

## Fairlight Alpha Fund LP

### Q3 2023 Letter

Dear Partners,

Fairlight Alpha Fund's third quarter 2023 returns were -11.1% net of fees. This compares to -3.3% for the S&P 500 Total Return index. Overall, since inception the fund has returned 421.7% net of fees and 43.3% on an annualized basis.

#### Performance vs. the S&P 500

We track the net asset value of Fairlight Alpha Fund (the "Fund") over time as calculated by our fund administrator based on our portfolio positions and prices over time on a dollar basis. The fund financials are also audited each year by an independent auditor with the assistance of the Fairlight management company and the fund administrator.

The tables below show the S&P 500 total return and partnership net returns, after fees, for each year 2019-2023, followed by the compounded returns over the same period, as well as the annualized gains.

#### Annual Returns

<u>Year</u>	<u>Fairlight Alpha Fund</u>	<u>S&amp;P 500 (Total Return)</u>	<u>Difference</u>
2019 <sup>1</sup>	38.1%	17.9%	20.1%
2020	26.3%	18.4%	7.9%
2021	146.5%	28.7%	117.8%
2022	15.8%	-18.1%	33.9%
2023 (YTD)	4.8%	13.1%	-8.3%

#### Compounded Returns

<u>Year</u>	<u>Fairlight Alpha Fund</u>	<u>S&amp;P 500 (Total Return)</u>	<u>Difference</u>
2019 <sup>1</sup>	38.1%	17.9%	20.1%
2020	74.4%	39.6%	34.7%
2021	329.9%	79.7%	250.2%
2022	397.9%	47.2%	350.7%
2023 (YTD)	421.7%	66.4%	355.3%
Annualized Gain	43.3%	11.7%	31.6%

(1) The S&P 500 returns represent the total return index, i.e., with dividend reinvestment included. Increases in value arise from stock price appreciation as well as dividend reinvestment. This provides a fairer comparison to the fund.

(2) The Fairlight Alpha Fund performance is shown net of partnership fees and expenses.

<sup>1</sup> The Fairlight Alpha Fund was launched on 01-Mar-2019 and so the 2019 performance and returns are presented for a 10-month period.

The fund, along with the overall small-cap market, faced a more difficult quarter this period. There’s a lot of discussion around skews in the reported market returns caused by the Magnificent Seven stocks, but the correction in small-cap stocks has created a lot of opportunities and there is no shortage of ideas that can be found that are very cheap on an absolute basis. As a measure of this the Russell 2000 index in the US has fallen by 17.6% since its peak on July 31. We avoid speculating on macroeconomics, but it is likely that the higher rate environment is now beginning to affect the economy and many companies because money is no longer free (or cheap). The great majority of the positions in our portfolio have no net debt and usually have large net cash or investment positions, and so may benefit in a higher rate environment and be protected from financial stress caused by higher debt costs.

We have been extremely busy looking at a lot of new ideas and have found that the US markets are now much more abundant with potential investments than a year ago, or even a quarter or two ago. In similar periods in the past, we have rotated out of some names that have held up better into names that have fallen to extremes of valuation and this approach has served us well over time.

Market and Portfolio Performance

There is always bad news to prevent investors from being fully invested in the market. In the 1970s it was the energy crisis and inflation (oil production per capita is estimated to have peaked around 1979). The 1980s saw continuing high inflation, then economic recessions, the cold war and a stock market crash in 1987. Into the 1990s it was the Savings and Loan crisis, Asian crisis, Russian debt default, LTCM crisis and dot-com bubble leading to absurdly high-tech valuations and subsequent crash. The new millennium saw September 11<sup>th</sup>, a housing boom, speculation, and reckless lending culminating in the Global Financial Crisis. This led to the end of the bank-less broker business model (Lehman, and Bear Stearns) and a period of low interest rates through the 2010s. There followed the rise of ISIS and the Syrian civil war, Russian annexation of Crimea in 2014, Brexit in 2016, market instability due to various asset bubbles and tepid global growth.

There are still many things to be concerned about: growing tensions and the likelihood of war in the middle east; the ongoing Russia-Ukraine conflict; increasing Chinese power and influence causing uncertainty and fear in the West; increasing chip wars and sanctions relating to semiconductor and technology sales; spiraling US debt levels; emerging market inflation and economic instability; cyber security threats; and job displacement and systemic shifts in society resulting from the rise of AI. All these fears are enough to make investors hide in their shells and not look to take on any risk. But if we look at stock market returns during all the previous decades (using the S&P 500 as a proxy) the picture looks very different.

Table 1: US market returns by decade (S&P 500).

<b>Period</b>	<b>Change</b>	<b>Compound Return</b>
1970-1979	17.2%	17.2%
1980-1989	227.4%	283.9%
1990-1999	315.7%	1,496.0%
2000-2009	-24.1%	1,111.3%
2010-2019	189.7%	3,409.4%
2020-YTD	30.7%	4,489.5%

Except for the 2000s in the wake of the Global Financial Crisis each decade produced positive returns. And post 2009 the market reached new highs by early 2013. Staying invested in the market over these decades even in a market index tracker would have produced a very healthy level of returns.

A recent area of concern among market observers is the US banks, particularly following events in March/April. This period saw increased apprehensions around US regional banks, as well as community banks. Concerns include bank runs, undisclosed technology or crypto exposures, further losses on Fixed Rate US Treasury and Agency positions held in Available-For-Sale and Held-to-Maturity portfolios, and the looming prospect of a recession. However, a close examination of financial statements from various US community banks reveals minimal signs of stress in many cases. Specifically, we like banks such as Citizens Bancshares Corporation (CZBS) and M&F Bancorp, Inc. (MFBP). Both banks have a history of effectively managing their loan books and participated in the ECIP program. Both are MDIs (Minority Depository Institutions), that have been given investments via preferred shares on favorable terms, enhancing their ability to grow domestically and provide credit to local areas. Moreover, large US banks, like Bank of America and Citigroup, are supporting them in terms of staff, guidance, and participation in syndicated loans (see the NFL press release<sup>2</sup>).

The valuation of these banks has declined over the last quarter, consistent with the trend observed in many other small and microcap stocks, making them even more compelling investments than before. They still have a long runway of growth ahead of them, notably high regulatory capital ratios and their fixed-rate investments are held in Available-For-Sale portfolios, which have already been reflected in their financial statements under AOCI. Rising interest rates have also boosted their earnings and particularly for Citizens Bancshares which has managed deposit costs effectively, boasting one of the lowest deposit cost bases among US banks. Given their deep-rooted connections to their communities and robust balance sheets, we anticipate they will increase deposits over time. In turn, as their loan portfolios expand, we project their earnings to at least double in the upcoming years. They are also well placed to weather a recession or economic downturn. We currently estimate that Citizens Bancshares is priced at a current multiple of 4.8x and M&F Bancorp is at 5.9x, with both holding cash reserves exceeding their market capitalization (nearly twice as much for M&F Bancorp). We're also exploring other opportunities among non-ECIP US community banks (and in one case building a position in) that we will discuss further in future letters.

Beyond the US, there are some names in East Asia that we like (and have mentioned before), such as Pax Global. Despite a decline in earnings this year, with Pax earning HK\$650.6 million in H1 2023 versus HK\$699.8 million in H1 2022 the long-term trend is one of growth. We believe Pax Global's business remains strong and is largely overlooked by the market. This growing business, trading at a 4.8x multiple, holds cash reserves equal to almost half its market cap. Furthermore, it is also returning capital to shareholders with a 6.5% dividend yield over the last two reporting periods and has accelerated its share buyback efforts, having bought almost 1% of shares outstanding over the last few months.

Throughout the year, we have reviewed thousands of companies, including many in the oil sector. While we are generally cautious about commodity-based businesses where the company lacks control over the price of what it produces, the valuations in several cases have reached extremely compelling levels. For example, Petrobras (PBR) and Ecopetrol (EC). Petrobras has distributed dividends of over \$2.30 paid this year<sup>3</sup>, while Ecopetrol has traded as cheaply as the \$9-\$10 range (close to our purchase price) and is paying approximately \$2.50 in dividends this year.

We factor in the potential cost of FX movements over time, but even under the most pessimistic scenarios the investments should work out well. We initially came across these ideas while looking at South American stocks in general. We saw that many market commentators had expressed concerns that Ecopetrol's dividends might be halted, especially following the election of Gustavo

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<sup>2</sup> <https://newsroom.bankofamerica.com/content/newsroom/press-releases/2023/06/the-nfl-secures--78-million-in-loans-from-minority-banks--streng.html>

<sup>3</sup> Using the Brazilian Real-to-dollar FX rate as of each pay date.

Petro as president of Colombia in June 2022. Similarly, there have been reservations about the sustainability of Petrobras's dividend. However, the government owns substantial controlling stakes in these companies and is also a recipient of their dividends. For Ecopetrol, the Colombian government owes money to Ecopetrol due to the Fuel Price Stabilization Fund (FEPC). This fund aims to stabilize fuel prices for Colombian consumers. It bridges the gap between international and national Colombian consumer prices by compensating producers and importers for this price difference. The primary goal is to cushion the impact of global oil price fluctuations on the Colombian market. This is achieved either through cash payment or by forgoing dividend payments due from the government's stake in these companies. In Ecopetrol's case, the dividends paid (or those that would be paid to the government) are applied against the outstanding balances.

This means the government can reduce the balance owed to Ecopetrol for its contribution to the Fuel Price Stabilization Fund. For example, in Q3 2023 this amounted to more than 8 trillion COP or US\$2 billion. At the end of July 2023, the balance of the Fuel Price Stabilization Fund stood at around 22 trillion Colombian Pesos, equivalent to \$5.4 billion.

Continued high oil prices, additional oil production, systemic regional importance and existing cash reserves reinforce our belief in the attractiveness of these investments. Even though Petrobras amended its dividend policy in July, from a minimum of 60% to at least 45% of free cash flow, this will give the company additional room to perform additional share buybacks. Judging by what has happened to date, and the actual treatment of shareholders (rather than speculated actions) we will maintain and monitor a holding in these stocks at current valuations.

Shifting attention back to the US, the microcap now presents some compelling opportunities across a variety of sectors. We are in the process of purchasing stakes in several ideas and so we will discuss these further in future letters. Given the illiquidity in some of these investments, our goal is to establish a meaningful level of investment before we write these up or post details.

### Historical Performance of Small-Cap, Illiquid and Family Stocks

The comparison between the performance of small-cap stocks versus large-cap stocks has been a frequent topic, but other metrics can also be indicators of potential pools of higher performing investments. Liquidity is an important factor that is often perceived as a negative characteristic, but highly researched, well-chosen stocks can outperform. This idea is supported by the seminal paper of Amihud and Mendelson (1986) on liquidity and stock returns<sup>4</sup>. Similarly, in private markets the returns of Private Equity ("PE") can be partially attributed to the non-public, illiquid nature of their investments<sup>5</sup>. We perceive the investments we have made in the past as benefiting from an illiquidity premium, akin to PE returns, but with the growth upside of Venture Capital returns.

We also came across another study relating to family-owned businesses which aligns with the kind of stocks that the fund invests in. The short Credit Suisse study: "Trust: the alpha factor for family-owned companies" examined the outperformance of these kinds of businesses compared to the broader market<sup>6</sup>. Notable examples of such companies include large-cap entities like Hermès, Merck, and L'Oréal. The outperformance of family-owned businesses is said to be 4% from 2006 to 2022.

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<sup>4</sup> Liquidity and Stock Returns, Amihud and Mendelson, 1986: <https://www.jstor.org/stable/4478932>

<sup>5</sup> <https://viewpoint.bnpparibas-am.com/the-illiquidity-premium-in-private-asset-markets/#:~:text=This%20outperformance%20can%20be%20seen,illiquid%20assets%20over%20prolonged%20periods.&text=Private%20assets%20are%20investment%20opportunities,markets%20such%20as%20stock%20exchanges>

<sup>6</sup> <https://am.credit-suisse.com/content/dam/csam/docs/equities/lux-european-entrepreneur-ef/market-commentary-ch-eng.pdf>

These kinds of studies serve as useful pointers, guiding us as to which part of the lake we should be fishing in and serve as an additional factor to take into consideration when reviewing businesses. Family-owned businesses and owner operators (that function in a similar way) often exhibit behavioral qualities less common in other publicly owned businesses: superior capital allocation and more favorable treatment of common shareholders. In terms of “liquidity alpha”, this phenomenon arises from outside the business itself, stemming from factors like stock price movements, wide bid/offer spreads, or periods of illiquidity that can result in substantial gaps between a company’s market price and its intrinsic value.

Outlook for the Remainder of 2023

The persisting turbulence in the markets has created many new opportunities. The best businesses and stocks are like resilient bubbles in a vast ocean, and despite being tossed by the waves of market sentiment, they have an inherent buoyancy that guides them to the surface, manifesting the underlying value that we recognize in calmer waters.

This has been an exceptionally busy period for us, because there are a huge number of ideas to analyze and sift through. And we aim to remain optimistic for the future, even in these difficult and uncertain times. But we endeavor to remember that there is both that: “there is always something to worry about” (Peter Lynch); but also that: “there is always something to do” (Peter Cundill).

We are continually grateful for our partners’ support and realize how precious time is for everyone. And so, we seek to maximize returns, and grow the size of each investor’s allocation within the fund over time. And always being vigilant to take best advantage of the market’s swings of pessimism and optimism.

Yours,

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AN INVESTMENT IN THE FUNDS IS SPECULATIVE AND INVOLVES A HIGH DEGREE OF RISK. OPPORTUNITIES FOR WITHDRAWAL, REDEMPTION AND TRANSFERABILITY OF INTERESTS ARE RESTRICTED, SO INVESTORS MAY NOT HAVE ACCESS TO CAPITAL WHEN IT IS NEEDED. THERE IS NO SECONDARY MARKET FOR THE INTERESTS AND NONE IS EXPECTED TO DEVELOP.

THE FEES AND EXPENSES CHARGED IN CONNECTION WITH THIS INVESTMENT MAY BE HIGHER THAN THE FEES AND EXPENSES OF OTHER INVESTMENT ALTERNATIVES AND MAY OFFSET PROFITS. NO ASSURANCE CAN BE GIVEN THAT THE INVESTMENT OBJECTIVE WILL BE ACHIEVED OR THAT AN INVESTOR WILL RECEIVE A RETURN OF ALL OR PART OF HIS OR HER INVESTMENT. INVESTMENT RESULTS MAY VARY SUBSTANTIALLY OVER ANY GIVEN TIME PERIOD.

THE PERFORMANCE DATA SHOWN HEREIN REPRESENTS THE PERFORMANCE OF THE FUND. THE RESULTS REFLECT THE DEDUCTION OF: (I) AN ANNUAL ASSET MANAGEMENT FEE OF 2%, CHARGED QUARTERLY; (II) A PERFORMANCE ALLOCATION OF 20%, TAKEN QUARTERLY, SUBJECT TO A "HIGH WATER MARK;" AND (III) TRANSACTION FEES AND OTHER EXPENSES ACTUALLY INCURRED BY THE FUND. THE RESULTS REFLECT THE IMPLEMENTATION OF THE INVESTMENT STRATEGY DESCRIBED IN THE FUNDS' OFFERING DOCUMENTS AND APPLIED IN THE FUNDS' TRADING ACCOUNTS. ALL INVESTMENTS INVOLVE RISK, INCLUDING THE LOSS OF PRINCIPAL.

RESULTS ARE COMPARED TO THE PERFORMANCE OF THE S&P 500 TOTAL RETURN INDEX (THE "COMPARATIVE INDEX") FOR INFORMATIONAL PURPOSES ONLY. THE FUND'S INVESTMENT PROGRAM DOES NOT MIRROR THE COMPARATIVE INDEX AND THE VOLATILITY OF THE FUND'S INVESTMENT PROGRAM MAY BE MATERIALLY DIFFERENT FROM THAT OF THE COMPARATIVE INDEX. THE SECURITIES OR OTHER INSTRUMENTS INCLUDED IN THE COMPARATIVE INDEX ARE NOT NECESSARILY INCLUDED IN THE FUND'S INVESTMENT PROGRAM AND CRITERIA FOR INCLUSION IN THE COMPARATIVE INDEX ARE DIFFERENT THAN THOSE FOR INVESTMENT BY THE FUND. THE PERFORMANCE OF THE COMPARATIVE INDEX WAS OBTAINED FROM PUBLISHED SOURCES BELIEVED TO BE RELIABLE, BUT WHICH ARE NOT WARRANTED AS TO ACCURACY OR COMPLETENESS. UNLESS NOTED OTHERWISE, THE RETURNS OF THE COMPARATIVE INDEX PRESENTED HEREIN DO NOT REFLECT FEES OR TRANSACTION COSTS, BUT THOSE RETURNS DO REFLECT NET DIVIDENDS, IF ANY.

**PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.**