

April 5, 2021

Dear Investors,

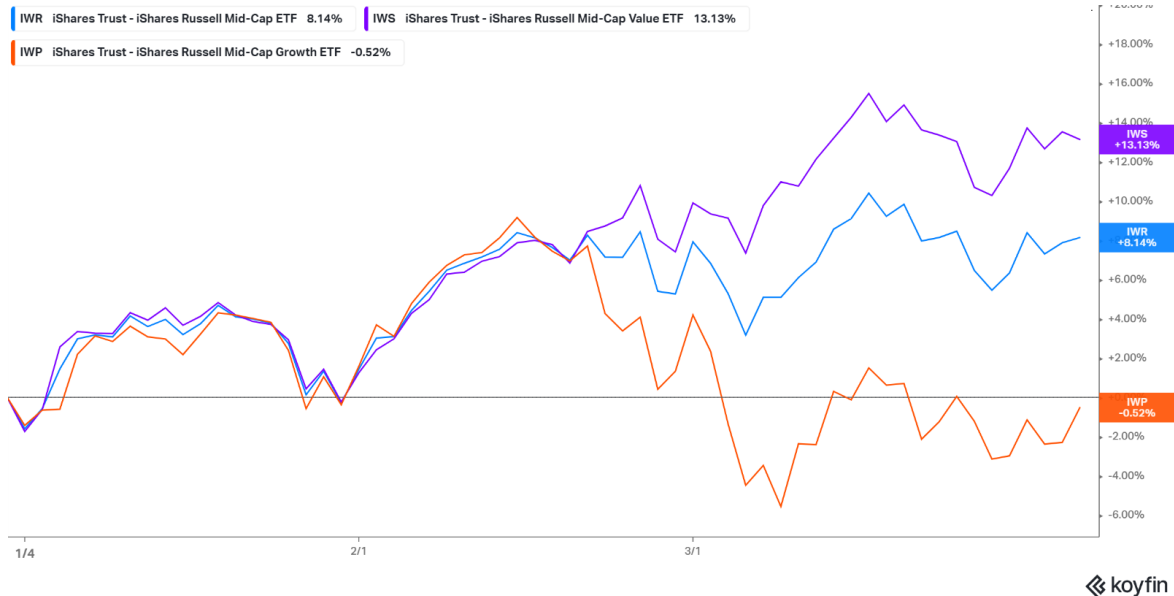
The Headwaters Capital portfolio returned +0.6% gross (+0.4% net) during Q1 21 compared to a +8.1% return in the Russell Mid Cap Index.

	Q1 21	YTD '21	Since Inception (1/4/2021)
Headwaters Capital (Gross)	0.6%	0.6%	0.6%
Headwaters Capital (Net)	0.4%	0.4%	0.4%
Russell Mid Cap Index	8.1%	8.1%	8.1%

*\*Note: Individual SMA performance may differ from the results presented above.*

1

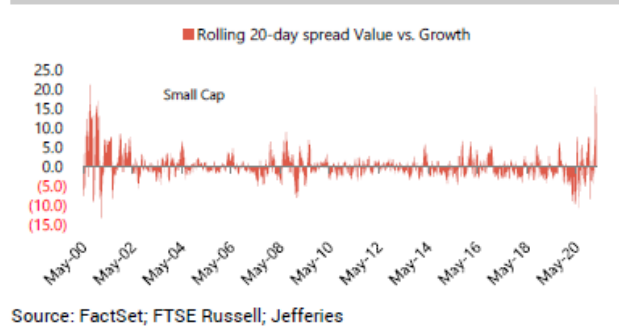
Quarterly performance in a concentrated portfolio such as Headwaters Capital's is designed to be driven by the performance of our individual companies during the quarter. In most quarters, the performance discussion will summarize these specific company results and why this drove outperformance or underperformance. However, the underperformance realized in Q1 2021 can simply be explained by the outperformance of value stocks over growth stocks and Headwaters Capital's relative under-ownership of these stocks. As shown in the chart below, the Russell Mid Cap Value Index rose by +13.1% in Q1 while the Russell Mid Cap Growth index declined by -0.5%.



As some historical reference on the magnitude of this divergence in performance, the intra-quarter outperformance of value versus growth was the largest ever (as measured on a rolling 20-day basis).

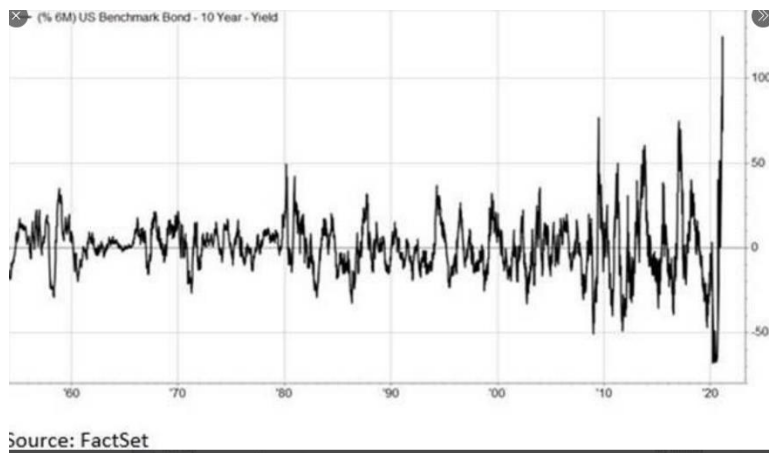
<sup>1</sup> The composite performance ("portfolio" or "strategy") is calculated using the return of a representative portfolio invested in accordance with Headwaters Capital's fully discretionary accounts under management opened and funded prior to January 1, 2021. The performance data was calculated on a total return basis, including reinvestments of dividends and interest, accrued income, and realized and unrealized gains or losses. The returns also reflect a deduction of advisory fees, commissions charged on transactions, and fees for related services.

**Chart 9 - This has been some of the best performance ever by Value vs. Growth**

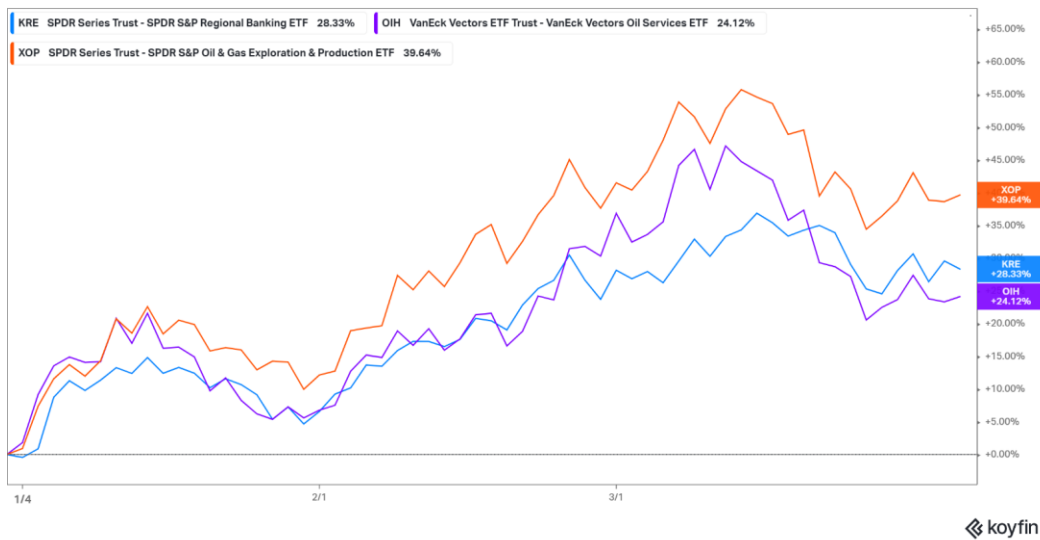


*\*Data as of 3/18/2021*

I think it's useful to peel back the onion on why the two different investment styles saw such dramatically different performance during the quarter. Value stocks outperformed given that many of these stocks were historically cheap at the beginning of the year, especially relative to growth stocks that were trading at stretched valuations (expensive on near-term earnings, not necessarily longer-term earnings). Additionally, many industries that are more heavily weighted in the value index such as financials and oil and gas benefitted from the rise in bond yields and commodity prices, respectively. Bond yields and commodity prices both rose as investors grew more confident that the combination of a global re-opening, increased fiscal stimulus and continued easy monetary policy would be supportive of strong GDP growth and inflation. Once again, I believe historical context for what occurred in Q1 2021 is useful: the 10-year treasury yield saw the largest percentage change in yield on record (admittedly from a very low rate).



As shown below, banks (+28.3%) and oil and gas stocks (+39.6% & +24.1%), were winners from these reflation themes due to positive forward earnings revisions. Consequently, these companies significantly outperformed even the broader mid-cap value index.



It was the lack of ownership of these companies that more acutely impacted the relative performance of the Headwaters Capital portfolio during Q1 2021. Investors may question why the portfolio was not positioned to take advantage of the value opportunity that was present heading into 2021. Note that many of these companies share the same characteristics: undifferentiated businesses in cyclical industries, below average ROIC, financial leverage that amplifies business cycles, and poor free cash flow. These business traits are the opposite of the characteristics of a typical company in the Headwaters Capital portfolio. As a result, these businesses are largely uninvestable for this portfolio. Yes, these businesses were cheap heading into the year and were likely under-earning relative to their normalized earnings power, but they were not businesses that aligned with a long-term investment approach. While there was certainly a trading opportunity in many of these value names, I believe it was exactly that, a trade and not a long-term investment opportunity.

**Top Contributor: American Financial Group (AFG) +30%.** American Financial Group is proof that I'm less concerned with whether a stock is a "value" or "growth" stock, but more concerned with the quality of the business and the durability of its earnings power. AFG was the top performer during the quarter as it successfully realized value for its life insurance segment through an announced sale of this business to Mass Mutual. Investors generally disliked AFG's life insurance business due to its interest rate sensitivity and investment portfolio leverage. As a result, the market was ascribing less than a book value multiple for AFG's life insurance business despite multiple publicly announced transactions of competitors that valued similar books of business at 1.2x book value (which is ultimately the multiple that Mass Mutual paid). Investor concerns with the life insurance segment presented an opportunity for us to purchase AFG at a discount to fair value with an opportunity to compound capital at a 10-15% annualized rate for many years to come. While I didn't expect an outright sale of the life insurance business, I applaud management for monetizing this asset and realizing value for shareholders. AFG's stock outperformed once the sale was announced as the value of this business was higher than the market appreciated. See below for a more detailed discussion of AFG.

**Top Detractor: LendingTree (TREE) -22%.** LendingTree is an online marketplace for consumer financial products such as mortgages, credit cards, personal loans and insurance. TREE's marketplaces connect consumers looking for financial products with lenders and insurance companies, effectively serving as an outsourced marketing partner for lenders and insurance providers. TREE's results were negatively impacted by ongoing stimulus payments that have served to improve the health of consumer balance sheets and reduce the demand for lending products, specifically credit cards and personal loans. As a result of lower consumer demand for loans, lenders have reined in their marketing budgets, which has translated into lower revenue for TREE. While it is difficult to



predict when consumer demand and, consequently, lender marketing budgets will rebound, I do expect both to rebound to pre-COVID levels. Additionally, TREE's CEO is heavily incentivized to improve performance at the business: he has foregone a salary and has instead accepted a performance-based options grant that can only be exercised once the stock price reaches a minimum hurdle price of \$432 (+108% from the current share price). The CEO also has a 16% ownership stake in the Company.

**Portfolio Buy & Sell Activity:** No buys or sells during the quarter. Portfolio trading activity will normally be discussed in detail in quarterly letters. Given the absence of trading activity this quarter, I would like to give investors background on the the portfolio's largest holding, American Financial Group.

### **American Financial Group ("AFG"): Family Legacy of Excellent Capital Stewardship**

#### *Summary Thesis*

- 1) Leading specialty P&C underwriting franchise with a consistent history of superior underwriting results.
- 2) Disciplined management team with a track record of sound capital allocation decisions.
- 3) Family business with high insider ownership (18% of company)

#### *Business Overview*

AFG is a diversified insurance company that generates 60% of its earnings from its specialty Property & Casualty ("P&C") segment and 40% of its earnings from its Life Insurance segment. AFG was founded in 1959 by Carl Lindner Jr and is now led by his two sons who serve as co-CEO's. In addition to their co-CEO roles, each brother is actively involved in the ongoing operations of the business: Carl Lindner III is President of the P&C segment and Craig Lindner is President of the Life Insurance segment. The Lindner family collectively owns 18% of AFG (\$1.7B value) and an additional 6% of the company is owned by executives and the company retirement plan.

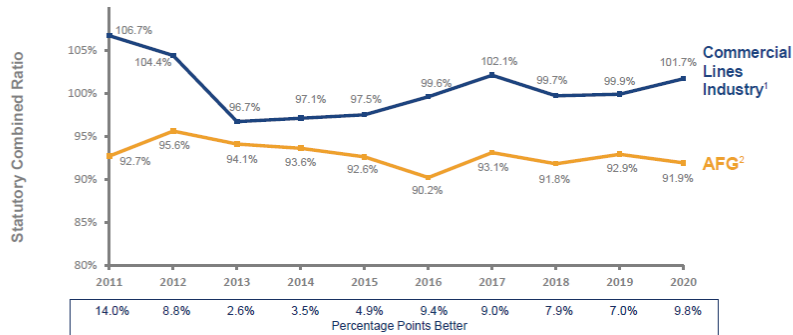
#### *Superior Underwriting Culture*

Most P&C businesses tout their superior underwriting capabilities as a competitive advantage, but in reality, there is little differentiation between each of these companies. As a result, most P&C companies are subject to pricing cycles in their specific lines of business that ultimately determine underwriting results. For investors, this is a black box that makes predicting results nearly impossible. AFG is one of the rare insurance companies where there is clear evidence that the company can consistently generate industry leading underwriting results. AFG's underwriting superiority is driven by a collection of attributes that allow the company to consistently grow book value at rates faster than the industry, regardless of underlying pricing cycles:

- 1) Aligned incentives: underwriters are compensated based on underwriting results over multiple years and underwriting targets are based on return on equity ("ROE") thresholds. Bonuses are subject to clawbacks if underwriting results develop unfavorably.
- 2) Diversity of Insurance Lines: 35 separate P&C insurance lines allows management to distribute capital to the highest return opportunities. When combined with the incentive compensation outlined above, capital only flows to segments where ROE targets can be met. This diversity of insurance lines serves to mitigate the risk from pricing cycles.
- 3) Ownership mentality: Significant insider ownership along with long-term equity incentive compensation drives underwriters, managers and executives to allocate capital to the highest return opportunity.

As a result of the above factors, AFG's P&C underwriting results have consistently outpaced the overall industry. Note that the combined ratio is a measure of the underwriting profitability for the company's P&C segment (a 90% combined ratio can be thought of as a 10% underwriting profit margin).

## Superior Underwriting Talent



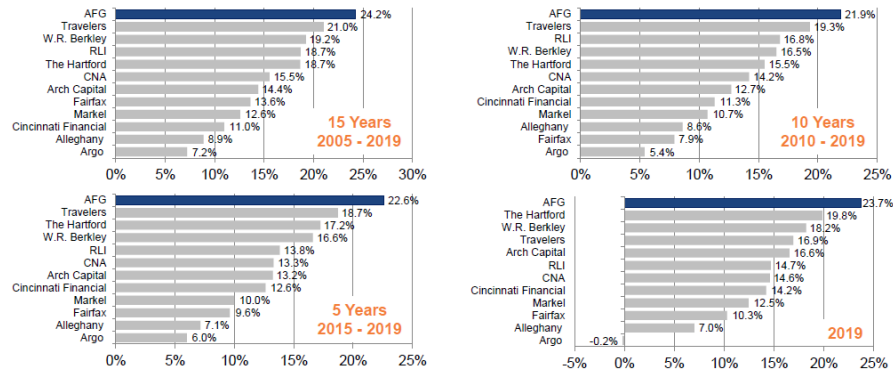
**7.7%**  
Points  
Better  
Over 10  
Years



<sup>1</sup> Commercial Lines Industry based on data from A.M. Best's U.S. Property/Casualty Review & Preview – March 2, 2020 for data 2011-2019 and Conning, Inc.'s Property-Casualty Forecast & Analysis (Fourth Quarter 2020 Edition) for 2020 data.  
<sup>2</sup> American Financial Group Form 10K filings.

Not only do these underwriting results compare favorably to the overall industry, they also stack up better than their highest quality peers.

## Pretax Property & Casualty Returns



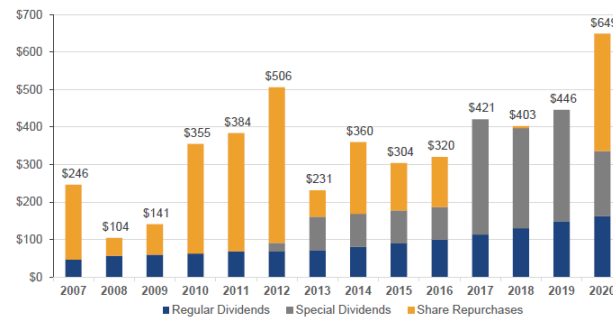
Source: Dowling & Partners

## Disciplined Capital Allocators

Management's capital allocation decisions extend beyond organic growth opportunities and serve as another tool to maintain a consistently high ROE. While underwriting results have been strong in AFG's P&C segment due to thoughtful allocation to each of these underwriting lines, the results are also bolstered by management's willingness to distribute excess capital to shareholders if organic growth opportunities do not meet the company's ROE thresholds. Management has always been thoughtful about balancing these myriad capital deployment opportunities. The chart below shows how management has used a combination of regular dividends, special dividends and share repurchases as capital deployment tools.

## Share Repurchases and Common Stock Dividends

Dollars in millions



Between years 2009 – 2012, AFG repurchased 33.7 million shares at a weighted average price of ~90.5% of adjusted book value (book value per share excluding unrealized gains/losses related to fixed maturities).



13

AFG generally operates with substantial excess capital, which has served the company well as it allows the company to be opportunistic with accretive M&A (Summit in 2014, National Interstate in 2016) or share repurchases (2020). AFG had \$1.1B of excess capital at YE '20 (\$4.3B once the Life Insurance sale is complete), resulting in a drag on ROE of nearly 4% for 2020 (has ranged from 2%-4% over the last 5 years).

Management's capital allocation discipline was on full display in Q1 when AFG monetized the life insurance portfolio through the sale to Mass Mutual. I was surprised AFG sold the entire business given that 1) Craig Lindner's duties were largely confined to this segment and 2) the amount of proceeds from an outright sale will likely be difficult to deploy quickly. There is some risk as to how AFG will use these sale proceeds, but as described above, I trust this management team to act in the best interests of shareholders. After all, the Lindner's are the largest owners of this business.

I would like to once again thank all of my initial investors for their support. As always, feel free to contact me if you have any questions about the portfolio.

Sincerely,

Christopher Godfrey



### Important Disclosure

This report is solely for informational purposes and shall not constitute an offer to sell or the solicitation to buy securities. The opinions expressed herein represent the current views of the author(s) at the time of publication and are provided for limited purposes, are not definitive investment advice, and should not be relied on as such. The information presented in this report has been developed internally and/or obtained from sources believed to be reliable; however, Headwaters Capital Management, LLC (the “firm”) does not guarantee the accuracy, adequacy or completeness of such information.

Predictions, opinions, and other information contained in this report are subject to change continually and without notice of any kind and may no longer be true after the date indicated. Any forward-looking statements speak only as of the date they are made, and the firm assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, which change over time. Actual results could differ materially from those anticipated in forward-looking statements.

In particular, target returns are based on the firm’s historical data regarding asset class and strategy. There is no guarantee that targeted returns will be realized or achieved or that an investment strategy will be successful. Investors should keep in mind that the securities markets are volatile and unpredictable. There are no guarantees that the historical performance of an investment, portfolio, or asset class will have a direct correlation with its future performance.

Investing in small- and mid-size companies can involve risks such as less publicly available information than larger companies, volatility, and less liquidity. Investing in a more limited number of issuers and sectors can be subject to greater market fluctuation. Portfolios that concentrate investments in a certain sector may be subject to greater risk than portfolios that invest more broadly, as companies in that sector may share common characteristics and may react similarly to market developments or other factors affecting their values.

**Past performance does not guarantee future results.**