies that provide a unique experience have continued to do well. Ulta Beauty (not owned) is a cosmetics and beauty company that provides an immersive in-store experience where you can experiment with the product, something you cannot do online. Best Buy (not owned) has enjoyed a turnaround with this same strategy in electronics. And the hotels that focus on a unique experience, mainly around exceptional service, have held up well against the new Airbnb model. The Retail and Hotel industries are examples of where there's a path for many to survive for *those that evolve*.

Digital Distribution is Free and Completely Customizable

Today's consumer wants what they want when they want it and they're willing to pay for it. They don't want a limited choice of 30 stations and someone else choosing when the show is on. They want the ability to binge on the media and device of their choosing and not be disrupted by advertisements or schedule. There's a short list of innovative companies who have effectively utilized technology to customize their digital offering specifically to each individual consumer. And these companies are and will continue to take the lion's share of the profits.

Investing Edge and Growth and Value Investing

Won't the investing industry fall prey to these same forces? Aren't human stock pickers relics of the past? To answer this question, I first walk you through a framework so bear with me.

There are 3 types of advantages you can have in the stock market: **informational**, **behavioral,** and **analytical**.

Informational advantage comes from better or faster data, behavioral from a superior reaction to the data, and analytical from better synthesis and deeper understanding of incomplete information resulting in more accurate forecasting. Within the last 10 years, stock pickers who rely on an informational advantage have been disrupted. Buffett likes to talk about "cigar butt" stocks, or stocks that are overly cheap because they're forgotten and under-covered. These opportunities have largely dried up as computers have infinite processing power and thus breadth while people are limited by their processing power and breadth of attention. The result is that the market has become almost perfectly efficient over the near term. The only way to outperform in this space is to have faster data and the area has become a highly contested arena inhabited by the Quants.

The below exhibit summarizes the 3 types of differentiation and places them in the time horizon they inhabit within a Discounted Cash Flow.

Informational advantage is in green and centers on this year's Free Cash Flow (FCF_0) and represents historic and current financial data. Behavioral advantage represents the past, present, and future, and an analytical edge inhabits a couple of quarters in the future to many years in the future.

3 Types of Differentiation

1) Informational Advantage – better or faster information

2) Behavioral Advantage – better reaction

3) Analytical Advantage – better or deeper understanding

$$Value = \boxed{\boxed{\frac{FCF_0\,(1+g_1)}{(1+r)^t}} + \boxed{\frac{FCF_1\,(1+g_2)}{(1+r)^t} + \cdots + \frac{FCF_t\,(1+g_t)}{r-g_t}}}$$

The point of this analysis and exhibit is to say that growth investing is protected from quants. Growth investing involves using qualitative analysis to forecast the future. Over 95% of the value of growth stocks comes from future Free Cash Flow[4]. Skill in this time horizon comes from higher quality qualitative analysis, a skill at which computers are not particularly adept.

In contrast to growth investing, value investing does run into some conflict with computer driven investing. Historically, the style has relied to an extent on looking under rocks others don't and favoring historical data over forecasting – both areas that fall under informational advantage. While I don't believe by any means value investing is dead, the pressure is real and value investors that drift away from their behavioral and analytical edges will struggle to generate alpha.

Performance and Portfolio Statistics

The Fund returned 5.80% net of fees in the second quarter compared to 2.60% for the S&P 500 and 1.31% for the Barclay Hedge Fund Index. The Fund returned 11.33% year to date ending June 30th compared to 8.24% for the S&P 500 and 4.33% for the Barclay Hedge Fund Index.

For the first six months, the portfolio returned 10.7% alpha and the Sharpe Ratio was 4.9. Correlation to the S&P 500 is 0.23 and Beta is 0.30.

Monthly Net Returns – Founders Class 1% AUM and 15% Incentive Fee

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2017	2.95%	1.47%	0.73%	3.20%	2.96%	-0.43%							11.33%
2018													
2019													
2020													
2021													

Data provided by Convergex FixQ and S&P Dow Jones Indices LLC. Comparisons are to the S&P 500 and the 13 week Treasury Bill. For more information on calculation methodology, please contact info@bluehawkinvestors.com.

To conclude, we thank our investors for their support. Please reach out with any questions.

[4] For a stock growing free cash flow 10% a year, less than 5% of a company's value comes from free cash flow over the next 12 months. This implies more than 95% of a growth stock's value comes from cash flows years 2 into the future.

Sincerely,

Jake DuBois

Appendix

Alpha is a measure of the difference between a fund's actual returns and its expected performance, given its level of risk as measured by beta

Beta is a measure of a fund's sensitivity to market movements.

Net asset value (NAV) - a fund's net asset value (NAV) represents its per-share price. A fund's NAV is derived by dividing the total net assets of the fund, less fees and expenses, by the number of shares outstanding

Sharpe Ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk.

Source: Morningstar

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