



HEADWATERS

CAPITAL

Small Cap Market Update
(August 2024)

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- The indices shown are broad securities market indices. They are not subject to management fees, transaction costs and expenses to which a managed fund or account is subject. You cannot invest directly in an index. Those indices that are not benchmarks for the strategy are not representative of the strategy and are shown solely as a comparison among asset classes. Certain indices have been selected as benchmarks because they represent the general asset class in which Headwaters Capital’s strategy invests; however, even such benchmarks will be materially different from portfolios in the strategy since Headwaters Capital is not constrained by the any particular index in managing the strategy.
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Headwaters Capital 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



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

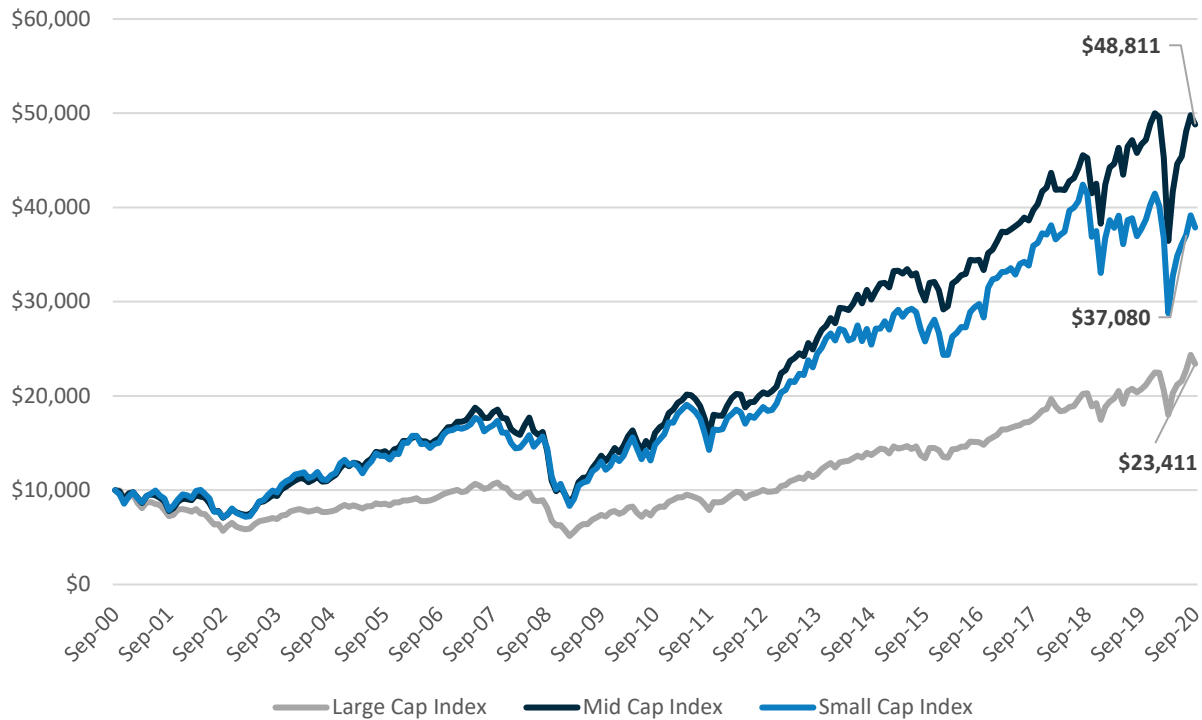
Combining the core investment philosophy with the discipline and patience to allow these companies to grow into their full investment potential while simultaneously minimizing costs and maximizing returns for investors.



Small Cap Market Update (August 2024)

SMID Cap: A History of Outperformance

20 Year Growth of a \$10,000 Investment

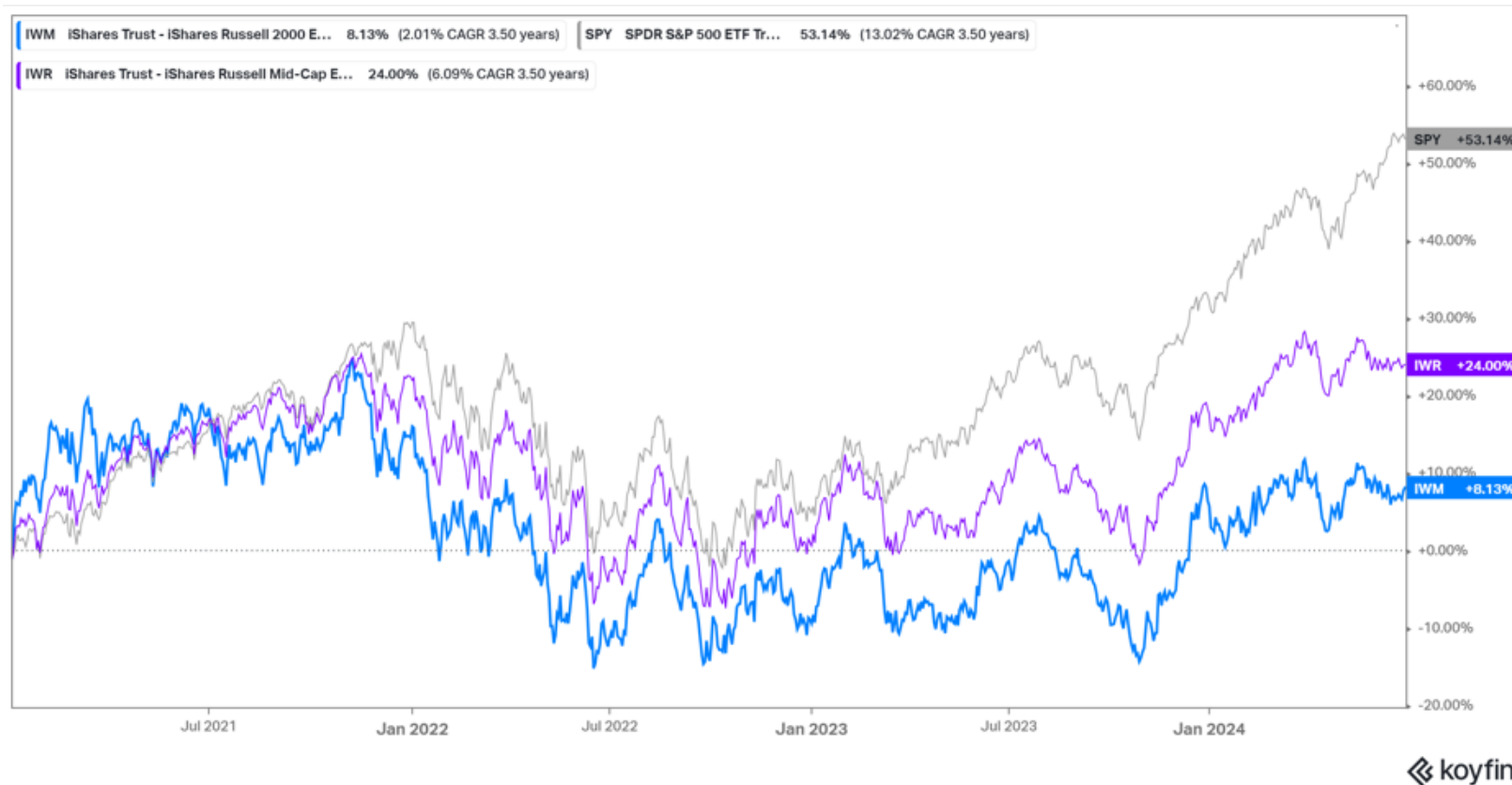


*Large Cap: S&P 500, Mid Cap: Russell Mid Cap, Small Cap: Russell 2000
Source: FTSE Russell & S&P Dow Jones

- 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.



More Recently, Small Cap Returns Have Significantly Trailed Large Cap Returns





2024 Small Cap Underperformance Relative to Large Cap Reached a Historical Extreme

Brutal Stretch for US Small Caps

Russell 2000 heads for worst first half to a year in history relative to the S&P 500

■ Russell 2000 Index versus the S&P 500 Index in first six months to a year



Source: Bloomberg

Note: 2024 is year-to-date through Tuesday, June 25

Bloomberg



Which Has Left Small Caps Historically Cheap on an Absolute Basis and Relative to Large Cap

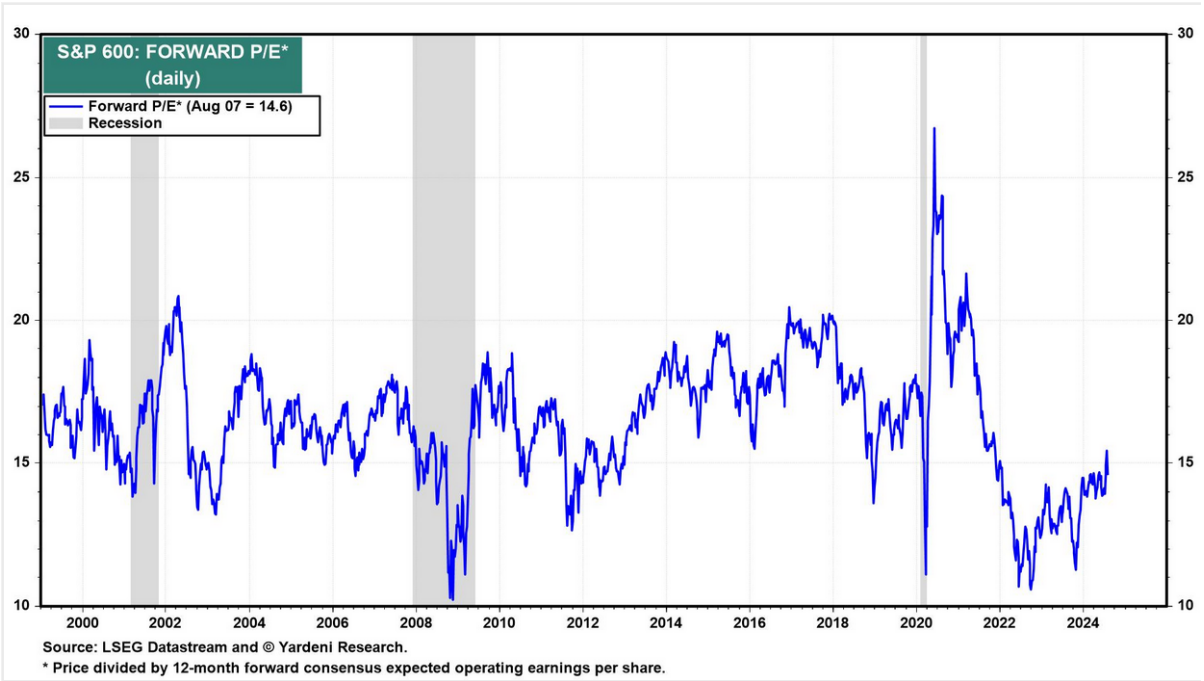
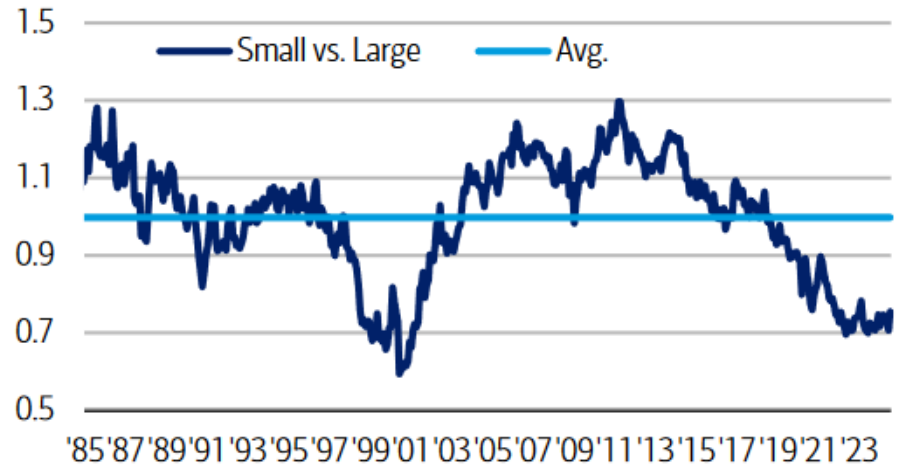


Exhibit 2: Small caps remain historically cheap vs large caps

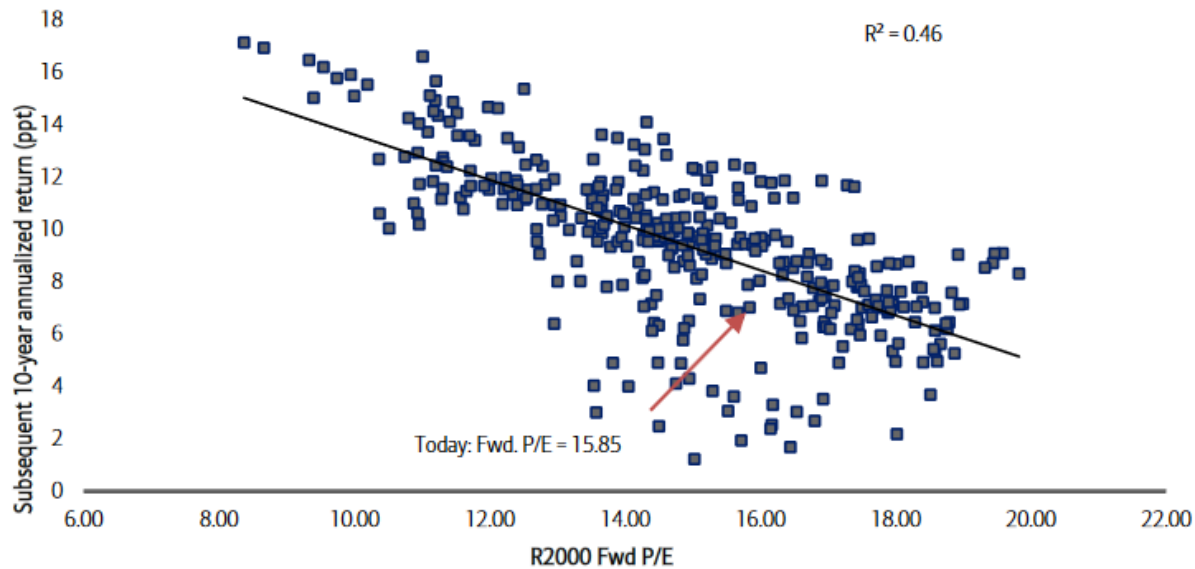
Relative Forward P/E: Russell 2000 vs Russell 1000, 1985-7/31/2024



Source: BofA US Equity & Quant Strategy, FactSet

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

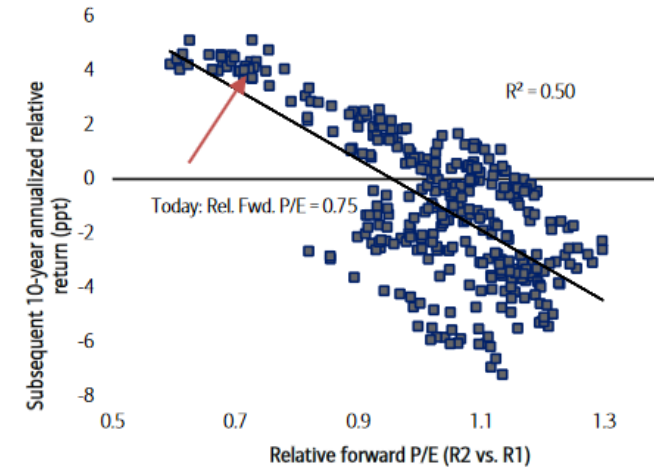
Exhibit 31: The absolute forward P/E for the Russell 2000 suggests 9% annualized ten-year returns
Russell 2000 forward P/E vs subsequent ten-year annualized returns, 1985-present (as of 7/31/24)



Source: BofA US Equity & Quant Strategy, FactSet

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Exhibit 30: 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 – 7/31/2024



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.

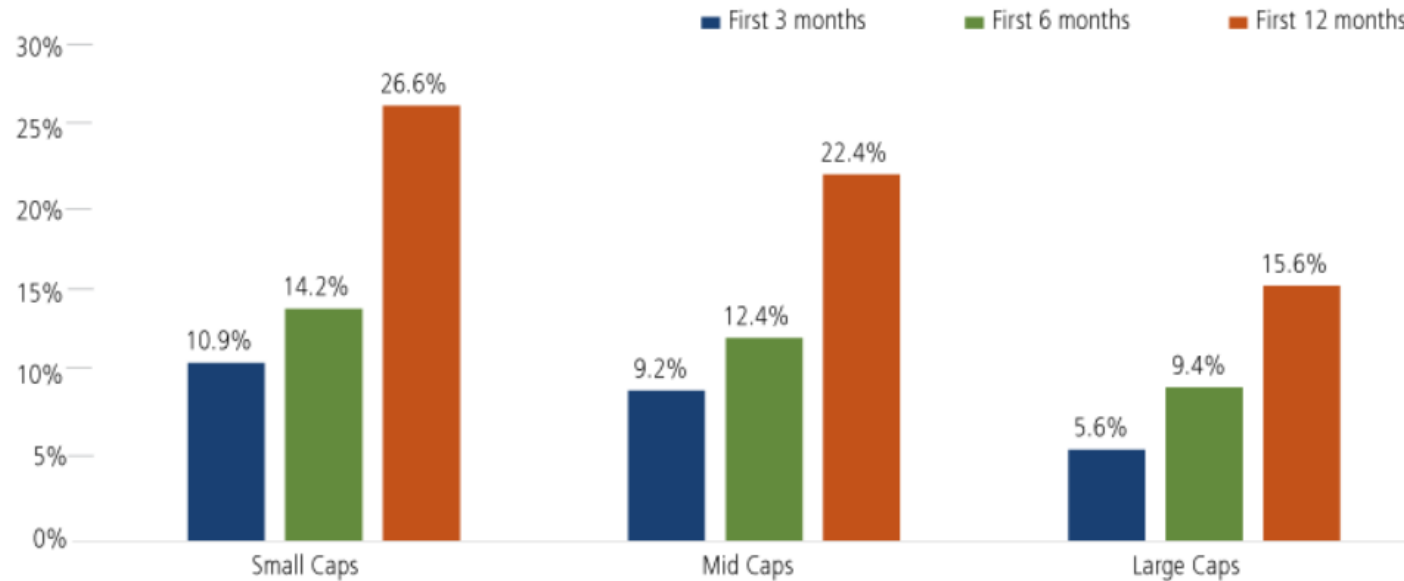
Source: BofA US Equity & Quant Strategy, FactSet

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Interest Rate Cuts Should be the Catalyst for Small Cap Outperformance

Rate Cuts Have Tended to Give the Biggest Boost to Small Caps
Performance after first Fed rate cut



Past performance is no guarantee of future results. Source: Jefferies using Federal Reserve Board, Haver Analytics, Center for Research in Securities Prices (CRSP®), and the University of Chicago Booth School of Business. Note: used fed funds rate from 1954 until 1963, then used the discount rate from 1963 until 1994 and the fed funds rate after that. Market caps defined by CRSP based on placing market caps into deciles. Deciles 1 and 2 are large and 6 through 8 are small.



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.

www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy

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

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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.

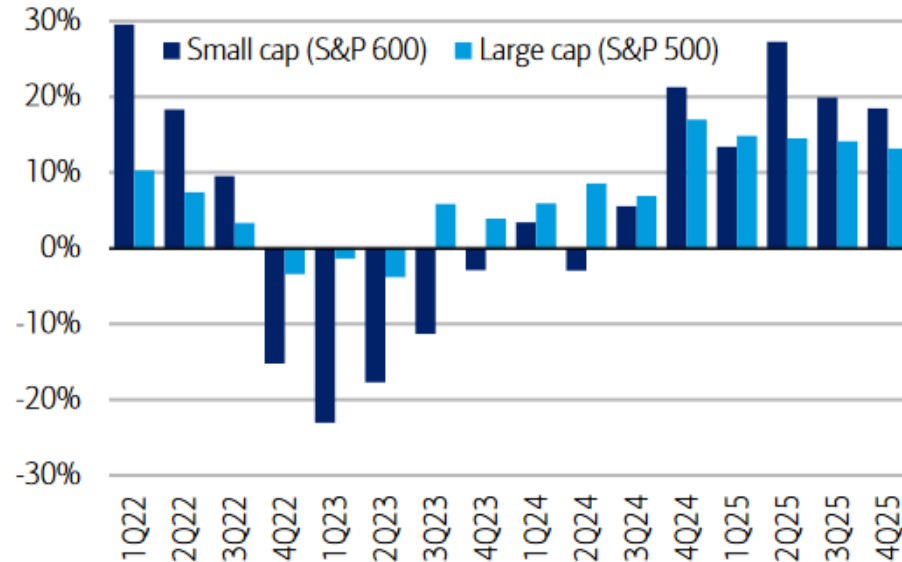
www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy

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

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Fed Rate Cuts Are Coinciding with Earnings Inflection for Small Caps, Providing Valuation and Earnings Tailwinds

Bottom-up consensus quarterly YoY EPS growth for small vs. large

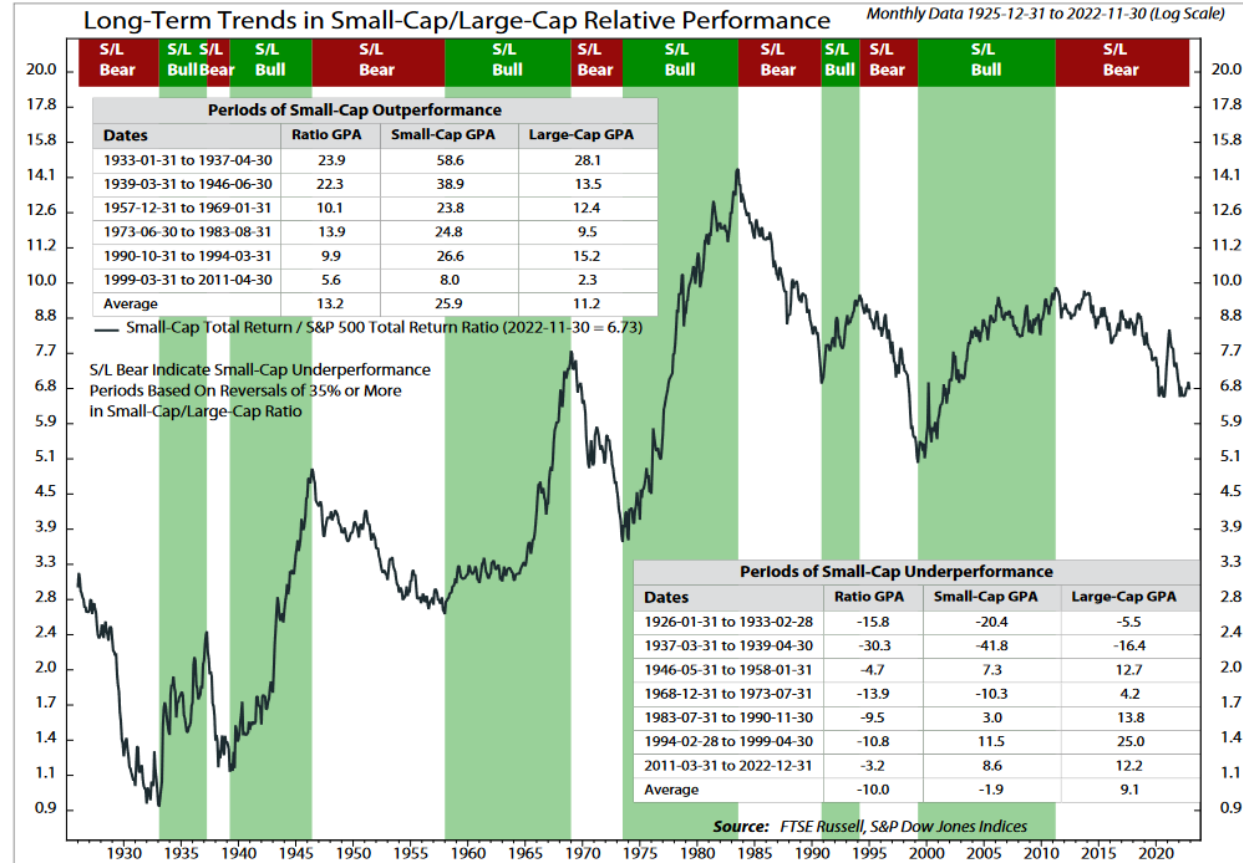


Source: Factset, BofA US Equity & US Quant Strategy

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- Small cap returns have been challenged over the last 18 months due to a declining earnings cycle
- This is typical behavior during a Fed tightening cycle as small caps are more economically sensitive and more exposed to higher financing costs
- Earnings growth is poised to inflect positively in 2H '24 and outpace large caps in 2025, further underpinning the positive outlook for small caps

Regime Changes Tend to Persist, Potential for Multiple Years of Small Cap Outperformance

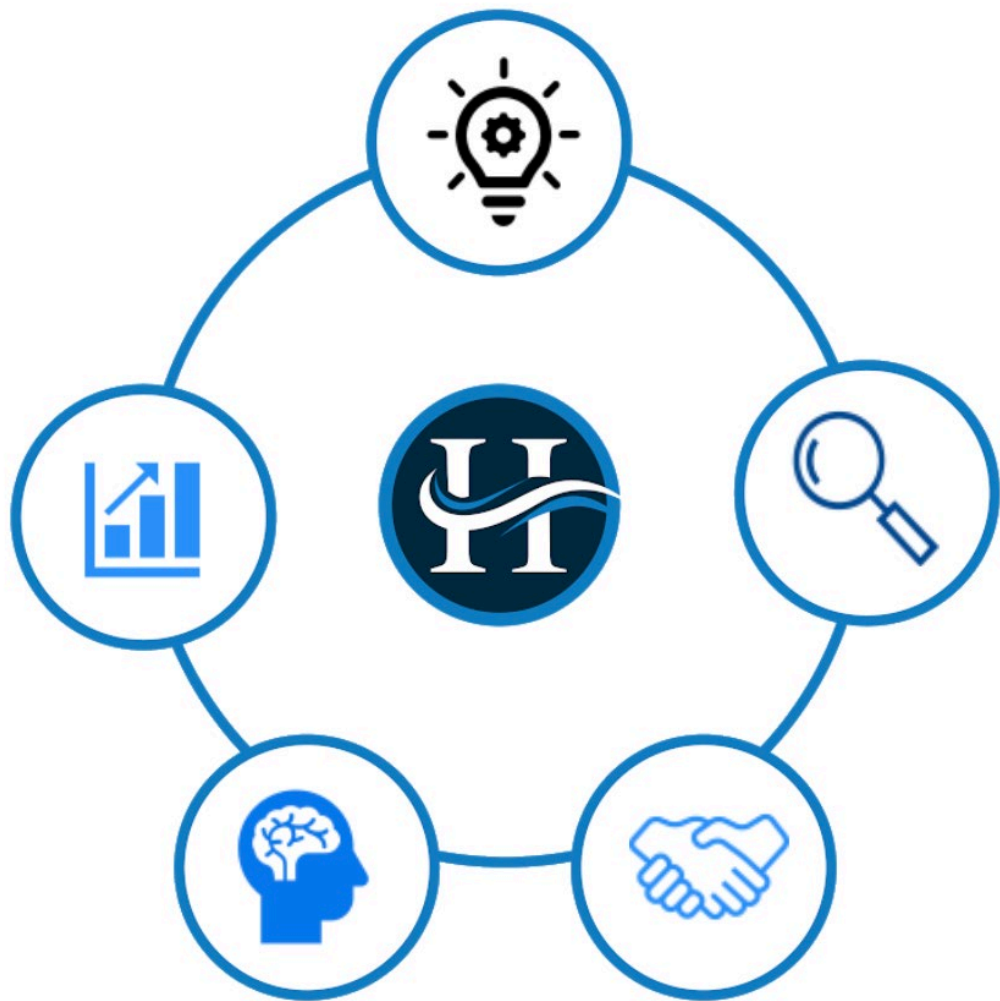


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Why Invest in Headwaters Capital?



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.

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

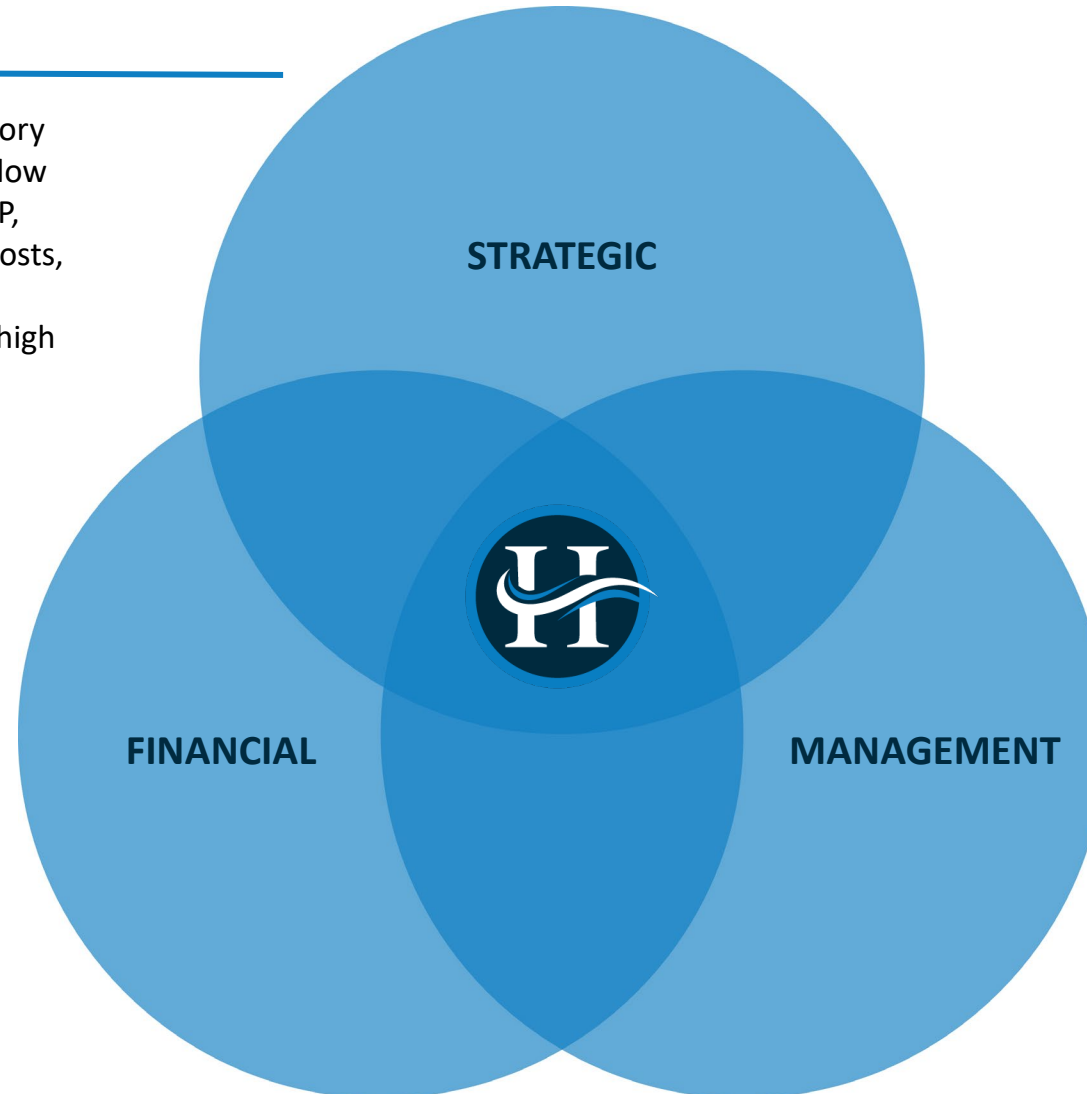
Passively Managed Index: iShares Russell Mid-Cap ETF

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.

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