April 8, 2020
Q12020

QUARTERLY RECAP AND OUTLOOK

We hope that you, your family, and loved ones are holding up and doing well in these unprecedented times.

There is no need to explain in detail what happened to the markets during the first quarter; we are all too familiar with the declines. That said, it was the worst quarter since 1987 and the worst return ever for a first quarter. Compounded with the anxiety and fear brought on by the global health pandemic, the unknown path for the economy post-pandemic has caused investors tremendous anxiety. And with reason. When markets drop, the loss felt by most investors is twice as strong as the joy felt from a similar sized gain. In cognitive psychology this is called *loss aversion* and is rooted in evolution. To survive, we are primed to fear loss as it could threaten our existence.

In addition to loss aversion, fight or flight is another instinctive reaction to the pain of watching investments decline. As investors, who play a passive role, we cannot control how the companies and funds we invest in operate or how they react to COVID-19 (where we do have control is hoarding toilet paper).[1] Therefore, since we can't *fight* and control each investment's destiny, the instinctive way out is *flight*, which in the case of owning liquid assets like stocks and mutual funds, means to sell. As we have stated in our recent market updates, it is in times like these that we must resist these ingrained reactions, remain focused on the long-term, and ignore (as best as we can) the short-term volatility. Over the long-term, the economy will come back, and with it stock prices will rebound.

Collectively, we are dealing with the greatest adversary we have seen since the Axis tried to take over the world in the late 1930's and early 1940's. The outlook is dim for the next few months on both the health and economic front. GDP for the second quarter will likely be the worst ever with estimates for the decline reaching up to a loss of up to 34%.[2] Unemployment is on track to grow every week and could reach levels last seen in the Great Depression. Many in the press have questioned if we are on track for our own Great Depression.

[1] From a rational perspective, the shortage makes no sense. The US produces 90% of the toilet paper we use, and the virus is not a gastrointestinal strain. If the average person uses twenty squares of toilet paper per day, one roll should last on average about eight days. You can calculate your stash at https://howmuchtoiletpaper.com. Based on the data on this site, the average person now has 500% more toilet paper than they need for quarantine! Again, this is just an example of consumers looking for control.

2 https://fortune.com/2020/03/31/goldman-sachs-prediction-gdp-contraction-q2/

There are differences between the Great Depression and today. The US has much more wealth now than it did in 1929 and has learned from fiscal and monetary policy mistakes made in the aftermath of the 1929 crash. We have a government that is reacting swiftly on the financial front with both fiscal and monetary stimulus. Congress drafted and passed $2T in stimulus in less than six weeks compared to 20 months during the great financial crisis in 2008/2009.[3] The Federal Reserve cut rates to zero in less than one hundred days vs. over 16 months in the financial crisis and has taken additional measures to provide liquidity to the market above and beyond what was done in 2008/09. The government will do all in its power to keep businesses afloat as they have already opened their pocketbooks to the airline industry and any small business with under 500 employees. We expect to see more stimulus in the months ahead and likely with equal or larger quantities.

We have been blessed with very low inflation for years, due in large part to globalization. We anticipate that this trend will slow and could even reverse. Countries are restricting exports of medical equipment to other countries and the US is dreadfully short of key medical equipment that cannot be fully manufactured domestically. Protecting intellectual property and ensuring stable supply chains post this crisis will likely lead to additional protectionist policies globally. In addition, recent progressive legislation in many states has raised wages, a large component of inflation. These forces will likely put upward pressure on inflation over the medium horizon, despite the fact that near-term demand-induced deflation is likely. Over the last few years, the government has run the largest deficits in history during a non-recessionary time. Today we have debt of around $23T and will most likely top $30T in the near future. With the large increase in our debt to GDP ratio, the government will be forced to keep the printing presses running.

Every generation has faced serious crises; the Revolutionary War, the Civil War, WWII, and the Spanish Flu Pandemic of 1918. In each, the will, drive and ingenuity of the American people prevailed.

While this pandemic will change the world forever, we are contemplating its impacts to ensure we are positioned as well as we can be to capitalize on opportunities the market presents us. There will be winners and losers. In the near-term, it's likely that industries in travel and leisure will be hard hit. Conversely, healthcare and technology companies could see benefits. Our research team is focused on investments that we believe will offer superior long-term financial and real-world returns over the long-term, some at very good prices. We also continue to optimize your portfolio strategy for the new world order.

Everyone will be touched by this virus and many of you may already have been. The team at Riverwater Partners is doing all we can to stay focused on running our business, and also trying to help our communities. We have been donating and delivering food, blood, and medical

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3 https://www.wsj.com/articles/how-fast-the-economy-crashed-and-washington-respondedin-charts-11585334137

supplies. We are committed to doing all we can and will be allocating 10% of our revenues this quarter towards relief efforts.

We are happy to announce a new addition to the team. Kirk Fox is joining Riverwater in the second quarter and we are happy to have him added to the research team. Kirk is an investment veteran with over twenty years of experience as an analyst and portfolio manager.

While we are Safe-at-Home, we will be conducting all first quarter reviews over Zoom (one of the technology beneficiaries) and if you have not received an invite yet, you will soon. It is easy to download, if you have not already, and we are here to walk you through the process if needed.

Again, we hope that you, your friends and family are holding up and doing well all things considered. Please reach out to us if there is anything we can do to help.

All the best,

Adam Greg Matt

DISCLAIMER: Past performance is not indicative of future results. The securities identified and described do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable.

RIVERWATER SMID STRATEGY

While on an absolute basis, our SMID (small and mid) cap equity strategy had negative returns, it outperformed its benchmark by a healthy margin. We sold three positions in the quarter: Abraxas (AXAS), Kemet (KEM) and Rosetta Stone (RST). We threw in the towel on Abraxas in early March after having trimmed it in early February before the collapse in oil. Kemet was a nice win considering it announced it was being acquired by Taiwan's Yageo, a component supplier. We sold Rosetta after losing trust in the management team. We also trimmed what had become our top holding, Shenandoah Telecom (SHEN), after it hit a 52-week high in March (it has to be one of only a handful of companies hitting an all-time high in this market). We initiated three new positions in the quarter:

Euronet Worldwide, Inc. (EEFT), an industry leader in providing secure electronic financial transaction solutions, operates one of the largest independent ATM networks in Europe, is the world's largest payment network for prepaid mobile top-up and the third-largest global money transfer company. Euronet has the opportunity to grow at a significant rate by leveraging its Digital Integrated Payments Cloud to meet the need for digital payments transformation. While the stock declined significantly during March, given the shutdown of Europe due to COVID-19, we believe the company's proprietary technology and vast network will allow it to grow over time.

Renewable Energy Group (REGI) provides lower carbon transportation fuels. The company utilizes an integrated production, distribution, and logistics system to convert natural fats, oils, and greases into advanced biofuels. REGI will be receiving $500 million from the government from the retroactive re-establishment of the Biodiesel Tax Credit (BTC). The company will have a net cash position as a result and will use it to pay down debt, buy back shares, and reinvest in capacity expansion. The BTC has been renewed for the next three years, allowing REGI to produce renewable diesel with a guaranteed cash flow. REGI's biodiesel has up to an 86% reduction in greenhouse gases vs. virgin diesel as well as a 15% reduction in nitrogen oxide emissions.

Agnico Eagle Mines (AEM) engages in the exploration, development, and production of mineral properties in Canada, Mexico, and Finland. It primarily produces and sells gold deposits, but also explores for silver, zinc, and copper deposits. AEM is an investment in the price of gold going much higher. Gold rose for most of 2019 and should continue with the recent collapse in interest rates and massive fiscal deficits in the United States on the horizon. AEM should trade at a premium due to its ability to grow production in safe developed countries. Like many Canadian companies, AEM is very focused on sustainability. Executive compensation is tied to ESG goals as well as financial numbers, which is rare compared to many US companies executive pay packages.

RIVERWATER LEI STRATEGY

On an absolute basis, our LEI (large equity income) strategy generated negative returns but, like the SMID, outperformed its benchmark. There were no trades made until early March. As the market had just begun to decline, we took the opportunity to, as we like to say, upgrade a number of positions. We sold companies that we did not believe would perform well in the years ahead, like Royal Caribbean Cruises and Weyerhaeuser Corp. and reallocated the proceeds to Starbucks and Ecolab.

Starbucks (SBUX) is the world's leading retailer of specialty coffee & tea, with 31,795 stores across the globe. Starbucks is an iconic brand that has led the consumer transition to a coffeehouse culture. (You may have personal experience?) This is particularly true in newer markets, like China, and with newer formats, like Roasteries. Importantly, SBUX has traditionally used sustainable business practices to care for both people and planet. Restaurant stocks sold off as a result of the COVID-19 closing of businesses, offering an attractive opportunity as we believe Starbucks will be less impacted and recover more quickly.

Ecolab (ECL) is the global leader in water, hygiene, and energy technologies and services that protect people and vital resources. Customers in 170 countries in foodservice, food processing, hospitality, healthcare, and industrial markets choose Ecolab products and services to keep their environment clean and safe. ECL's proprietary sensing technology allows customer equipment – hotel washing machines, restaurant dishwashers – to consume less power and water, thereby reducing their environmental impact. In 2018, ECL helped its customers prevent more than 1 million foodborne illnesses, save 188 billion gallons of water, and conserve 19 trillion BTU's of energy. ECL has 90% recurring revenue, making its business very predictable. The recent market selloff gave us the opportunity to invest in this superior business focused on sustainable growth.