



HEADWATERS
CAPITAL

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ACTIVE MANAGEMENT IS NOT DEAD, BUT IT MUST EVOLVE

	LOW COST PASSIVELY MANAGED INDEX OPTION	ACTIVELY MANAGED MUTUAL FUND	HEADWATERS CAPITAL MANAGEMENT
HOLDINGS	827	99% of Mutual Fund assets are in funds with more than 40 stocks	20-30
TRADING/ TURNOVER	N/A	77%	<20%
TAX EFFICIENCY	Deferred capital gain taxes	High turnover creates annual capital gains distributions that are taxable	Long investment horizon & low turnover minimizes capital gain taxes
FEES	0.23%	1.41%	1.25% or performance free

Passively Managed Index: iShares Russell Mid-Cap ETF

Actively Managed Mutual Fund: US Mid-Small. *Source: Personal Fund*

- **Index funds:** Low cost and tax advantaged, yet their broad ownership of all stocks prevents outperformance.
- **Mutual funds:** Less diversified than index funds, but are still overly diversified preventing mutual funds from materially outperforming. After layering in excessive trading costs, capital gains taxes associated with high turnover and the high fee structure, mutual funds rarely outperform index funds.
- **Headwaters Capital:** Concentrated and low turnover investment approach is a superior alternative to both low cost index funds and actively managed mutual funds as it allows for material outperformance versus an index while also minimizing trading costs and taxes.



CORE INVESTMENT PRINCIPLES



INVESTMENT PHILOSOPHY

Allocating capital to a limited number of exceptional businesses that, through their sustainable competitive advantages and long runways for growth, can compound capital at above average rates of return.

INVESTMENT APPROACH

Combining the core investment philosophy with the discipline and patience to allow these companies to grow into their full investment potential while simultaneously minimizing costs and maximizing returns for investors.



STRATEGY OVERVIEW

ACTIVE

Fundamental, bottoms-up approach to individual security selection.

CONCENTRATED

High conviction strategy of 20-30 names, long only.

SMID CAP

Investments in companies with market caps of \$0.5B - \$20B. No forced selling if grow > \$20B.

LONG-TERM

Targeted investment periods of 3-5 years, ideally longer.

MARKET EXPOSURE

Fully invested with cash position less than 5% of portfolio.

SEPERATELY MANAGED ACCOUNTS

SMA structure provides transparency into portfolio holdings and liquidity for investors.

ALIGNMENT

Portfolio Manager has significant amount of personal net worth invested in the strategy.

FEES

Performance Fee structure for Qualified Investors; 1.25% management fee for non-Qualified

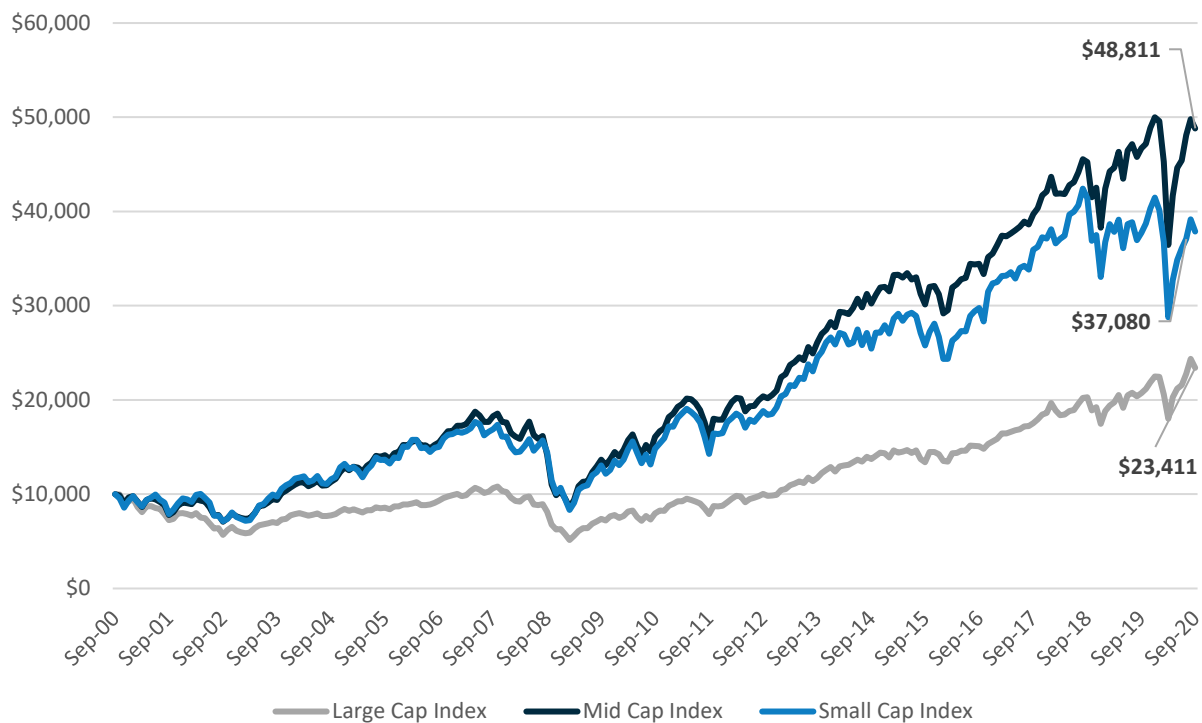


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Small Cap Market Update (November 2023)

SMID CAP: HISTORY OF OUTPERFORMANCE

20 Year Growth of a \$10,000 Investment

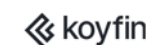
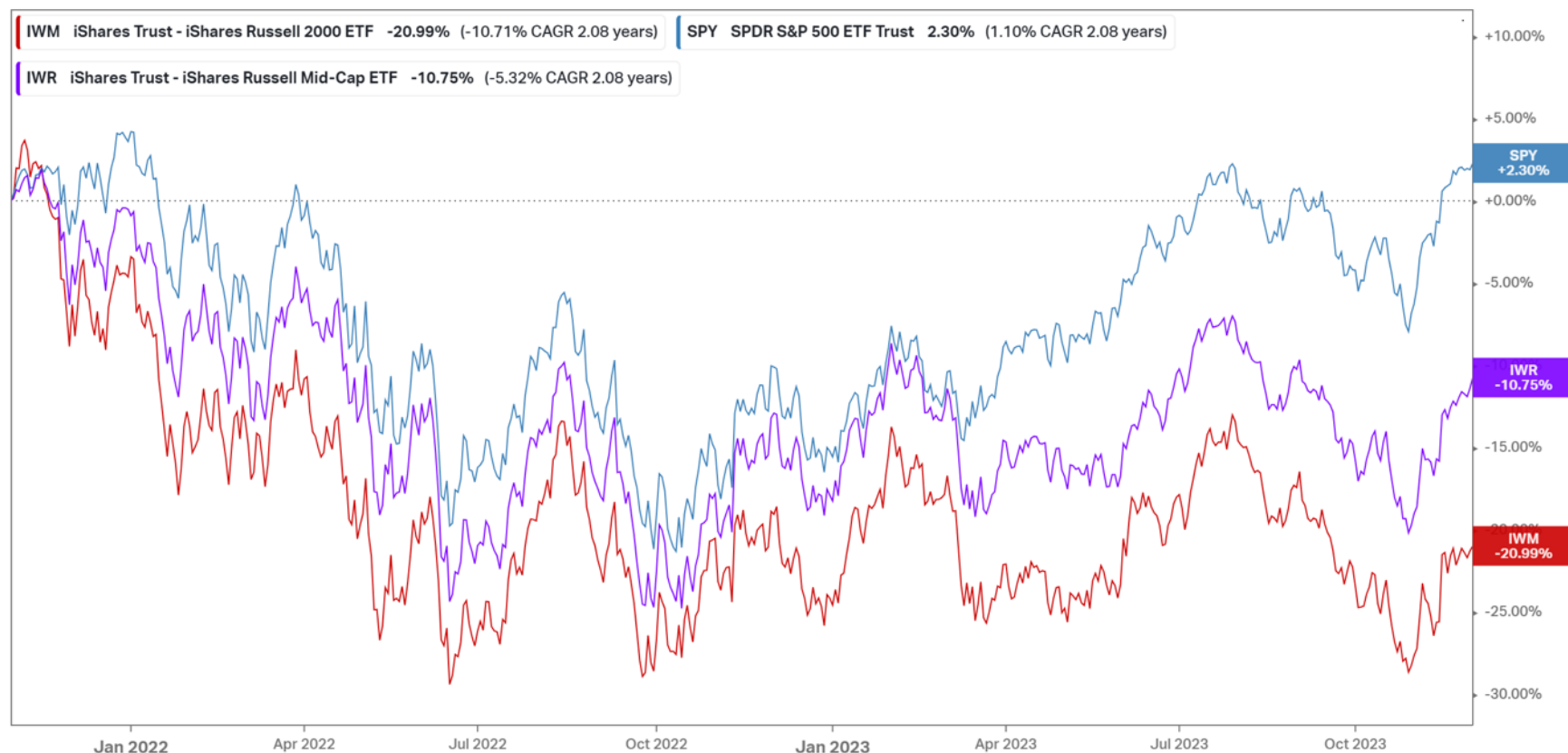


*Large Cap: S&P 500, Mid Cap: Russell Mid Cap, Small Cap: Russell 2000
Source: FTSE Russell & S&P Dow Jones

- Empirical data shows that both small and mid-cap stocks have consistently outperformed larger cap stocks over long time periods.
- By limiting investments to these “headwaters,” the fund seeks to participate in what has historically been a higher return portion of the equity market.



The Opportunity in Small Caps: Small Cap Has Already Seen a Dramatic Correction



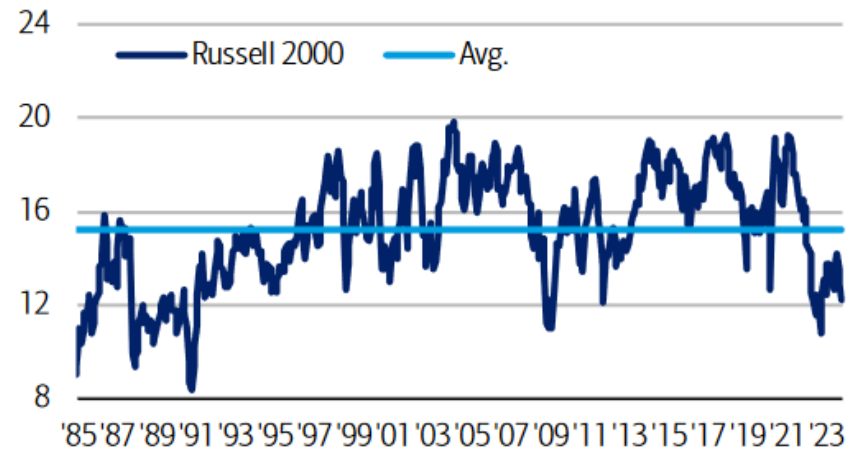
- Peak to Trough decline for small caps was -30% and small caps are still -21% from the highs experienced in 2021
- Peak to trough decline for mid caps was -25% and mid caps are still -11% from the highs experienced in 2021
- Over the last 18 months, the market has been led by a small number of large caps (the Magnificent 7)



Underperformance a Combo of Multiple Compression and Negative Earnings Revisions

Exhibit 1: Small cap forward P/E below the long-term average

Russell 2000 Forward P/E, 1985-10/31/2023

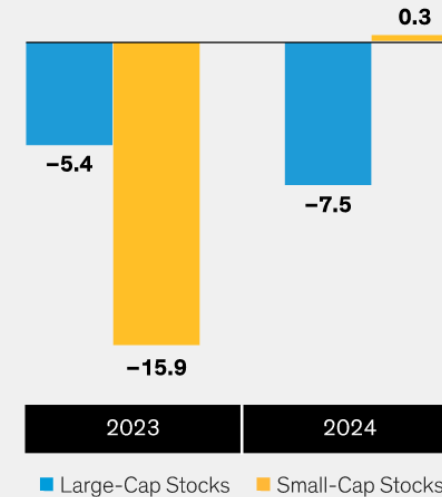


Source: BofA US Equity & Quant Strategy, FactSet

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Year-over-Year Improvement in Earnings Estimates Favor Small-Caps

Change in Earnings Forecast (Percent)

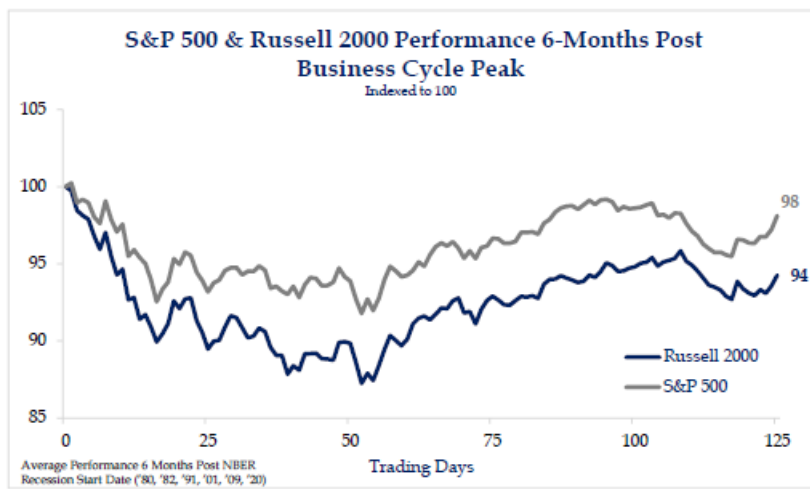


Source: Alliance Bernstein

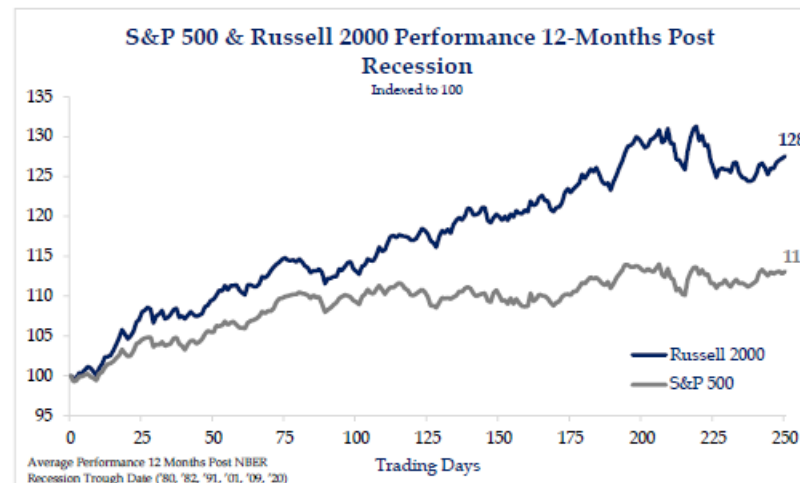
Small Caps Outperform Coming Out of a Recession

11/18/22

WHILE SMALL CAPS LAG HEADING INTO RECESSION



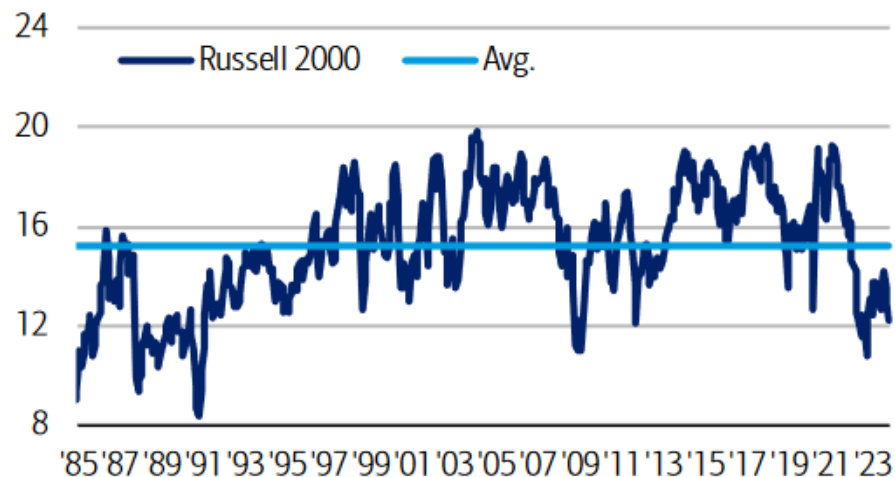
THEY LEAD IN THE RECOVERY



Small Caps Are Cheap on Both an Absolute and Relative Basis

Exhibit 1: Small cap forward P/E below the long-term average

Russell 2000 Forward P/E, 1985-10/31/2023

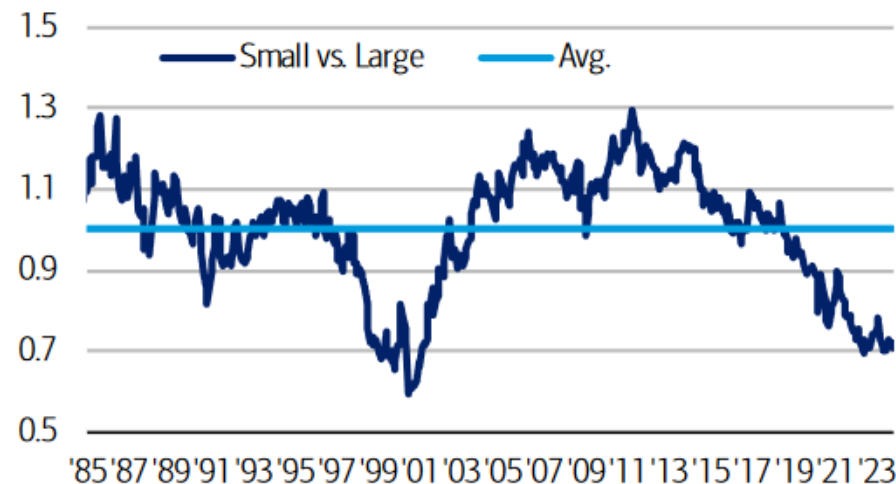


Source: BofA US Equity & Quant Strategy, FactSet

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Exhibit 2: Small caps remain historically cheap vs large caps

Relative Forward P/E: Russell 2000 vs Russell 1000, 1985-10/31/2023



Source: BofA US Equity & Quant Strategy, FactSet

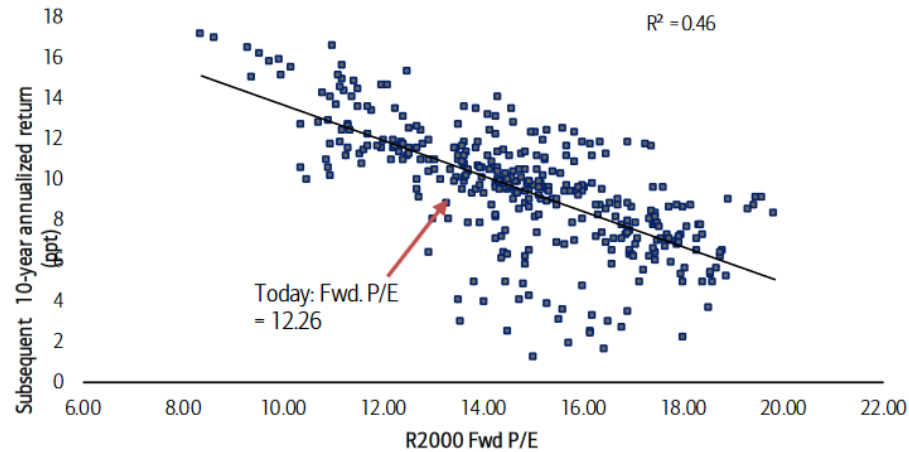
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And these Valuations Have Historically Led to Strong Absolute and Relative Returns

Exhibit 28: The absolute forward P/E for the Russell 2000 suggests double-digit annualized ten-year returns

Russell 2000 forward P/E vs subsequent ten-year annualized returns, 1985-present (as of 10/31/23)

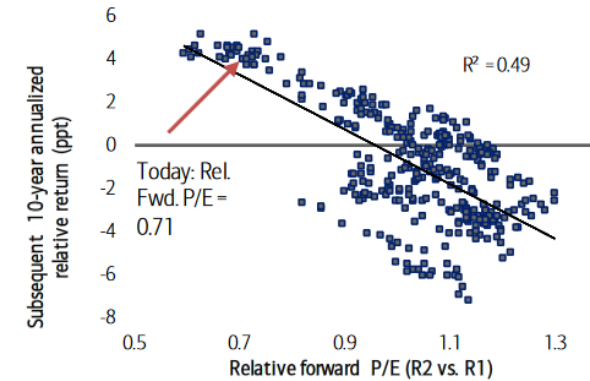


Source: BofA US Equity & Quant Strategy, FactSet

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Exhibit 27: Relative multiple suggests that small caps could outperform large caps over the next ten years

Relationship between relative fwd. P/E of Russell 2000 vs Russell 1000 and subsequent 10yr annualized relative returns, 1985 – 10/31/2023

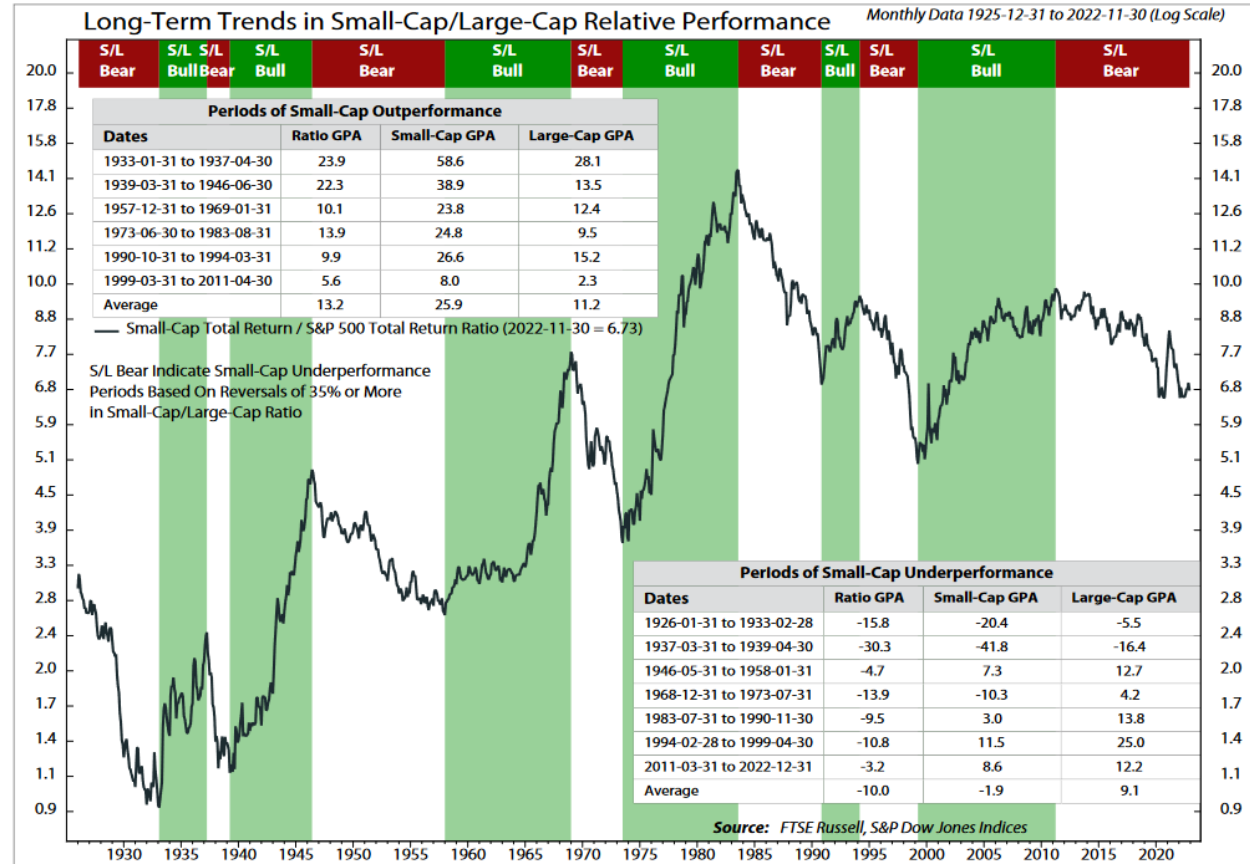


Note: Represents the relationship between the relative forward PE for the Russell 2000 vs the Russell 1000 (since 1979) and subsequent rolling 10-year annualized returns differential.

Source: BofA US Equity & Quant Strategy, FactSet

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Regime Changes Tend to Persist



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And When Central Banks Pause Hiking Cycles, Bullish for Small Caps

Exhibit 47: Small caps typically outperformed, on average, once the Fed stops hiking – which was particularly true in the 70s/early 80s
Relative performance (ppt) of small caps vs. large caps around Fed tightening cycles since 1971 with returns prior to and following the final rate hike

Start of hiking	End of hiking	3m before last hike	6m before last hike	12m before last hike	Full hiking cycle	3m after last hike	6m after last hike	12m after last hike
3/31/1971	8/31/1971	-2%	-1%	14%	-3%	-5%	4%	-10%
3/31/1972	7/31/1973	-3%	-13%	-25%	-26%	5%	5%	2%
3/31/1974	5/31/1974	-6%	3%	3%	-19%	3%	1%	18%
6/30/1975	6/30/1975	5%	33%	23%	N/A	0%	-3%	12%
4/30/1976	5/31/1976	-3%	16%	14%	-11%	-1%	4%	22%
12/31/1976	3/31/1980	-10%	-7%	1%	17%	7%	19%	31%
8/31/1980	5/31/1981	12%	15%	33%	33%	-5%	-6%	-4%
5/31/1983	8/31/1984	-2%	-4%	-7%	-3%	-4%	1%	-1%
12/31/1986	9/30/1987	-2%	-6%	-6%	-3%	-6%	3%	2%
4/30/1988	2/28/1989	3%	-4%	5%	-4%	0%	-6%	-11%
2/28/1994	2/28/1995	-2%	-3%	-7%	-5%	-3%	3%	-5%
6/30/1999	5/31/2000	-20%	1%	-2%	-2%	5%	1%	16%
6/30/2004	6/30/2006	-3%	6%	6%	5%	-4%	-3%	-3%
12/31/2015	12/31/2018	-6%	-10%	-6%	-2%	1%	-2%	-5%
Full history	Average	-3%	2%	3%	-2%	-1%	2%	5%
	Median	-3%	-2%	2%	-3%	-1%	1%	0%
	Hit Rate	21%	43%	57%	23%	43%	64%	50%
70s-Early 80s	Average	-1%	6%	9%	-2%	1%	3%	10%
	Median	-3%	3%	14%	-7%	0%	4%	12%
	Hit Rate	29%	57%	86%	33%	57%	71%	71%

Note: based on Russell 2000 vs. Russell 1000 indices for hiking cycles from 1983-now. Prior to 1981, source of historical returns: CRSP®, Center for Research in Security Prices, Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy

Source: CRSP, Bloomberg, BofA US Equity & US Quant Strategy



Strongest Returns Occur in First Year

Exhibit 13: Small cap returns in first year of secular outperformance cycle

Based on CRSP data for small and large cap US stock returns

Yr 1 Start	Yr 1 End	Small	Large	Relative (Sm. Vs Lg)	
5/31/1932	5/31/1933	286%	111%	175%	
1/31/1964	1/31/1965	22%	16%	5%	
7/31/1974	7/31/1974	0%	0%	0%	
10/31/1990	10/31/1991	62%	33%	30%	
3/31/1999	3/31/2000	51%	22%	29%	
3/31/2020	3/31/2021	119%	59%	61%	
		Avg.	84%	36%	48%
		Median	51%	22%	29%

Source of historical returns: CRSP®, Center for Research in Security Prices, Graduate School of Business, The University of Chicago. Used with permission. All rights reserved.

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Source: CRSP, The University of Chicago; BofA US Equity & Quant Strategy

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Exhibit 14: Small cap returns in second year of outperformance cycle

Based on CRSP data for small and large cap US stock returns

Yr 2 Start	Yr 2 end	Small	Large	Relative (Sm. Vs Lg)	
5/31/1933	5/31/1934	12%	4%	8%	
1/31/1965	1/31/1966	33%	7%	26%	
7/31/1974	7/31/1975	39%	16%	23%	
10/31/1991	10/31/1992	9%	10%	-1%	
3/31/2000	3/31/2001	-21%	-27%	6%	
3/31/2021	3/31/2022	-11%	14%	-25%	
		Avg.	14%	2%	12%
		Median	12%	7%	8%

Source of historical returns: CRSP®, Center for Research in Security Prices, Graduate School of Business, The University of Chicago. Used with permission. All rights reserved.

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Source: CRSP, The University of Chicago; BofA US Equity & Quant Strategy

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Exhibit 15: Small cap returns in third year of outperformance cycle

Based on CRSP data for small and large cap US stock returns

Yr 3 Start	Yr 3 end	Small	Large	Relative (Sm. Vs Lg)	
5/31/1934	5/31/1935	-9%	8%	-17%	
1/31/1966	1/31/1967	3%	-3%	6%	
7/31/1975	7/31/1976	29%	19%	10%	
10/31/1992	10/31/1993	32%	14%	18%	
3/31/2001	3/31/2002	22%	-1%	23%	
3/31/2022	10/31/2022	-11%	-14%	3%	
		Avg.	15%	7%	8%
		Median	22%	8%	10%

Source of historical returns: CRSP®, Center for Research in Security Prices, Graduate School of Business, The University of Chicago. Used with permission. All rights reserved.

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Exhibit 16: Small cap returns in fourth year of outperformance cycle

Based on CRSP data for small and large cap US stock returns

Yr 4 start	Yr 4 end	Small	Large	Relative (Sm. Vs Lg)	
5/31/1935	5/31/1936	90%	48%	41%	
1/31/1967	1/31/1968	41%	9%	32%	
7/31/1976	7/31/1977	24%	-1%	25%	
10/31/1993	10/31/1994	0%	3%	-3%	
3/31/2002	3/31/2003	-27%	-24%	-3%	
		Avg.	26%	7%	18%
		Median	24%	3%	25%

Source of historical returns: CRSP®, Center for Research in Security Prices, Graduate School of Business, The University of Chicago. Used with permission. All rights reserved.

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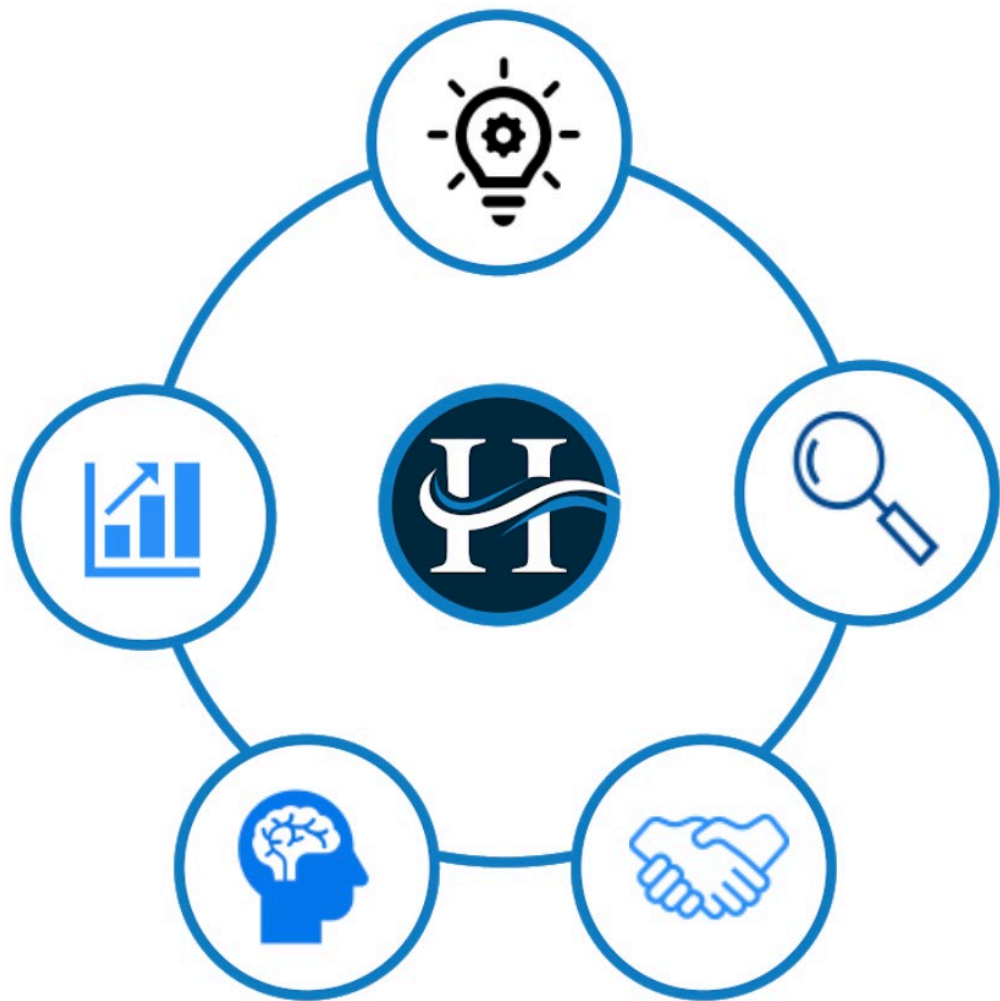
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Concern Around Investing Too Soon is Exaggerated: Very Difficult to Time the Bottom

S&P 500 Returns - 2 Years Following Market Trough				
Initial Investment (T-12)	Initial Investment (T-6)	Market Trough	Initial Investment (T+6)	Initial Investment (T+12)
27%	40%	6/13/1949	30%	11%
83%	71%	9/14/1953	69%	44%
22%	24%	10/22/1957	32%	10%
-3%	1%	10/25/1960	-14%	-19%
6%	18%	5/26/1970	30%	11%
-4%	10%	10/3/1974	28%	21%
9%	2%	3/27/1980	-9%	-18%
24%	45%	8/12/1982	12%	2%
13%	18%	10/11/1990	7%	6%
12%	5%	10/9/2002	33%	10%
11%	14%	3/9/2009	31%	18%
61%	51%	3/23/2020	39%	14%
Average	22%		24%	9%

WHY INVEST IN HEADWATERS CAPITAL?



DIFFERENTIATED

Investments in a limited number of high conviction ideas with a long-term investment horizon. This is the future of active management.

FOCUSED

Focused only on the highest quality companies with durable competitive advantages and above average growth potential, factors that have historically led to stock outperformance.

ALIGNED

Portfolio manager invested alongside you.

EXPERIENCED

Professional experience investing in SMID cap stocks.

PERFORMANCE

Designed to deliver superior investment returns through security selection, a cost efficient investment approach and a focus on SMID cap stocks, which have historically outperformed the broader market.

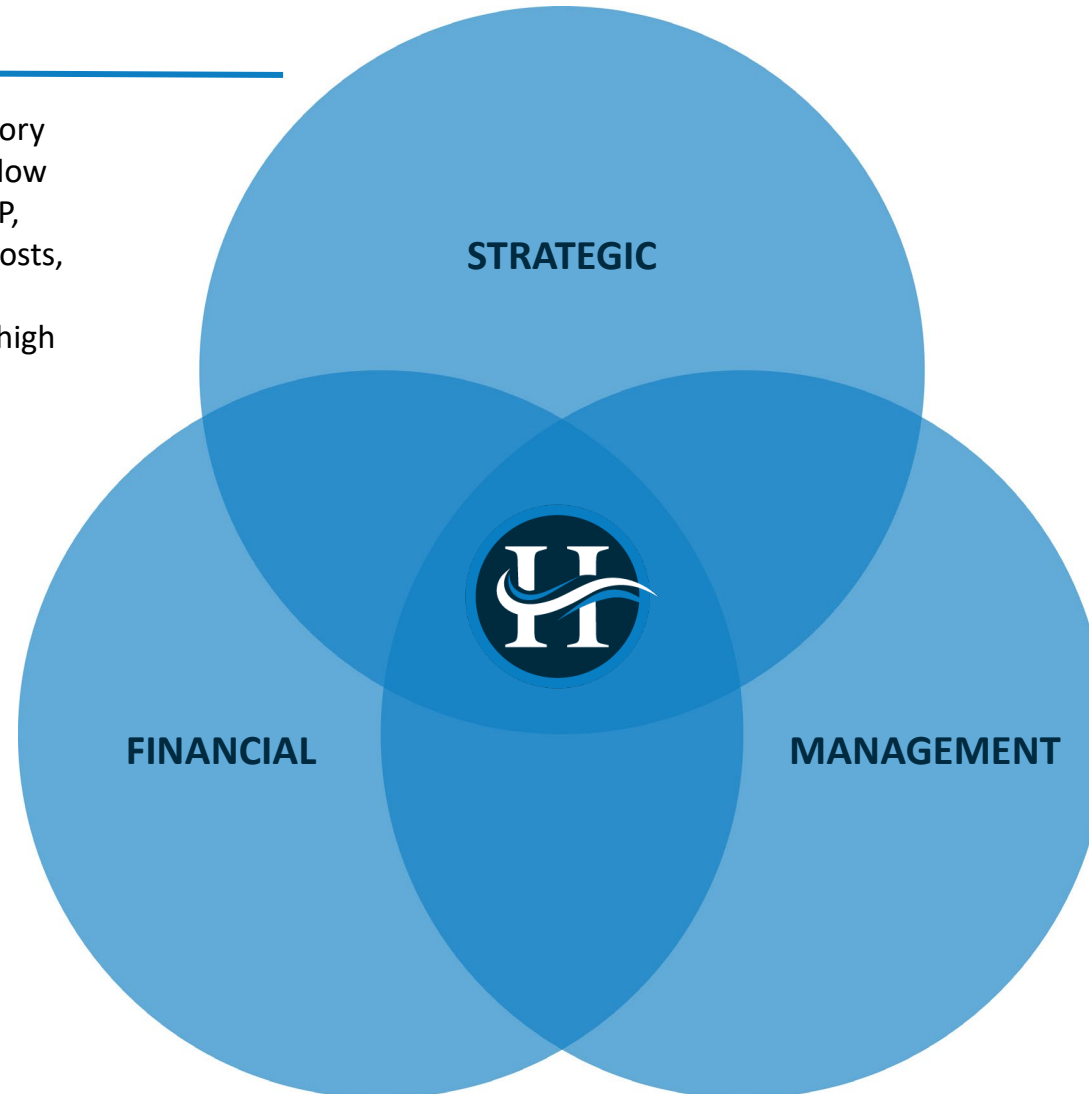


Appendix



ATTRIBUTES OF A POTENTIAL INVESTMENT

-
- Market leader in a product category
 - Durable competitive advantage: low cost producer/scale, monopoly, IP, network effects, high switching costs, high barriers to entry, etc
 - Stable and predictable revenue: high recurring revenue, low customer churn/high retention rates, consumable revenue



-
- High return on invested capital
 - Long-term revenue growth potential driven by a combination of market share gains and overall industry growth tailwinds
 - Free cash flow generation
 - Low financial leverage

-
- Management skin-in the game: founder, ownership stake, long-term incentive compensation
 - History of prudent capital allocation