April 8, 2025

Dear Investors,

The Headwaters Capital Management, LLC ("Headwaters Capital," "Headwaters," or the "Firm") portfolio declined -9.0% (-9.2% net) during Q1 2025 compared to a -3.4% decline for the Russell Mid Cap Index over the same period. A brief discussion of the performance and trading activity during the quarter is presented below.

Headwaters Capital Performance:

	Q1 25	2021	2022	2023	2024	Cumulative Since Inception (1/4/2021)
Headwaters Capital (Gross)	-9.0%	17.9%	-22.7%	34.8%	14.0%	27.3%
Headwaters Capital (Net)	-9.2%	17.1%	-23.4%	33.0%	13.1%	22.5%
Russell Mid Cap Index	-3.4%	22.6%	-17.3%	17.2%	15.3%	32.3%

**Performance for the Headwaters Capital portfolio has been calculated by Liccar Fund Services from 1/4/2021-12/31/2023.*

***Performance for the Headwaters Capital portfolio has been calculated by Longs Peak Advisory Services from 1/1/2024-3/31/2025.*

****Performance presented is that of a representative account invested in the strategy. Individual SMA performance may differ from the results presented above.* [1]

Q1 25 Performance Discussion

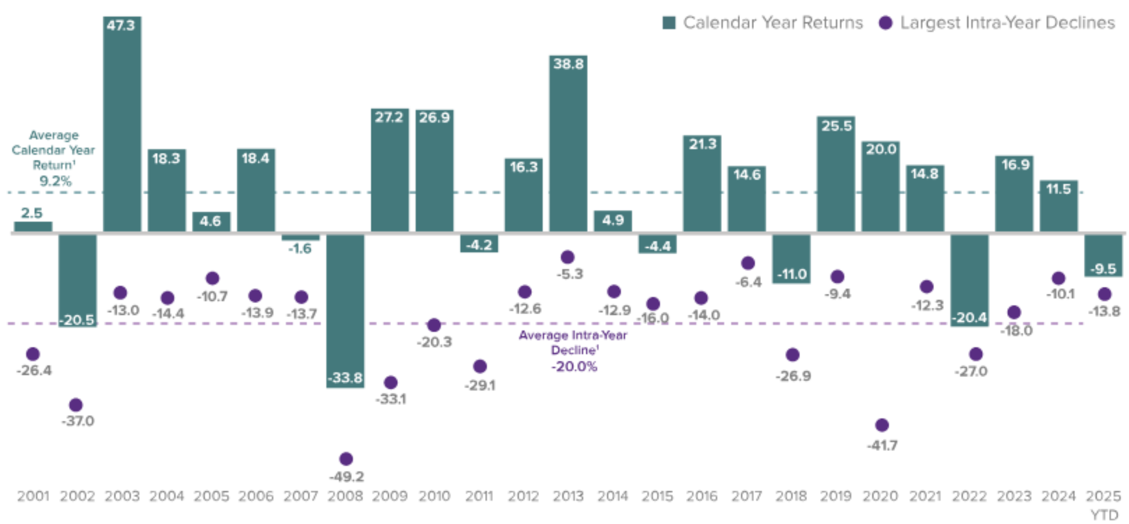
One week into Q2 and somehow the Q1 performance discussion feels completely irrelevant. The Q1 commentary was written on 3/31/25 prior to Trump's tariff announcements but still provides helpful context about Q1 performance and typical equity market corrections. A more fulsome discussion of more recent developments follows the Q1 update.

As someone who is heavily invested in the strategy and has aligned incentives with all investors in the strategy, I don't enjoy seeing the Q1 performance any more than you do. Unfortunately, the portfolio performed exactly as expected during this period of heightened uncertainty. Economic and policy uncertainty is a difficult cocktail for smaller companies who are perceived as more vulnerable to economic downturns. Given the economic backdrop that transpired in Q1, it was not surprising to see small cap stocks lead the market lower. However, this volatility is normal for small caps. While the Russell 2000 experiences a ≥ -10% drawdown almost every year, the index has generated a +7% annualized return since inception through 4/4/25 (+8% if we measured at YE 2024 prior to this selloff).

[1] 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. For further information about the total portfolio's performance, please contact Headwaters at the email address listed.

Large Intra-Year Declines Are Frequent

Russell 2000 Calendar-Returns and Intra-Calendar-Year Largest Declines, 12/31/00-3/31/25



¹*Year-to-date data is not included in averages*
Past performance is no guarantee of future results.

Source: Royce Funds

In general, I would expect the Headwaters portfolio to outperform the market during periods like Q1 given the quality bias of the companies in our portfolio, which makes them more resilient to economic shocks than the average small cap company. So why did the portfolio underperform the market in Q1? The underperformance was primarily the result of the size bias of the HCM portfolio compared to the Russell Mid Cap Index. The average and median market caps of companies in the Headwaters Capital portfolio are much smaller than the Rusell Mid Cap Index. During the quarter, investors sought safety in larger companies, which was a headwind to relative performance. This dynamic can be seen not only between indexes where the mid cap index significantly outperformed the small cap index, but also within indexes where larger companies outperformed smaller companies.

HCM Portfolio v. Index (Q1 25)

	Headwaters Capital	Russell Mid Cap	Russell Small Cap
Q1 25 Return	-9%	-4%	-10%
Largest Quintile of Market Cap Return		-2%	-9%
Smallest Quintile of Market Cap Return		-9%	-18%
Average Market Cap ($ Billions)	$ 8.6	$ 29.6	$ 3.5
Median Market Cap ($ Billions)	$ 4.8	$ 10.8	$ 0.8

I do not enjoy talking about these factors and how they impact performance because this is a concentrated portfolio designed to outperform over longer time periods as opposed to a bet on specific factors. However, given the extreme nature of this dynamic during Q1, it's worth noting since it had a significant impact on relative performance (and has been a persistent headwind to relative performance since inception).

Post-Liberation Day Update (April 6th)

As an economics major, this trade war is hard for me to comprehend. Economics 101 teaches the principles of comparative advantage, or when a country can produce a good or service at a lower opportunity cost than another country. International trade allows countries to specialize in what they do best and trade for other goods, leading to greater overall efficiency and mutual gains. Econ 101. While there may be sound arguments for implementing tariffs that target certain industries or countries, tariffs levied against every US trading partner seem extreme. Howard Marks always has an incredible way of summing it up better than I ever could. As he said, Italy should make the pasta and Switzerland should make the watches. Maybe a little too folksy for the current environment, but you get the idea. A more concrete example is Madagascar, where the US currently has a trade deficit and a country which is now subject to 47% tariffs.

> "Madagascar is a low-income country with an extraordinarily strong ability to produce vanilla beans. Americans enjoy the vanilla beans, but we do not much benefit from selling our various ware to low-income people from the island nation. It makes sense for us to lean toward net imports in our interactions with the Madagascans." *Source: The Dispatch*

I never imagined we would get to this point, so I certainly can't predict the ultimate outcome. In this highly uncertain environment, it is imperative to remove emotion and focus on facts to make high probability decisions that can enhance long-term returns for the portfolio. For example, the broad market volatility and indiscriminate selling has already presented opportunities to upgrade the quality of the portfolio by adding to certain positions with attractive valuations while simultaneously harvesting tax losses on other positions. This maintains equity market exposure, better positions the portfolio for a rebound and minimizes the tax burden of the portfolio.

In terms of the difficult question of when to increase equity market exposure, it is nearly impossible to predict the outcome of these trade policies and the ultimate economic impact. Stepping back from this uncertainty, we can use some frameworks to help assess the risk/reward of remaining invested and potentially increasing equity exposure. As discussed above, volatility is normal for small caps, but it increasingly looks like this will not be a typical correction. Since 11/25, the Russell 2000 has declined by -25%, which is well into bear market territory. Since the Russell 2000 index was created in 1984, the index has experienced 8 other sell offs > 25%. Each of these previous periods were terrifying times to be an equity market investor as evidenced not only by the significant decline in the value of the market, but also the dramatic decline in earnings for the companies in the index.

Russell 2000 Declines of > 25%

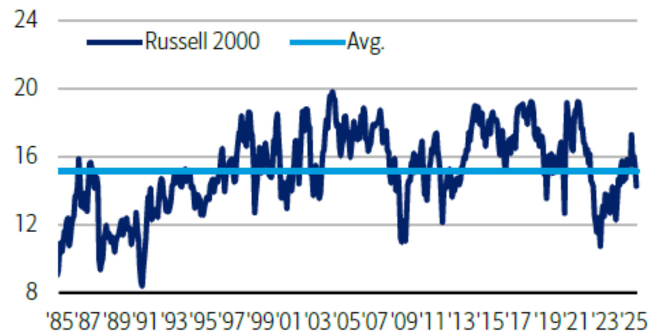
Period	Cause/Event	Peak to Trough Decline	Trough P/E Multiple	10 Year Yield @ Trough	Peak to Trough Earnings Decline*	Months to Recover to Prior All Time High
1987	**Black Monday**	-39%	9x	9.9%	-74%	24
1990	**Persian Gulf War**	-31%	8x	9.1%	-50%	12
1998	**Emerging Market Debt Crisis/Long-Term Capital Management**	-34%	13x	6.0%	-39%	14
2001-2002	**Tech Bubble**	-43%	13x	4.1%	-70%	17
2007-2009	**Great Financial Crisis**	-58%	11x	2.9%	-53%	25
2018	**Fed Hikes/Recession Fears**	-27%	13x	3.2%	-13%	N/A
2020	**COVID**	-42%	16x	0.7%	-61%	8
2021-2022	**Fed Hikes/Recession Fears**	-31%	11x	3.1%	-38%	37
2024-2025	**Trump Trade War (4/4/25)**	-25%	13x	3.9%	TBD	TBD

**Source Bank of America Merrill Lynch*

Despite the significant economic shocks experienced in each of the periods above, the market has gone on to make new all-time highs after each of these events. Using this table as a starting point, history suggests that stocks will not only survive this period of heightened uncertainty but will go on to make new all-time highs in the future. I can't tell you what will happen in the short term, but this context should provide some comfort that by elongating your investment time horizon, you can increase your odds of generating positive returns.

Thinking through the short-term market dynamics, the trough P/E multiple is the most useful data from these previous periods as it provides a guidepost to consider when the market has sufficiently priced in the bad news. As of the close of the market on 4/4/25, the forward P/E multiple on the Russell 2000 stood at 13.4x. Note that the chart below is only through 3/31/25 and does not encompass the early Q2 sell-off.

Exhibit 6: Small cap forward P/E slightly below long-term average
Russell 2000 Forward P/E, 1985-3/31/2025



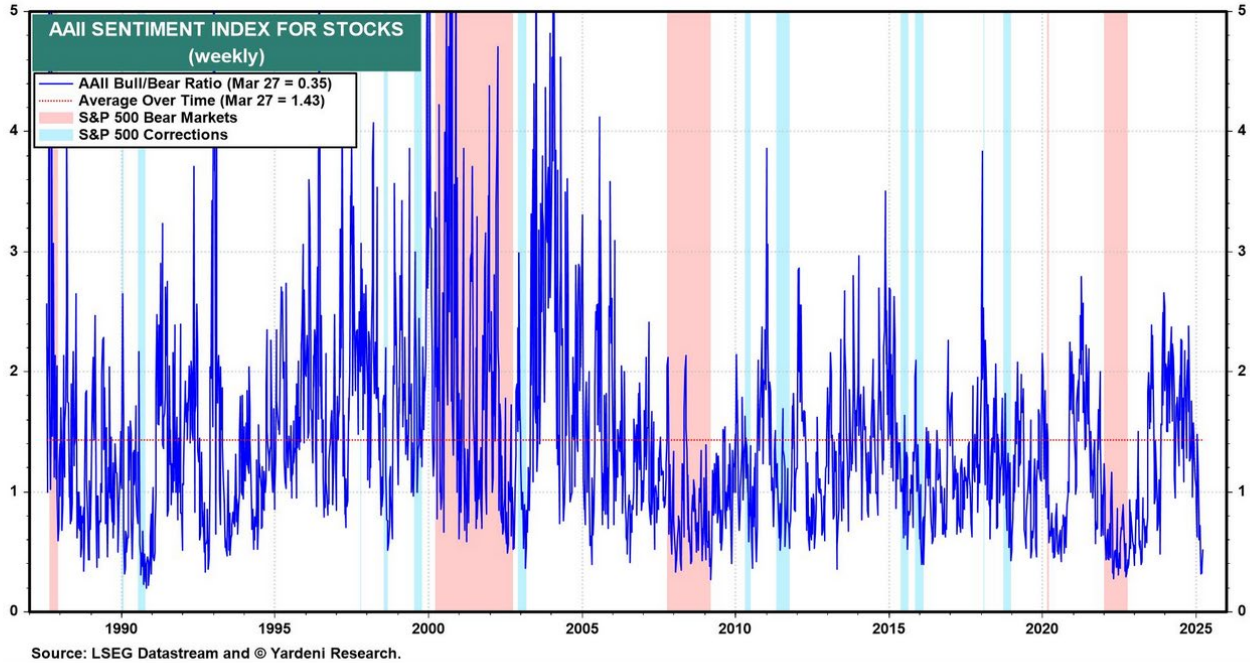
Source: BofA US Equity & Quant Strategy, FactSet

BofA GLOBAL RESEARCH

The only time the Russell 2000 has traded at a lower multiple was in the depths of the Great Financial Crisis and in mid-2022. In both of those instances, the Russell 2000 troughed at a multiple of 11x. The obvious pushback is "but earnings estimates need to come down!" Of course they do! People were saying the same thing in March of 2009 when the US banking system was teetering on the edge of collapse and corporate layoffs were reaching a peak (and they were right). As I have repeatedly written, the market is forward looking and is already pricing in these earnings cuts, it's why the market multiple is compressing. Said another way, maybe the market is actually trading at 18x trough earnings estimates?

Sitting here today, I'm not going to tell you that we don't re-visit the 11x P/E multiple. If we go forward with these tariffs, it almost seems certain that we will. Nobody knows how this ends. What we can do is use these facts to make rational and high probability investment decisions. An 11x P/E multiple represents -18% of downside and would take the peak to trough decline to -39%. The only drawdown worse than this hypothetical scenario was the Great Financial Crisis (-58%). As the table above shows, markets tend to recover their all-time highs within 1-2 years, which would equate to a +34% return from 4/4/25. If you have a longer investment horizon and can stomach some short-term volatility, the risk reward is beginning to skew positive.

Other more tactical trading indicators demonstrate the level of fear in the market today. The VIX (a measure of volatility and often referred to as the "Fear Gauge") closed at 47 on Monday 4/7 and has only exceeded this level in three other periods (LTCM, Great Financial Crisis and COVID). The bull/bear spread of individual investors is also at extreme bearish levels, which has historically signaled a good time to increase equity market exposure.



I'll reiterate, I don't know when or how this ends, but for longer term investors, this may prove to be just another blip on the long-term trend of positive returns. It certainly seems scary and unpredictable right now, but short-term sentiment indicators suggest we are nearing a point of maximum pessimism and valuations are nearing a trough. I remain confident that the best course of action is to extend your investment time horizon and focus on the long term. The Headwaters portfolio is composed of competitively advantaged businesses with conservative balance sheets and strong financial characteristics. Owning quality businesses during challenging economic times like today enables us to not only resist the temptation to sell but also enables us to confidently add to positions when opportunities arise.

If you are considering an allocation to small cap equities either as a portfolio diversifier or because you share some of my long-term optimism, please reach out to discuss in more detail.

Q1 25 Portfolio Review

Top Contributor: Brown and Brown ("BRO") +22%. BRO was a stand-out performer during the quarter and is a perfect example of the market rotation that occurred in Q1. Fundamental results remained strong, but were largely in line with expectations. However, the stock was a beneficiary of multiple expansion as investors viewed BRO's P&C brokerage business as a safe haven in a tumultuous market. BRO's multiple expanded from 18x EBITDA at the beginning of the quarter to 21x by the end of the quarter. While I continue to expect BRO to post strong results from a combination of pricing, volume and M&A, the stock is trading at a peak multiple on what is likely near peak P&C rates given the prolonged strong pricing environment over the last 4 years. Given the significant outperformance during the quarter and elevated valuation, I significantly reduced the position size as I saw better opportunities in other parts of the market (see discussion below).

Top Detractor: Transcat ("TRNS") – 30%. TRNS delivered a disappointing quarter as results from their 2021 Nexa acquisition materially missed expectations. As a reminder, TRNS provides inspection and calibration services for test and measurement instruments in the life sciences and industrial industries. These calibration and testing services are highly regulated by governing bodies (FDA, etc) and are required to be performed on a regular schedule. NEXA provides more project-based consulting services and this part of NEXA's business saw a material decline in performance. Management appears to have ring fenced the issue and more importantly, the core calibration business for TRNS continues to perform well. Given the critical nature of Transcat's services, the continued trend toward outsourcing these services and ample M&A opportunities, I continue to believe in the long-term thesis for TRNS.

Trading Activity

Buy: CBZ, Undisclosed Position

Sell: N/A

During the quarter, two new positions were added. The fist new company added was CBIZ ("CBZ"), a provider of accounting, tax and advisory services to small and midsize businesses. The addition of CBIZ was funded with proceeds from the partial sale of BRO, which had grown to be the largest position in the portfolio. BRO has been a core holding in the HCM portfolio since launch and has been a meaningful outperformer (+170% gain, or a 26% IRR) thanks to a hard market in P&C pricing and disciplined capital deployment through accretive M&A. BRO's multiple has expanded in conjunction with these strong results, which has also contributed to stock price performance. Today, BRO is trading at an all-time high multiple and it's hard for me to envision a stronger P&C pricing market than what we just experienced. Additionally, given BRO's current size, tuck-in acquisitions no longer contribute as significantly to earnings growth. Larger M&A transactions are more competitive and carry higher multiples, which mutes EPS accretion and comes with increased execution risk. Given that BRO was also the beneficiary of a "risk-off" trade during Q1, it was an opportunistic time to reallocate proceeds into CBZ, which was temporarily caught up in the small cap sell-off.

When looking at CBZ, I see a lot of similarities to BRO 4 years ago. Similar to BRO's P&C brokerage services, accounting and tax services are essential and required in any economic environment. High customer retention, ongoing new business wins and moderate pricing increases provide visibility into future revenue growth. CBZ also generates strong free cash flow, which will be utilized for M&A that can contribute more materially to results than for BRO. Valuation was also attractive with the stock trading down to a level not seen since July of 2019. CBZ's multiple compression was driven by a soft earnings report at the end of February when the company forecast lower revenue than expected from Marcum, its most recent acquisition. The sell-off was exacerbated by broader equity market weakness the following week, creating a temporary dislocation that HCM capitalized on. Speaking with management after the earnings call, I gained comfort in the outlook for the acquired Marcum business and increased conviction that the expense synergies associated with the deal are likely to exceed street expectations. Assuming the stock recovers back to its 14x EBITDA multiple, my price target of $114 on 2027 estimates represents +72% upside from our purchase price, or a +22% IRR. For a business that shares many of the same characteristics as BRO (CBZ even has a small P&C brokerage business), this significant upside warranted a re-allocation of funds.

Undisclosed Small Cap

The second position added during the quarter will remain undisclosed at this time given that it is a relatively unknown company with limited liquidity and a name that I may repurchase at a later time. The position was ultimately sold during the early Q2 market selloff as there were more attractive opportunities in the portfolio and this was a good source of tax loss harvesting. A brief summary of the business is below. If any existing investors are interested in more detail, I am happy to discuss or share the full investment thesis.

At a high level, this company has two business segments. One is the crown jewel that has compounded revenues at +14% for a decade and operates with 30% EBITDA margins. This business has high barriers to entry and consummable-like revenues. It's an ideal HCM portfolio company. The second business is highly commoditized, has seen flat revenue since 2018 and has seen significant margin pressure to the point that the Company is now operating near/below break-even. Thanks to recent investments and a new manufacturing site that was opened during the 2H of 2024, management communicated that the business had finally found its footing and could operate profitably in 2025. I did not initiate a full position in this business as I was trying to gain comfort with the outlook for a business that was brand new to me after meeting the management team in December. Unfortunately, I lost trust in management with the Q4 earnings report as the bad business continued to perform poorly and management no longer signaled confidence in operating the business at a profit.

The obvious question is why invest in this Company when it is burdened by a business that can't generate a profit. The answer comes from the upside associated with the good business (I estimate that business alone is worth 3x of the current market cap of the company) and a belief that no rational capital allocator would continue to operate a business that can't generate a profit (much less earn an appropriate return on capital). Furthermore, the founders own more than 50% of the Company, so presumably they are incentivized to increase the value of the company. One of the founders recently stepped down as CEO and his replacement formerly led the good business segment, signaling a strategic focus on this part of the company. However, it is unclear to me if the founders care about the value of their holdings in the company as they already have significant wealth even at the current valuation. I continue to engage in active dialogue with the current management team about ways to drive shareholder value. Pending significant changes to capital allocation, I would consider adding this position back to the portfolio.

As always, if you have any questions about the portfolio or the market, please do not hesitate to contact me.

Christopher Godfrey

Important Disclosure

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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.

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