

Dear Partners:

The Fund returned 15.80% during the first-half of 2017. Since inception (in May of 2014), the Fund has returned 71.10% vs 37.59% delivered by the S&P 500 Total Returns (our benchmark) as shown below:

	Q1 2017	Q2 2017	1st Half 2017	Since Inception
Fund ¹	11.18%	4.15%	15.80%	71.10%
S&P 500 Total Returns	6.07%	3.09%	9.34%	37.59%

During the first-half:

- We added to our *existing* positions in Apple (AAPL), Entravision Communication (EVC), Quotient Technology (QUOT), Sprouts Farmers Market (SFM), and Viacom (VIAB).
- AAPL and Verisign (VRSN) were our top performers, with EVC, QUOT, and LSB Industries (LXU) rounding out our top five contributors.
- We concluded the first-half with ~20% of the portfolio in cash, and no leverage was utilized (as usual).

Despite the importance of possessing an analytical advantage when it comes to investing, legions of market participants engage in a common ritual of entering the same “consensus” numbers, in the same financial models as everyone else . . . with as much efficacy as a rain dance. The point isn’t that this sort of “analysis” focuses on numbers (numbers remain as important as ever), but that it does so to the detriment of the bigger picture. While this emphasis on *what* “the numbers” will be (and *when*) is essential in building sparkling spreadsheets, it forgets that numbers, unlike rabbits, don't multiply by themselves.

In contrast, we spend our days thinking through the questions central to the creation (or destruction) of value over the long-term.² To do so, we prioritize *insight* over *info*, and aim to analyze investment opportunities through the eyes of a long-term business owner. What follows are three examples of portfolio investments where the Fund is either benefiting, or positioned to benefit, from the bigger picture.

Responsibly Partying

We have long viewed AAPL as a classic (albeit high profile) example of how sloppy logic, hot air, and short-termism can obscure the substantial long-term strengths of a best-in-class business. Even more interesting, AAPL’s size and prominence only seem to amplify the volume and uniformity of the distortion working against it. Rather than shout into the already loud discussion, we instead put our money where our mouth was, and made AAPL the Fund’s largest investment.

With AAPL up ~24% during the first-half (and ~51% over the last 12 months), FANG³ quickly became FAANG as market pundits raced to add another “A” to their favorite acronym. After what seemed like a lifetime of waiting to join the party, it was hard to believe we suddenly found ourselves as invitees of *the* crew Jim Cramer once described thusly:⁴

¹ All performance numbers are calculated before allocation (no management fee, performance fee of ¼ of gains in excess of 6%) to the General Partner.

² Examples: Do the numbers make sense? Why? How/why will the numbers improve? What could go wrong?

³ An acronym penned by Jim Cramer to describe Facebook, Amazon, Netflix, and Google

⁴ [11/2015 CNBC: Cramer - The Psychology Of Why FANG Is So Valuable](#)

“These high-flying stocks become something akin to modern art or professional sports teams, valuations that, while they can’t be explained in simple numbers, can be absolutely understood from the perspective that there just aren't enough of them to go around.”

Despite our suspicion that FANG’s ongoing momentum is driven more by an old-fashioned fear of missing out, than any sort of actual scarcity, it is hard to deny the robust gains experienced by FANG’s investors. Nearly two years after Mr. Cramer’s comment, one still needs more than “simple numbers” to justify the valuations as seen in the below table:

6/30/2017	Facebook	Amazon	Netflix	Google
Price / Earnings:	37.65x	181.95x	180.01x	33.71x

Lest you think the rarefied air of triple-digit multiples encouraged us to abandon our mantra of purchasing optimistic prospects at pessimistic prices, it is worth noting that AAPL traded no higher than ~18.3x *trailing* earnings during the first-half. On a net-cash basis, AAPL’s multiple looked even more austere at just ~14.7x. In a world where the S&P 500 is selling at ~25x trailing earnings, AAPL continues to look more like the designated driver than the life of the FAANG party.

Why so? Underlying the pessimism surrounding AAPL are the persistent narratives (mostly unchanged over the course of our ownership) that generally materialize in the following three falsehoods:

- **Too Obvious:** reminder to us “*eediots*” that AAPL is too big, and too well followed, for the consensus to be wrong.
- **Law of Large Numbers:** widely applied to conclude that AAPL’s business can’t grow forever, and neither can its share price.
- **One Hit Wonder:** AAPL is too dependent on the “wow” factor provided by the aging iPhone, and no longer innovative enough to change that dependence anytime soon.

And so it is, within every falsehood, a kernel of truth. In this case, two kernels:

- AAPL is as large (and well-followed) as they come, and
- AAPL does indeed rely on the iPhone for a disproportionate amount⁵ of total sales.

Although we don't dispute these realities, we suspect the uniformity of the conclusions likely says more about the analytical process (or lack thereof), than the conclusions produced. Specifically, in focusing on short-term metrics around the iPhone, analysts prioritize what they can quantify (and thus model) over efforts to *think* through the structural (but often qualitative) question(s) underlying all AAPL pessimism. This emphasis on *info* over *insight* is so pervasive, no one stops to consider the question driving the bigger picture:

Does the iPhone contribute to AAPL’s efforts to develop - and maintain - a sustainable competitive advantage?

We believe the answer is an emphatic **yes!** Simply put, each AAPL product - especially the iPhone - is *additive* to AAPL’s broader competitive advantage. Contrary to the pervasive narrative that AAPL’s competitive advantage relies solely on “loosey goosey” intangibles such as the design aesthetic and/or cool factor of current product models, we believe AAPL’s real killer product is more of a silent assassin. Often lost among efforts to quantify the potential of AAPL’s latest and greatest products, is the more qualitative - but no less deadly - advantage provided by:

The Apple Ecosystem

⁵ iPhones account for as much as ~2/3 of AAPL’s total sales

Underlying nearly every aspect of AAPL's business, AAPL's ever-expanding ecosystem offers a competitive advantage that lasts well beyond any current product release cycle. In other words, it's not about a better camera, a bigger screen, or all the heavy breathing surrounding a new product release; instead, it's about how each product feeds, nourishes, and expands the AAPL ecosystem. A brief flyover of the key drivers of AAPL's ecosystem is worthwhile:

- **Product Excellence:** AAPL controls what products it makes, how they are made, and just about everything in between. By retaining control of both hardware and software, AAPL is able to reliably deliver among the very best products with a level of perfection, polish, and profitability that few (if any) competitors have been able to match.
- **Customer Experience:** Whether they are already a loyal member of the AAPL ecosystem, or just eager to buy the newest thing, AAPL's ecosystem attracts - and maintains - the most valuable of all technology consumers. By emphasizing quality over quantity, AAPL trains customers to covet exceptional products backed by exceptional service. In contrast, consider Samsung's exploding phones and the fiasco that ensued. Surely Samsung's bigger screen or lower prices paled in importance when compared to the sort of service provided by AAPL's network of (friendly) retail stores.
- **Economic Advantage:** AAPL attracts tech consumers able (and willing) to pay premium prices for premium products. The favorable demographics of AAPL's user base - and their lucrative spending habits - further reinforce the loop by ensuring that app developers, banks, musicians, and everyone in between prioritize development for, and with, AAPL's ecosystem. This not only makes AAPL's offerings more compelling for the consumer, but also severely minimizes the economics available to competitors. Case in point: despite selling less than 20% of global smartphone *volume*, AAPL regularly captures better than 90% of global smartphone *profits*.⁶ How do you like them apples?!

In the spirit of full disclosure, we generally view claims of ecosystems and/or virtuous cycles with a healthy dose of skepticism. You should too. That said, let's be blunt: if you don't think AAPL's best product is its ecosystem, you ain't paying attention!

When you put it all together, even if/when competition manages to surmount the technical, economic, and marketing hurdles of competing with AAPL, they still need to convince consumers the high switching costs are worthwhile despite their deep involvement (and current satisfaction)⁷ with the AAPL ecosystem. Beyond all the euphoria surrounding the current iPhone or fears of growing replacement cycles, AAPL's long term success will depend on maintaining and growing the faithful. Or as Gregg Rosenberg aptly says in his excellent write-up:⁸

“You cannot steal away a customer who will not even look at your product.”

Although we think AAPL's valuation remains reasonable on the basis of trailing earnings,⁹ if you think *forward* earnings will be better than *trailing* earnings, (as we do) AAPL's valuation looks even more restrained. Then again, if forward earnings projections are your thing, rumor has it the real ragers are hosted by Amazon (AMZN) and Netflix where partying responsibly means not spilling your drink . . .

⁶ [2.8.2017 Digital Trends: Apple Took A Whopping 92% Of Smartphone Industry Profits For Q4 2016](#)

⁷ An April 2017 Morgan Stanley survey (detailed in this [article](#)), found that ~92% of iPhone owners who were “somewhat or extremely likely” to upgrade in the next 12 months, plan to stick with AAPL.

⁸ [10.2015 Seeking Alpha: Apple - A Misunderstood Giant](#)

⁹ Albeit less so, at higher prices

I've Got A Stock Here . . .

Did you hear about the large-cap (~\$27 billion) stock that lost nearly 1/3 of its market cap in just three days during the first-half? Rather than some sort of speculative biopharma, or faddish momentum play, the recipient of this bloody beatdown was none other than homely supermarket operator Kroger (KR)!

In a scene that brought to mind our favorite market-related comic (as seen nearby), we watched the one-two punch unfold:

- KR's (unexpected) profit warning
- AMZN's decision to add Whole Foods Market (WFM) to their shopping cart

While the portfolio has never held positions in AMZN, KR, or WFM, no portfolio exists in isolation; and, our investments in SFM and QUOT place us squarely within the boxing ring.

And so we watched as the market rapidly pivoted from AMZN *might* be well-positioned to compete in groceries *someday*, to AMZN will *certainly* destroy the grocery industry *now*. Just as quickly, nearly \$40 billion was added to AMZN's market value, while the already unfashionable grocery space sunk even further.

At this point, it is worth mentioning that we are as impressed as everyone else with AMZN's transition from humble bookseller to the juggernaut it is today. We recognize the list of businesses/industries "disrupted" by AMZN is long and growing, and believe AMZN's impressive distribution capabilities, technical/logistical wizardry, and large (satisfied) user base are potent weapons in affecting further disruption. Even so, it is hard to make a case the sky is falling (especially soon) in the grocery space, and harder yet for the grocery-related names within our portfolio!

Before we get into the specifics of our investments, a few examples illustrate complications sure to greet AMZN's arrival into the grocery sector:

- **Perishables:** We agree that no one is better positioned than AMZN to successfully conquer the logistics necessary to enable grocery delivery, but suspect perishables - at AMZN scale - are sure to introduce a variety of complications unlike anything else AMZN has mastered to date. To the extent AMZN aspires to be a full service grocer, perishables will be an essential offering. Thus, AMZN will either have to coordinate delivery times with customers, or develop the sort of packaging capable of shielding food from any number of complications (e.g., weather, animals, etc). No matter how you cut it, already thin margins are sure to get even thinner.
- **Returns:** Whereas AMZN will require the physical return of a book for a refund, customers who complain about dog food (for example) often receive another bag without a return required. In other words, when it comes to complaints about dog food AMZN doesn't want the the physical product returned, and takes the hit. One wonders how this model will evolve when it comes to human food? What happens when I wanted cherry tomatoes, but received Roma tomatoes instead? What happens if my perishables, um, perish?
- **Interchangeability/Uniformity:** Much of what AMZN currently sells is uniform in terms of size and specifications such that all new books of the same UPC = the same product. Although we recognize inventory management is hardly that simplistic, variability across products (such as books) pales in



comparison when it comes to the complications inherent in food. Case in point, considerations such as ripeness, condition, and size can vary dramatically when it comes to food.

- **Measurements:** Speaking of size, if I ask for 2 pounds of Roma tomatoes, am I ok with only getting a little under/over my request if it isn't otherwise possible to find a group of (unprocessed) tomatoes that add up to a perfect 2 pounds?
- **Restrictions:** What about booze, cigarettes, and any number of other adult-only products? Does AMZN avoid selling these categories entirely? Or, do they add additional complications to their delivery process to verify they deliver only when an adult is present? What happens if someone is already intoxicated, do they still drop off that case of vodka?

Perhaps the answer to these concerns (and others) is AMZN will figure it out as they always have. That said, any number of issues (e.g., packaging requirements, schedule coordination, etc) all but ensure AMZN's foray into groceries will be a premium offering. Along those lines, we suspect AMZN wisely intends to leverage WFM's existing infrastructure and infamous emphasis on premium products (at premium prices) to pad some of the costs of making grocery delivery a reality. Either way, we suspect the long-term takeaway from AMZN's acquisition is increased competition in the grocery space, and believe our grocery-related investments are both in uniquely defensive positions.

Let's Get Ready To Rumble

Although we expounded on our SFM bullishness in our year end letter, one paragraph is particularly worth repeating when it comes to considerations about SFM's ongoing competitiveness:

“In contrast to WFM's (expensive) devotion to all things organic, SFM offers ‘fresh, natural, *and* organic’ products in a strategy they describe as ‘Healthy Living for Less.’ This more flexible approach enables SFM **to sell all sorts of perishables (50%+ of their sales)**, even if such products aren't necessarily grown 100% organically. More importantly, the ‘for Less’ part of the strategy materializes into **management's ongoing goal to offer produce at a 20-25% discount relative to other grocers in the market.** In fact, discounted produce is a fundamental piece of their customer acquisition strategy (from the 10-K): ‘We believe the majority of our customers are initially attracted to our stores by our fresh produce, which we offer at prices we believe are significantly below those of conventional food retailers and even further below high-end natural and organic food retailers.’ In other words, SFM's prices (especially for produce) are not just lower than those offered at WFM, but are often below comparable prices at both Walmart and Kroger. Although this reality may not register for those in the New York City echo chamber, it is well known among SFM's shoppers (us included).”

In short, SFM is defended by both price (lower than competition by design) and emphasis (heavy on perishables).

But what if AMZN uses groceries as the loss leader in pursuit of a grander plan? (More on that grander plan in a bit) In this case, we suspect the threat is probably most dramatic/imminent for manufacturers of non-perishables and the retailers most reliant on them. To the extent AMZN becomes the non-perishable deliverer of choice, national brands will be forced to compete on name recognition alone (and advertise accordingly). Worse yet, these brands will likely be forced to battle against the ultimate store brand: AMZN's.

Under siege by private-label store brands and changing consumer preferences, national brands are already battling slowing sales. We suspect AMZN's entry is bad news for grocery categories dominated by brand recognition (e.g., Campbell's soup, etc), and even worse news for categories that are brand-agnostic (e.g., spices, canned vegetables, etc).

QUOT to the rescue! With brands eager to increase name presence, and grocers (not generally known for their tech savvy) forced to compete with the savviest of them all, it is hard to imagine a better scenario for QUOT's offerings. While we thought QUOT was well positioned to benefit from the pre-AMZN state of affairs, we suspect the opportunity is even more compelling if *everyone* has to fight to prevent AMZN from establishing a beachhead in the grocery space.

As such, we remain as bullish as ever on QUOT's prospects, and shared our bullishness as an entry to the recent Sohn Investment contest in April (a copy of which is included with this letter).

Someone Grab The Popcorn!

When it comes to the bigger picture, those hyperventilating about AMZN's entry into the grocery space are likely missing the forest for the trees. Guided by a CEO famous for saying "your margin is my opportunity," we suspect AMZN's CEO is well aware of where the real profit margins are:

	Kroger		Sprouts		Alphabet (a.k.a. Google)	
	Sales (millions)	Profit Margin	Sales (millions)	Profit Margin	Sales (millions)	Profit Margin
2014	\$108,465	1.6%	\$2,967	3.6%	\$66,001	21.4%
2015	\$109,830	1.9%	\$3,593	3.6%	\$74,989	21.1%
2016	\$115,337	1.7%	4,046	3.1%	\$90,272	21.6%

According to personalization platform BloomReach, "55% percent of people in the U.S. now start their online shopping trips on Amazon.com . . . that stat marks a 25% increase from the same survey last year . . . over the same time, the percentage of shoppers who start product searches on search engines like Google (GOOG) dropped from 34% to 28%."¹⁰ AMZN is ideally positioned to increasingly become the place to search when consumers want to BUY something, leaving Google as the place consumers search when they want to KNOW something. Because informational searches are considerably less lucrative than transactional searches, this is likely to hurt GOOG where it counts.

With GOOG up nearly 18% during the first-half (~31% over the last twelve months), we suspect GOOG's shareholders would be wise to take AMZN's CEO at his word regarding margins. Make no mistake, AMZN's big picture is advertising, *not* groceries.

In Closing

The Fund continues to seek investments in companies we understand, at prices below our best estimate of intrinsic value. Simply put, if we are more right than we are wrong, the performance of the Fund should be very satisfactory over the long-term . . . but it almost certainly won't be as timely (or painless) as it has been so far.

May 1st marked the three year anniversary of the Fund. Thank you for the support, encouragement, and trust along the way. As always, please feel free to email or call with any questions or concerns.

"With my sunglasses on, I'm Jack Nicholson. Without them, I'm fat and 60."
Jack Nicholson

¹⁰ 9.27.2016 Recode: [55% Of Online Shoppers Start Their Product Searches On Amazon](#)

Past performance is not necessarily indicative of future results. The performance data presented represents that of Pomeroy Capital Partners, LP (the “Fund”). Performance results represent fund-level returns, and are not an estimate of any specific investor’s actual performance, which may be materially different from such performance depending on numerous factors. All performance results are estimates and should not be regarded as final until audited financial statements are issued.

Performance results have been compared to the S&P 500 Total Returns Index (the “Index”) for informational purposes only. While this Index is widely used as a proxy for overall market performance, we offer no guarantee that the Index will always reflect an appropriate benchmark for the Fund whose holdings, performance, and volatility may differ significantly from the securities that comprise the Index.

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