Dear Investor,

This is the second of our semi-annual letters that we began providing this year in addition to our monthly market commentary. In this letter we will review our performance in the first half of 2021 including our biggest impact performers as well as our investment themes.

Rod Capital 2021 Mid-Year Review

For the first half of 2021, RCM rose 7.81% with a reduced average net exposure of 52.6%. The S&P 500 returned 15.25%.

In January, we took an unusual hit shorting Gaotu Techedu (GOTU), a Chinese educational services company with extremely questionable financial reporting and business practices. We were squeezed as the stock rose 103% with the meme buying frenzy of Gamestop and AMC. We managed to hold onto some of the short position, which dropped 86% in the next five months. Our overall result was a -0.25% loss from Gaotu Techedu in the first half, despite our being correct about the company. We did benefit from meme buying that same month with a short-term hedge position in IRobot (IRBT) in January, which has contributed 1.13% in the same 2021 time period. Stocks involved in meme trading were more of a distraction in the first half, but ultimately at least resulted in a modest net positive return for us.

Our top performer in the first half was Fly Leasing (FLY), an air leasing company, which represented a gain of 4.03% for the fund. We took on this position in 2020 on valuation and increased the size after highly credible sources were openly reporting about a strategic review and buyout offers for the 2 billion enterprise value company. The stock was trading well below our estimate of its net asset value and did not receive a significant premium from the news that it was shopping for bidders. The company was ultimately acquired for a premium as we expected. Our biggest loser was American Airlines (AAL) which lost us -1.03% and was used as a hedge for our air leasing equities.

Our most successful investment theme was our real estate holdings led by American Homes 4 Rent (AMH). These and other real estate stocks continued to recover in the first half and rose toward their net asset values. On the long and short side, real estate contributed a net of 3.69% to our fund. Other recovery stocks, however, reversed their ascent in the latter portion of the first half due to renewed virus concerns.

The shorting of exchange traded funds (ETFs) as a hedge against our individual names represented a loss of -5.11% in the first half of the year. The aggressive rise of large and mega cap technology companies in the last couple months benefited our large cap positions in Facebook (FB) +1.12% and Alphabet (GOOGL) +0.98% but we were underweight in large cap names as they rallied.

Short-term results were a strong contributor in March and in May but our overall short-term event volume continues to be well below our average since inception. We expect steady improvement in coming quarters as market efficiency continues to make a comeback.

Our overall results reflected a cautious stance in the market. This caution was elevated in the last couple months of the first half when we reduced our exposure by more than 20% due to inflation and cryptocurrency concerns.

<u>2021 Comments</u>

A new strain of Covid-19 has increased fears about the recovery - and knocked down some of our top positions in the last couple months. We believe these fears are overblown. Vaccinations have effectively shielded the vulnerable. Those who are voluntarily unvaccinated will receive less sympathy from a vaccinated public that now wants their freedom. It is a likely fact that variants of the virus will forever continue and vaccinations will forever evolve for the vulnerable while the rest adapt and increase immunity to this virus. We strongly believe in a continued recovery for the hardest hit industries and are increasing our positions in recovery stocks such as air leasing, events, and real estate, despite the pullback which began in May.

The fundamental question and risk for us has less to do with the virus and more to do with inflation. The optimists believe that inflation will be tame as technology and business adds more than enough value to eclipse any rising cost of human capital and supply shortages of materials. When people predicted “peak oil” years ago, where oil supplies were supposed to fall and shoot prices through the roof, shale drilling technology saved the day and made the United States the world’s largest oil producer again. The idea is technology will continue to save the day.

The pessimists believe that Earth’s resources and human labor are reaching limits. All while democracies and dictatorships seem ready to reign down on excess, raise taxes, and possibly even concern themselves with the environment and the poor. In addition, the pessimists believe that supportive monetary policies of the last few decades are about to be forced to an end, causing a cycle of rising costs of labor and materials that have not been seen since the 1970s.

As a hedge fund, our responsibility is to consider and weigh these possibilities. If the pessimists are even a little bit right about inflation, then it is time to take cover. We took cover early and the market is mostly ignoring these risks and accepting the narrative of policymakers of a temporary inflation spike. We hope they are right and are following the data. Right now, however, the wheels of rising costs are spinning and it will be a challenge to slow down that momentum. That is why we increased our exposure to real estate investment trusts that benefit from inflation and reduced or shorted stocks that will suffer in an inflationary economy.

Consider how Apple (AAPL) may be squeezed with rising costs of overseas materials eating into their 40ish percentage gross margins. And then add rising operating expense costs for employees demanding higher salaries and more perks. If Apple cannot fully pass on those costs to consumers, we could begin to see the company in a cycle of stagnant or declining year over year earnings. How would that begin to justify a nearly 30 times multiple of their earnings? That's one reason we are still shorting Apple.

Consider Amazon (AMZN) and their 1.3 million employees (that's the size of Dallas!). Labor cost pressures could significantly cut into their relatively thin margins. Can they pass those costs on to consumers? Maybe. We are following closely. Compare these questions to an air leasing business like Aercap (AER). The stock trades at a discount to the total resale value of its airplane assets – whose values will rise in an inflationary environment. Aercap brings in around 50-100 times more cash flow per employee than the large companies mentioned here. Those are some reasons why we are long Aercap.

Covid-19 has shaken the world into devaluing cash. We've come to learn that when people do not value cash, they can turn the equity market into a casino. Look at a ridiculous company like Microstrategy (MSTR), whose CEO has essentially turned the stock into a Bitcoin investment vehicle – except only half of the enterprise value consists of Bitcoin. Most of the rest of the enterprise 'value' has no basis and buying that stock is essentially like buying Bitcoin at a giant premium. The CEO is even selling more MSTR stock to buy more Bitcoin. So we are short.

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You might think that being from Las Vegas would make me at home in this casino-like environment. But this get-rich-quick environment is seducing a large amount of people to increase reckless risk taking and has trained them to tolerate losses and buy every dip of everything. A true inflationary environment can create a swift rude awakening for this kind of behavior as monetary policy is forced to adapt. If Apple or more speculative stocks like Tesla (TSLA) show that they cannot make up for their rising costs with their pricing power, they can fall and take the whole world of high speculation stocks with them. This is why we remain conservative with our exposure to speculative stocks.

Looking Ahead

A recent event demonstrates the inefficiency of today's market. One of our portfolio companies was moved from S&P small cap indexes to S&P mid cap indexes in June because it had grown in value. Sounds like no big deal, right? Wrong! The stock promptly dropped 10 percent as a result. Why? Because allocators in today's market pour money into small cap and large cap passive index funds but forget about the "Mid cap" stocks in the 2-10 billion range (why does "Mid cap" even exists as a category when it only represents 9% of total market capitalization?).

Passive investing creates a bunch of valuation distortions that more active investors like us need to fill. It's no accident that we are finding increasing value in this twilight zone "Mid cap" area. When we throw in small caps into the mix, around 75% of our exposure is in companies in the 1-20 billion range - while only 17% of the total stock market capitalization is in this area. We believe market participants are throwing money at index funds rather than stock picking and will come around to filling this valuation gap.

As mentioned before, we are believers in high quality recovery stocks. One example in our top 20 portfolio is Live Nation (LYV), owner of Live Nation Entertainment and Ticketmaster. This business owns 28 properties and manages nearly 300 venues. They are the market leader in event sales and advertising with a high barrier to entry (only one main competitor), strong management, and consistent growth. They were crushed by Covid and the stock has recovered – but their valuation has lagged the rise of others with similar pre pandemic figures. We believe this gap will be reduced as the Covid overhang fades.

Another theme we are adding to, including around earnings season, is permanent and temporary staffing service companies. Some of these stocks like, ASGN Inc. (ASGN), provide excellent value and are often overlooked as growth stories despite the near-term reality of staffing shortages, high turnover rates, and various labor recruitment challenges. Businesses are also utilizing more temporary staff in order to adjust to work from home demands from employees and the benefits from lower costs overall.

We have also begun an anti-inflation strategy of increasing positions of companies whose stocks have high pricing power and cash flow per employee versus those with low pricing power and cash flow per employee. As an example, of the largest mega-cap companies, Facebook (FB) has the highest rate of earnings per employee and maintains a top position in our portfolio. Meanwhile, high quality undervalued real estate investment trusts (with limited labor expenses) have become around half of our portfolio on a net basis. We have reduced consumer positions to less than one tenth of our exposure at this time.

Correlations are beginning to decline in today's market. Waves of purchases are giving way to more selective buying and selling. We believe this trend is positive but will contribute to volatility as opportunities for greater entry points and exits open up. With higher conviction, we will be able to increase the quality of our exposure. These trends toward higher market efficiency also point us toward higher short-term event volume. With a higher quantity of short-term event opportunities, we will be able to meaningfully increase our short-term exposure back to our pre-Covid days.

Today's asset prices are rising and costs are rising. The market is responding to the first part but hasn't yet digested the second part. We are paying a lot of attention to this and acting decisively on both the long and short side.

- Perry Rod, CIO Rod Capital Management

For more information about our fund please register at www.rodcapitalmanagement.com.

Thank You,

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