October 17, 2017

Dear Investor:

The Russell 2000 finished the quarter strong, moving to +5.7% for the quarter, outperforming the S&P 500 which finished up +4.5%. Together these results put our Small / Large Blended Benchmark up +5.4% for the quarter. For the year, the small and large cap indices are now up +10.9% and +14.2%, respectively, putting our benchmark up +11.8%. Choice Equities Fund was up +3.8% and +2.9% on a gross and net basis for the quarter, pushing our year-to-date results to +15.4% and +11.9%, respectively.

We are pleased to report solid gains thus far year-to-date, particularly given our lack of exposure to the hot technology sector (the S&P 500 IT sector is up +26% thus far) while also running a net portfolio exposure that has leaned a little conservative. While these factors have not been advantageous to us thus far this year, we expect these things to normalize over time as they tend to do. Though we are content with performance thus far this year, we are more enthused about recent progress on both the portfolio and the business administration front, as we feel recent initiatives position us well to make continued progress on our chief goal of safely compounding capital at high rates of return.

**EXECUTIVE SUMMARY**

As is usual in our quarterly letters, we will offer some brief comments on the portfolio and the current investment environment. In this letter, we will provide an update on business operations and discuss the three new positions we added in the third quarter. We will also spend quite a bit of time talking about deals, given it is a theme that is particularly relevant to many our holdings.

**BUSINESS UPDATES**

We are delighted to announce Claire Young has joined our team as Sr. Vice President of Finance and Administration. She will handle a number of our day to day administrative affairs, onboarding of new clients and various compliance and bookkeeping responsibilities. She comes to us with much experience in this area, having spent 16 years in the financial services industry prior to her arrival here. We expect Claire's addition will improve our client service and also allow us to devote a greater proportion of our time to finding winning investments. We look forward to introducing her to you soon.

We are also excited to inform you that our website went up a few weeks ago. It can be accessed here: www.choice-equities.com. We only have a few documents posted up on the site thus far, but we look forward to adding additional letters, case studies and various communiques to the site soon. Please let us know if you have any thoughts, comments or suggestions on the format or the content. And if you like what you see, please tell your friends.

**NOTABLE PORTFOLIO PERFORMANCE DRIVERS**

LAWS, the portfolio's largest holding, began to show signs of life late in the quarter and contributed a 3% gain for the fund. Perhaps of more consequence, the company announced a sizeable acquisition a few days after the quarter closed. We view the deal quite positively as the company is beginning to augment its organic growth with accretive acquisitions and believe continued good reports from the company are coming. New portfolio addition GMS is off to a good start and also contributed nearly 3% to our fund's return. We will cover this new position in more detail in the following section. On the negative side, our entry into VRTV in 2Q looks a bit early. The stock's adverse reaction to 2Q earnings cost us almost 2% of fund performance in the quarter. For now we are holding pat, as the stock we originally viewed as cheap is now even cheaper.

**PORTFOLIO ACTIVITY**

We have discussed deals in relation to many of the distribution companies we know so well quite a lot in prior letters, and for good reason. Many of these companies have used acquisitions effectively to advance their market share gains, consolidate their industries and accelerate their growth engines. These transactions have often proven to generate real synergies, as the acquiring company gains customers and brings volume-based purchasing advantages to their newly acquired entities. This market consolidation opportunity is an important one, primarily because it presents a lasting growth opportunity for companies with the ability to execute on these initiatives.

But there is another important aspect to these deals too. Wall Street frequently neglects this growth opportunity. When most sell-side analysts publish their models, they typically only model for organic growth and acquisitions that have already been announced, leaving unannounced potential acquisitions unconsidered. On the face of it, this treatment makes sense. Acquisitions and their timing is unpredictable. And they are not always greeted favorably by shareholders. After all, traditionally the share price of the average acquiring company declines on deal announcements. The standard convention holds that deals are risky, probably not a good use of shareholder capital and frequently do not recoup the premium often paid to the target company.

But this standard convention only applies to deals on average. In some business models, these acquisitions make a great deal of sense. For many of our distribution companies, they are only acquiring smaller versions of themselves which presents a relatively low risk acquisition strategy. If the deals are done at reasonable prices and offer actual realizable synergies, then they should provide a lasting source of value creation. With these dynamics in mind, we tend to look favorably upon many of these deals.

This of course is not to suggest that all deals are good ones or that we like all roll-up strategies. Sometimes companies pursue ill-fitting acquisition strategies or make bad deals or pay too much. But in this little corner of the investment world, we have seen great shareholder value created time and again by successful operators pursuing this playbook. Our charge then is to differentiate between responsible roll-ups that create value and those that do not. If we can do so, then we have built a core competency in a small and enduring market niche that positions us to participate in the frequently outsized returns that accompany successful execution of these strategies.

Without further ado, let us take a look at our three new holdings. One is a distributor, one is a holding company that in many ways looks a like a distributor to us and another is a radio broadcasting company.

GMS – Gypsum Management & Supply, Inc., founded in 1971, is the leader in the ~$12B market for wallboard and ceiling materials for residential and commercial construction uses. The top four players own approximately half of the market, with the rest split fairly evenly among about 400 smaller players. Over the years, management and the long-time owners of the company have successfully created an entrepreneur-friendly culture. The corporate parent ensures best practices and scale-based purchasing power are shared across the company while individual branches pursue a sound local go-to-market strategy. When companies are acquired, they often continue doing business under their existing name. These attributes have made GMS a preferred destination for independent wallboard distributors selling their business which has enabled the company to consistently widen its leadership position within the industry – a notion that appears to be underappreciated in the investment community.

To highlight how Wall Street sometimes does not account for the earnings power associated with market consolidators, we will examine the average of the sales growth estimates for the eight analysts that cover the stock. When looking at forward projections, we see the analysts anticipate sales growth solidly in the double digits for the upcoming two quarters. This seems to fit the historical pattern given the company has posted mid-teens topline growth for each of the past five years. But after the next two upcoming quarters, the growth forecast is basically cut in half and moves into the mid-single digits range. So, what gives? The analysts are forecasting organic sales growth as they always do, though they are only incorporating sales growth for acquisitions that have already been completed. If the company truly has a lasting consolidation opportunity, then it seems the analysts are missing a big piece of the growth story.

Given these favorable attributes described above, we have been watching this one closely since the company made its debut in the public markets in 2016. When shares sold off on the back of 4Q 2017 earnings results after the company reported rising wallboard costs had pinched gross margins in the quarter, we quickly built a meaningful position. It seems market participants interpreted that the gross margin contraction occurred due to competitive inroads and assumed this lower profitability level would persist into the future. In reality, it is a fairly common seasonal dynamic that frequently reverses itself in coming months, and a feature of the marketplace that management has much experience in navigating. Perhaps the company's short history as a public company created this adverse reaction. Whatever the reason, we viewed shares at 8x FY2017 EBITDA, multiples in line with or cheaper than many of its building products distribution peers, quite attractively and believed little of the long horizon consolidation growth opportunity was incorporated into the price. We view the company as an attractive candidate to be a long-term compounder.

IESC – IES Holdings, Inc. is a holding company operating four business verticals that offer industrial products and infrastructure services. As the reincarnation of a failed roll-up of electrical contracting businesses from the late 1990s and mid 2000s, it presents a great case study of how the roll-up strategy can go wrong – and since new ownership stabilized the company in 2011– what must go right to execute the strategy effectively.

In the late 1990s, IES was buying electrical contracting businesses left and right, piecing them together in an attempt to drive supersized growth. But they went too fast. In 1999 alone, the company did 30 deals. At this pace, management could barely put these companies together under one roof, let alone integrate them properly to extract synergies. (And this of course assumes synergies were there in the first place. We have come to view synergy targets in people and service company transactions skeptically as they often have a history of being overly optimistic.) The company also had a convoluted reporting and compensation structure in place which created misaligned incentives and deterred the business's ability to execute. Simply put, this was an irresponsible roll-up destined for failure.

But as is often the case in the investment world, from yesterday's foibles come today's opportunities. Throughout the decade-plus history until 2013, the company lost of a lot of money. The positive side effect from these ugly losses is that they created a Net Operating Loss Carryforward that provides the company a tax shield on some $400M of gross taxable income. In 2011, new ownership got involved and began to pursue a playbook they had previously executed with success in a prior venture at Patrick Industries.

Our conversations with management reveal a team that is appropriately focused on several key initiatives. Since 2011, the team has been pruning unprofitable operations and taking costs out of the business by pursuing a leaner and more decentralized operating structure. The corporate office is now principally focused on capital allocation where it conducts a disciplined review of potential acquisition targets (IES has done three acquisitions per year in each of the last three years) while evaluating opportunistic share repurchases. They have changed the compensation scheme to create better alignment of interests across the various entities. And management is not overstating the synergy case from putting the companies together. Instead they are relying on a low tax rate and their ability to provide liquidity to interested sellers to incentivize other potential candidates to join the team.

Shares hit an air pocket this summer when two legacy sites which had been problematic for years began losing money and created a hiccup in the company's earnings trajectory. With no sellside analysts covering the ~$350M market cap company, few noticed these stumbles appear only temporary. On further examination, we found a company with a clean balance sheet that had been growing cash flows in excess of 25% per year trading with a 10% free cash flow yield. With minimal capex requirements and minimal taxes due, we expect management to continue to pursue shareholder friendly uses of cash and view the long-term growth opportunity quite attractively.

ETM – Entercom Communications Corp. is the number four player in the radio broadcasting industry. It owns 125 radio stations across 28 US markets and has ~4% of industry market share. In February of this year, Entercom announced it would be merging with CBS Radio, the industry's number two player and owner of ~9% of the market. When the merger is completed, Entercom will add the majority of CBS's 127 stations from their 26 markets into the fold, thereby giving it coverage in nearly all of the nation's top 50 markets.

Many investors hold a dim view of the radio industry. It is certainly understandable how this attitude has come to be pervasive. The industry has slowly but steadily lost share of advertising spend from competition to other mediums over the last 20 years. Two of the top four players are now on the verge of bankruptcy after ill-conceived and poorly timed debt-fueled acquisition sprees. Concurrently, CBS Radio, despite its impressive assets in attractive markets, seems to have largely been an afterthought at CBS headquarters of late and has likely been starved of capital and attention for much of the last two years.

However, our research suggests a brighter picture may emerge. Radio still reaches more Americans than any other advertising medium available. And it still offers the best ROI of all advertising platforms. Its decline in market share looks to be bottoming, and most industry projections suggest continued modest growth for the vertical. Of the top four players who collectively control ~36% of the market, two appear to be seriously distracted creating an opportunity for a new winner to emerge.

We think ETM may be that winner. It is a founder-owned and family-run company that is well-regarded in the industry. Once the CBS Radio merger is complete, the new entity will have a national reach. The deal brings a number of cost synergies. And our upside case suggests potential revenue synergies can be realized as the company capitalizes on the benefits of offering local content on a national basis to advertisers. We initiated a position with shares offering a low-double-digit free cash flow yield. While we do not know exactly what the future will hold, we believe we are paying an attractive price to invest in proven operators with significant skin in the game who also have one of the best balance sheets in the industry.

Shorts/Hedges/ETFs – We still hold a few small short positions in three ETFs as hedges though we have trimmed them throughout the quarter. We also currently hold a short position in a multi-level marketing company, at an approximate portfolio weight of 50bps. The positions have not had a significant impact on performance thus far.

**2017 OUTLOOK** – We again have no meaningful changes to report in our broader investment views from our outlook a few months ago. Broad market valuations continue to look to be skewed toward the full side of fair, a level that makes sense given the consensus view the US and global economies are on firm footing and showing continued steady growth. Some of the so-called Trump trades began perking up again as 3Q came to close. Investors are clearly greeting the prospects of tax reform with enthusiasm. Our focus remains on earnings which continue to exhibit steady growth and remain a critical driver of equities. We are optimistic about recent additions to the portfolio and continue to believe our prospects are more exciting than what can be found in the market itself.

**CONCLUSION**

As always, we are happy to discuss any portfolio holdings or our investment outlook with you at any time. Please reach out to us at any time. In closing, we are honored and privileged to have the responsibility you have entrusted in us in managing your capital, and we look forward to continuing our relationship further into the future.

Best regards,

Mitchell Scott, CFA
Portfolio Manager

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1. All market and company data is sourced from Factset and company filings and is current as of 9/30/17.
2. CEF uses the S&P 500, Russell 2000, a custom Blended Small/Large Benchmark and the Barclays Hedged Long/Short indices as its primary benchmarks. The S&P 500 and Russell 2000 are common large and small cap US equities-based indices. The custom Blended Small/Large Benchmark is provided to capture a larger proportion of small cap performance versus large cap performance (at a 3:1 ratio) due to the similarly high proportion of small caps found on the Good Businesses Focus List as well as the strategy's general preference of having an investment mix more heavily weighted towards investment in small caps. The Barclays Hedged Long/Short index (an index of equities-based hedge funds) serves as an appropriate benchmark over the long-term given the index has a similar long-term goal of capital appreciation through equities investing.
3. CEF Net Returns are hypothetical results calculated from actual gross results in a manner consistent with the 1% management fee and 18% performance fee offered to clients.

**APPENDIX**

**CEF GOALS, PHILOSOPHY, APPROACH AND ALIGNMENT**

*GOALS* – We seek to generate market-beating returns over any rolling multiyear investment horizon while minimizing the risk of permanent impairment of capital. Additionally, we seek to communicate with our investors in a transparent and straightforward manner and ask only that they accept investment risks that we ourselves are willing to take. *Given the majority of our investable capital is invested alongside theirs, we invest our limited partners' capital as if it were our own, because it is.*

*PHILOSOPHY* - We approach investing in public equities as an opportunistic businessman would. We spend most of our time studying businesses and building circles of competence in areas likely to offer attractive investment prospects and invest in only our most compelling opportunities. We view risk primarily as the likelihood of a permanent impairment of capital and pursue a carefully balanced willingness to trade some short-term portfolio fluctuations for the opportunity to earn higher returns over the long-term. We focus on growing, understandable businesses and seek to buy them at a substantial discount to our estimate of their intrinsic value. When we find them trading at attractive prices, we often act in size and weight our best ideas accordingly. And all things being equal, we prefer to devote more of our efforts to small stocks where we believe greater price/informational inefficiencies can often be found.

*APPROACH* – We invest via a long-bias hedge fund structure and concentrate our long investments in our best 10 to 15 ideas. Our work begins with a two or three-year outlook, and we only pursue investments we believe are likely to offer us a reasonable chance to generate an annualized return of 20% or better. While we pursue long-term oriented investments and seek to compound capital in a tax efficient manner, we readily acknowledge the often-turbulent markets do not always fit neatly into this framework and know some trading activity is sure to follow as a result. In the short book, we seek to generate absolute profits in a few stocks where we have uncovered a company entering financial duress or an excessively optimistic valuation where we feel their earnings outlook is likely to worsen materially. We will also use industry or market specific ETFs to mitigate market risk and will look to employ options and other opportunistic hedges when conditions appear favorable.

*ALIGNMENT* – We believe appropriate alignment of interests is the bedrock upon which all successful partnerships are built. Our primary means of ensuring proper incentive alignment is through significant co-investment of our personal wealth alongside our limited partners. Secondarily, we offer an investor friendly fee structure. We charge a modest management fee to support investment operations and charge an annual incentive fee on new profits only. Finally, commensurate with our fee structure which is intentionally structured such that the majority of fund earnings will be earned only if we generate compelling investment results, we commit to operating the fund as a boutique shop with a limited asset size. As many of our best investments often come from small stocks, we believe it is important to preserve our ability to take concentrated positions in our best ideas. Our size and structure ensure we are incentivized to generate compelling returns, not gather assets.

Think of it this way. *On the one hand, we are incentivized to generate the best investment results possible. On the other hand, we are unwilling to invest in a way we feel is likely to result in a meaningful loss of our own investment capital. What more could one want from an investment manager?*