GORA
GREAT OCEAN ROAD ADVISORS

July 2022

June 2022 letter

Dear Fellow Investors,

Thank you for being a part of Great Ocean Road Advisors.

For the June quarter, the GORA Southern Endeavor Fund retraced -17.3%, net of fees and expenses.

The Retail sector (XRT) retraced -22.6% and the S&P500 retraced -16.1%.

It is very volatile in financial markets. Rising interest rates, inflation and concerns of recession have frightened investors. Main St is frightened too. This quarter saw a major retracement across the broader markets. Our error was two-fold: we underestimated the degree to which pessimism can, at least in the short-term, overcome healthy fundamentals for households and businesses, and then the outsized impact this can have on investor sentiment for small-cap, illiquid companies where we have investments.

Despite our performance broadly matching indices, within the portfolio there was wide divergence. Our largest investment appreciated 20% during the quarter. Our shorts fell materially, helping cushion the impact of the sell-off, but were too small within the context of the depth of the bear market that afflicted Consumer.

The drag on our portfolio was disproportionately caused by two small-cap IPOs from 2021; ARHS and FXLV. Both stocks entered the quarter with strong fundamentals while trading at valuations we believed unsustainably low. Both received positive revisions during the quarter on healthy earnings updates. However, their small market-caps and low liquidity caused each to experience outsized selloffs in the bear market. Valuations therefore ended the quarter further compressed: ARHS to just 3x EV/EBITDA and 5x P/E, FXLV to 4x EV/EBITDA and 6x P/E. We have neither added nor sold shares in either.

Their stories are emblematic of the wider sector where much of our coverage now trades at multiples lower than at any point so far this century. Our deep surprise is that this is occurring at a time when total household income from salaries is growing above 10% and the unemployment rate is below 4%. Those good numbers count for nothing if they will soon be swapped. However, at the risk of sounding pollyannaish, there are reasons to expect a downturn would be shallow and the investment landscape is rich with opportunity if we simply don't drive off a cliff.

Painful describes the June quarter, but we are also appreciative. Our live tracking of the largest equity hedge fund portfolios measures investment returns across active managers much worse than the numbers at the top of this page. These funds don't invest in bad businesses. Instead, we have seen economic pessimism slow activity whose effect on share prices is being amplified by financial market pessimism. The herd is running away from good assets not because they have become bad, but because animal spirits have darkened. A cool head paired the ability to stay invested has the potential to reap outsized returns.

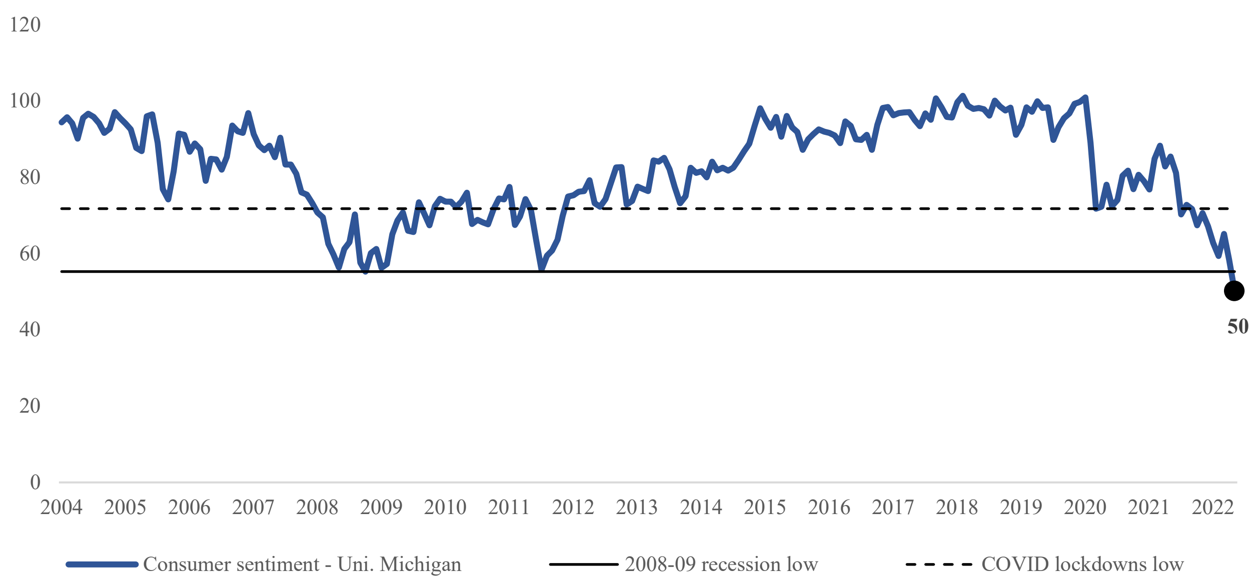
Market views – the undamaging recession

In our last quarterly letter, we wrote that we do not see a damaging recession coming for the US economy. We stand by that view but concede avoiding recession may now be unlikely. Pessimism and uncertainty have driven activity to cool in virtually every corner of the economy we follow. In fact, it seems increasingly possible the economy is currently in recession to be declared with hindsight.

That said, we do not believe a recession would be damaging because the foundations of the economy are healthy. Wages, wealth, debt levels, and productivity are all in position to buffer the effects of inflation and rising interest rates. The most recent sustained recession of 2007-08 is a red herring in estimating the magnitude of a future recession because excessive financial risk-taking then created a downward economic spiral. Today, psychology is a greater nemesis than hard financial realities in driving a slowdown.

Where we are cautious is the low-end consumer. Lower income households, who carry far less in savings and were disproportionately buoyed by stimulus checks in 2021, are nearing depletion of their excess cash buffers. This group is sensitive to inflation in gas and groceries. In contrast, high income households are insulated from inflation in non-discretionary items and continue to enjoy strong wage growth. Their balance sheets are robust. The top-half of wage earners account for approximately 70% of spending activity and so make up for low-end weakness in the aggregate. The only thing holding the high-end back today is sentiment.

A chart of consumer sentiment encapsulates the current environment. In June 2022, it reached its lowest level in 50-years. Lower than the low points of both the 2008-09 financial crises and 2020's COVID lockdowns.



As long-term investors, weak sentiment does not deter us. Sentiment has never proven an effective lead indicator on activity further out than just one or two months. Only incomes, wealth and productivity do that. Sentiment surveys are better thought of as measuring how positive vs. negative this morning's newspaper headlines were. And media narratives have been particularly pessimistic lately. Macaulay and Song (2022) measure that almost half of the drop in sentiment among households can be explained by exposure to negative economic narratives.

Our own anecdotal example of overly negative news headlines concerns household savings rates. During the June quarter, mainstream news outlets such as Forbes, Bloomberg, and Newsweek reported on the sharp declines in household savings rates as evidence of an economic downturn and household finances becoming stretched. What these articles overlooked is that all of the reduction in household savings reported by the Bureau of Economic Analysis is being caused by artificially high tax rates in 2022, resulting from realized capital gains in 2021. In fact, if household tax rates in 2022 matched 2021, the dollar value of savings would be *above* last year's levels and far higher than trend rates. It's not inflation eating into household savings so much as the tax bill on their GameStop investments. Nonetheless, the effect of news stories suggesting dwindling savings is further dampening the household psyche.

We therefore see a world where pessimism is at extremes, but fundamentals are okay, even good. What does that mean for investment returns? Below we show periods of consumer sentiment peaking and troughing over the past 50 years along with the subsequent 12-month market returns. It has historically been far better to invest when sentiment troughs than when it peaks. Calling a few hundred households each month to ask them how they are feeling apparently yields poor investment advice.

Sentiment reaches highs		
Date	Sentiment	Subsequent 12mnth S&P return
Aug-1972	96	-6.2%
May-1972	90	1.2%
Mar-1984	101	13.5%
Jan-2000	111	-2.0%
Jan-2004	104	4.4%
Jan-2007	97	-4.2%
Feb-2020	101	29.0%
Average	100	5.1%

Sentiment reaches lows		
Date	Sentiment	Subsequent 12mnth S&P return
Feb-1975	58	22.2%
May-1980	51	20.0%
Oct-1990	64	29.1%
Mar-2003	77	32.8%
Oct-2005	75	14.2%
Nov-2008	55	22.2%
Apr-2020	71	43.6%
Average	64	26.3%

Looking forward, we are watching closely for a stabilization in activity. It will come. People get bored of being scared. And when they do, they will return to their normal spending habits, especially when they have jobs that are paying them well.

Further, we continue to believe inflation will abate, rather than spiral out of control. Every major supply-chain bottleneck stoking inflation conversations 12-months ago has now turned deflationary: shipping and trucking rates, lumber and steel, computer chips, used car prices. These, coupled with the slowdown in demand over the past three months, will eventually work their way into cooling end-market price levels.

To be clear, there are risks and challenges. Inflation in gas and groceries has geopolitical causes and is affecting not just the willingness, but the ability of certain households to spend. For most households though, these challenges can be overcome.

> **John Maynard Keynes:** "There is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations."

Bassett Furniture Industries Inc. (BSET)

BSET remained the fund's largest position on June 30th and returned +20% during the quarter despite the worsening sentiment among households and in financial markets.

The source of its returns has been continued strong earnings performance. During the final week of the June quarter, BSET reported earnings that included revenue 10% ahead of consensus and earnings per share 81% ahead. We believe share price appreciation was further buoyed by the company's initial share repurchases where we have previously offered small input as investors.

Our BSET thesis remains that its large order backlog supports profitability for the coming year, its position as a domestic manufacturer has become a long-term advantage in a period of deglobalization, and management's improvements to profitability can sustain long-term margins.

We remain further interested in BSET as an investment because of the irrational discount current market prices have the company trading at. Cash and inventories alone account for more than 100% of the share price and it carries no debt, while also owning a real estate portfolio.

BSET assets, value per share	
Cash and investments	$9.93
Inventories	$10.32
Other net working capital and commitments	-$3.95
Real estate	$6.05
Net realizable value of BSET	**$22.35**
Share price	$18.02
Premium of realizable value to share price	**24%**

Our bullishness notwithstanding, BSET is not immune to the effects of negative consumer sentiment described above. We have observed a softening in order intake and made a partial reduction to our position size as a result. The company's order backlog remains large enough that should the pause in consumer spending be just a pause, it won't even be visible in BSET's results. However, should the pause deepen, BSET will eventually deplete its order backlog and see worsening profitability. Given the favorable valuation illustrated above, we will gladly and expeditiously add back the shares we sold at higher prices should our checks show demand for discretionary products recovering.

Short position in restaurant chains (BLMN, CAKE, DRI, EAT, SHAK)

We usually eschew discussing short positions but felt it pertinent to describe one short investment given the current market environment – dining restaurant chains. This is our largest thematic, top-down short investment.

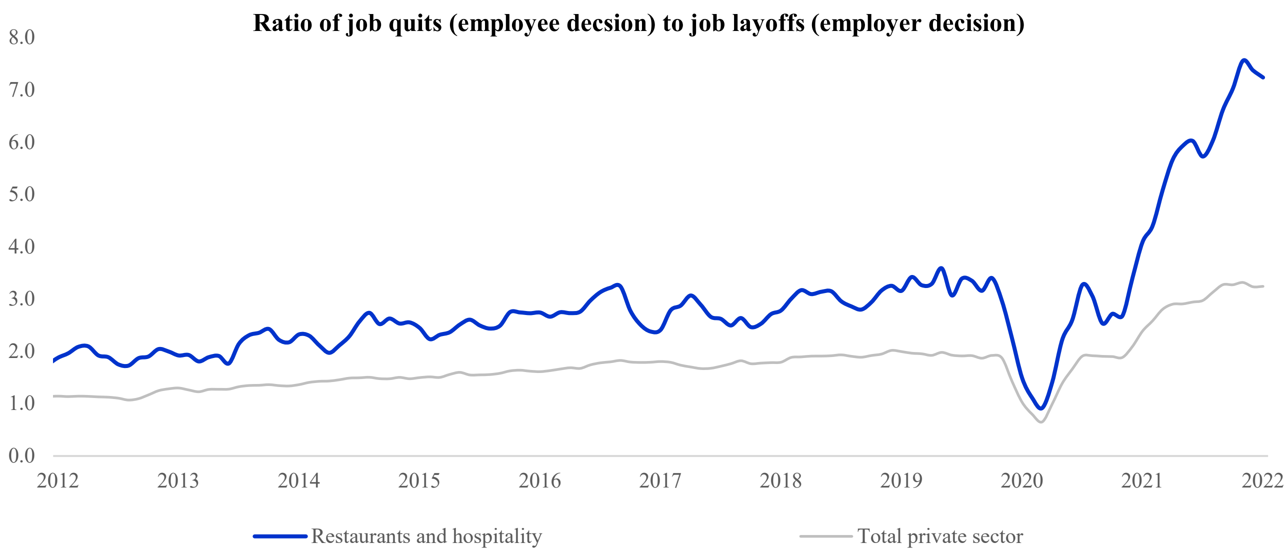
Our reticence for writing about shorts is due to their being a small part of the portfolio (avg. short is 1-2% vs. avg long 6-8%), and because of the well-publicized risk of becoming a short squeeze target. However, this year provides a perfect example of why we short. We believe the outlook for the balance of the year is also conducive to holding these restaurant shorts.

We short sell when we develop a researched, idiosyncratic view differentiated from the market view, whose addition to the portfolio will dampen volatility. This is clearly more helpful in bear markets. Unlike some short sellers, we believe there exist few opportunities for public companies to go to zero. By the time a company has IPO'd, it almost always possesses the scale, operational expertise, and access to capital that de-risk it from a zero outcome. Instead, we invest in shorts where we believe the share price should rise modestly in a bull market, fall modestly in a neutral market, and fall materially in a bear market. Our small position sizes in shorts mean they will never fully offset long investment declines in a major bear market, but they can mitigate the damage. This is exactly what our restaurant shorts have been doing in 2022.

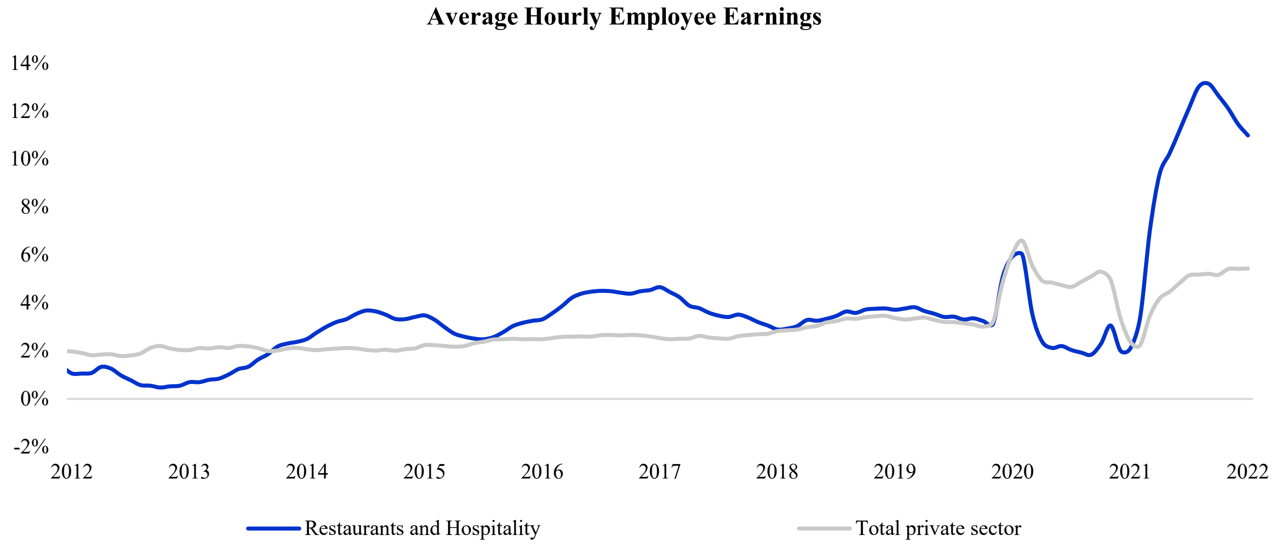
Five restaurant companies: BLMN, CAKE, DRI, EAT and SHAK have been portfolio shorts during the first six months of the year, and we expect will remain shorts for balance of the year. Their share prices have declined between -20% and -50% YTD, all underperforming major indices.

Our negative view towards dining restaurants has been predicated on cost pressures. We felt that while restaurant sales were likely to be strong in 2022 coming out of the pandemic, as the market anticipated, the industry was uniquely exposed to spiraling costs. Profitability was therefore likely to underwhelm, and perhaps even decline, despite the robust sales.

Labor is the best example of a cost pressure facing restaurants. Wage growth across the economy is well understood. However, less well understood is that labor shortages have become far more acute for the restaurant industry than any other sector of the economy. This shortage is revealed through our chart below comparing the ratio of job quits to job layoffs in the restaurant sector and for the broader economy as a whole.



The consequence of the supply-demand imbalance for restaurant staff has been rapid wage growth. A typical restaurant worker is today earning just over 10% more than they were this time last year. With labor costs accounting for ~30% of sales at a typical restaurant, this is a powerful cost headwind.



Restaurant expense pressures haven't been confined to labor either. Their second largest input cost, food and beverages, has been inflating throughout 2021 concurrent with the heating economy. Inflation then spiked at the beginning of 2022 as a result of the invasion of Ukraine and consequent suspension of its critical food exports, causing global food markets to tighten. Our own food input cost index, which tracks a basket of primary food sources such as wheat, soyabeans, barley, and proteins, has jumped more than 40% since the beginning of the year.

The effect of these two spiking cost pressures on restaurant profitability is severe, even with healthy sales. All of our restaurant companies experienced deteriorating profit margins in their most recently reported quarters, with the exception of SHAK. SHAK's prior year was burdened by high geographic exposures to still sensitive covid areas. It's 15.2% reported restaurant margin in 2022 remained well below the 24% profit margin it showed in 2019.

	BLMN		CAKE		DRI		EAT		SHAK	
	2021	**2022**	2021	**2022**	2021	**2022**	2021	**2022**	2021	**2022**
Restaurant profit margin %	18.8%	**17.1%**	13.6%	**12.8%**	22.8%	**19.8%**	13.9%	**12.2%**	15.0%	**15.2%**

Looking forward, we remain short these companies but for a shifting reason. These restaurant companies sought to offset inflationary cost pressures by rapidly raising menu prices. The industry has passed through to customers the equivalent of five years' inflation during ordinary times condensed into under two years. These increases were initially being absorbed while the consumer was buoyant. However, demand elasticity takes time to be tested and there are growing signs of customer pushback against higher restaurant prices. This issue is amplified because price awareness at restaurants is far higher than in most consumer categories due to high frequency of use. Their customers are noticing the price hikes and getting annoyed.

DRI reported at the end of June that customer traffic to its restaurants is now in decline and that the broader industry is faring worse. We forecast the margin degradation of cost pressures on restaurants is likely to continue and be exacerbated by weakening traffic. Further, valuation multiples for these companies aren't cheap even after their sell-off due to negative earnings revisions.

New position – EZCorp (EZPW)

During the June quarter, the fund entered a new long position in EZCorp (EZPW).

EZPW is the second largest pawnbroker globally. Its more than 1,000 stores generate annual revenue of just under $1 billion, primarily by providing short-term loans to the 25% of US households without access to traditional banking credit. Unlike for traditional banks, there is no credit risk associated with EZPW's customer loans because each loan is fully collateralized by a customer asset, usually high-value jewelry. In the event of loan non-repayment, ownership of the collateralized asset passes to EZPW which then sell it through their stores at a gross margin typical of retail. Non-repayment is rare – approximately 90% of loans are fully repaid, a level that has been surprisingly sticky through economic cycles.

We have invested in EZPW for three reasons: demand for EZPW's services is improving, competitive pressures are easing, and the stock is being priced for the reverse.

Pawnbroking demand drivers are surprisingly counter cyclical. When times are good, their customers are flush with cash, dissipating the need for loans. A perfect example was the recent period of Biden's 2021 stimulus payments, which disproportionately benefited households likely to use pawnshops. Checking accounts balances for this group jumped to more than 2x normal levels during this window. EZPW's pawn loans outstanding (PLO), from which it derives its income, plummeted to 30% below normal levels – customers simply didn't need their services in 2021.

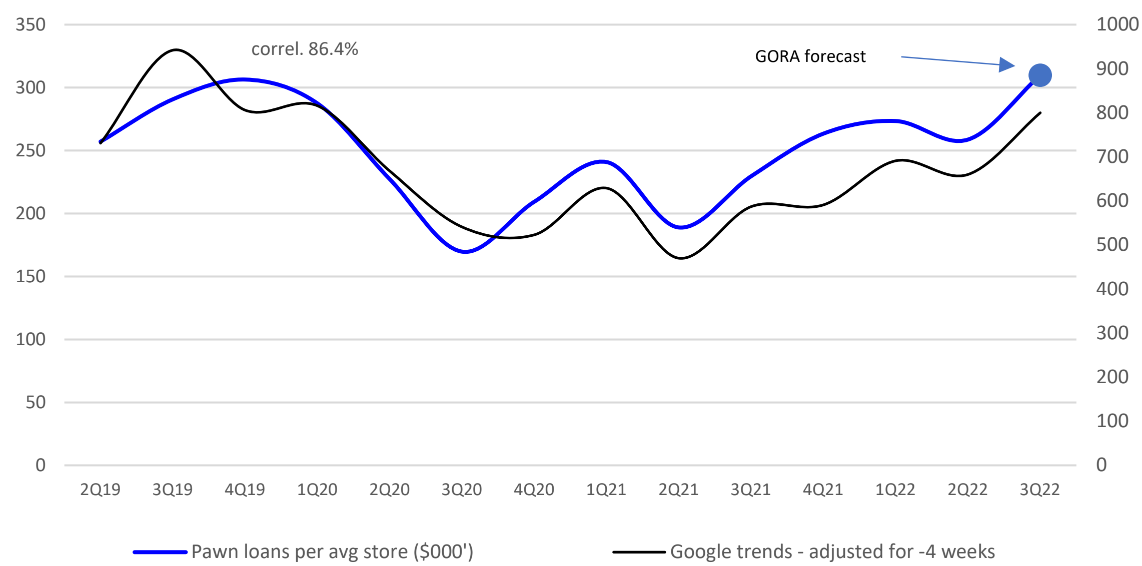
Now it's 2022 and the world has changed. Although household bank accounts remain healthy in aggregate, lower income households are beginning to deplete their excess savings. As we described at the beginning of this letter, this group is sensitive to inflation in non-discretionary categories such as gas and groceries. Demand for pawn loans is picking up and we expect demand will remain strong for the foreseeable future. While we do not expect a severe recession, we note EZPW's business performed well through the 08-09 recession on an absolute basis, and magnificently on a relative basis.

How can we be sure demand is improving while non-pawnbroking retailers are seeing a pull back? We share five reasons:

1. There is strong momentum in EZPW's recently reported results – its PLO grew 40% y/y last quarter.
2. Our conversations with private pawnbrokers across the country confirm strong demand. They saw further acceleration in the June quarter, unreported by EZPW. One contact shared his PLO was up 100% y/y.
3. Business sections of local newspapers who are finding good news stories rarer are turning to their local pawnbrokers for interviews. We uncovered three stories from community papers across the country speaking to pawnbrokers about their surging demand: story, story, story.
4. Given the global nature of its business (EZPW has over 600 stores outside the United States and owns a near-majority stake in Australia's Cash Converters), we spoke with a number of pawnbrokers outside the US. Our most

interesting conversation was with the President of the National Pawnbrokers Association of the United Kingdom who shared the biggest challenge for the industry is finding access to capital to serve the growing loan demand.

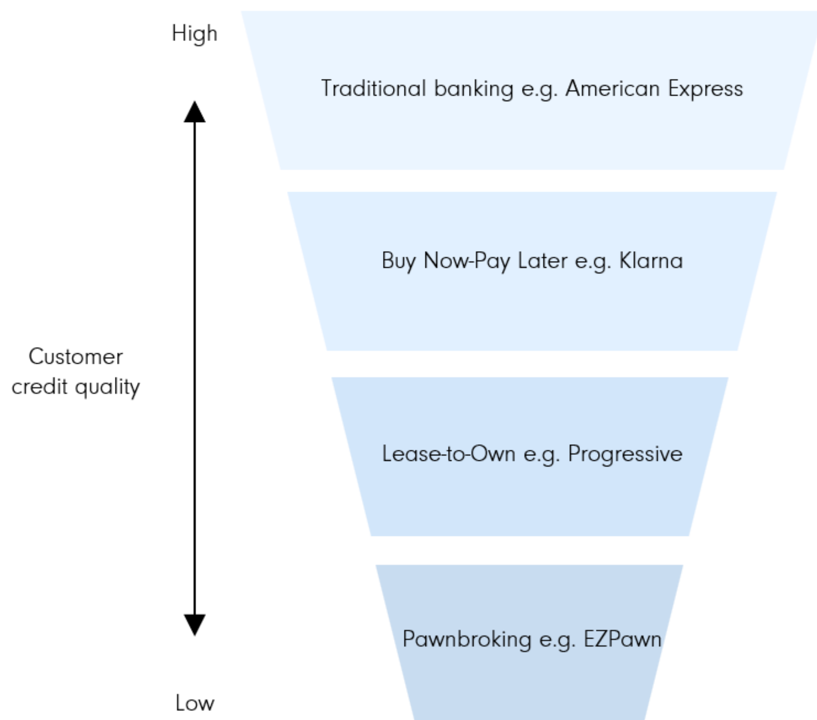
5. Simple often works. A simple search analysis for terms such as 'Pawn Loan' reveals a strong correlation with the financial results reported by EZPW. It shows recovery in demand volumes over the past four quarters, and further acceleration in EZPW's unreported 3Q22 (June quarter).



The above supports conviction in our view that demand for EZPW is growing at a time when so few consumer categories are enjoying volume growth. At the same time, competition from non-pawnbroking financial providers is easing.

EZPW's competition in providing customer loans can be illustrated through the funnel below. Each stratum of the financial services funnel targets an income/wealth segment of the population. Those at the top (traditional banking institutions such as American Express), target high income customers considered to be high credit quality. As we move down the funnel, customers are restricted from access to credit by the higher tier providers and instead are offered loans by providers seeking to serve customers with progressively lower credit histories. The final stop is pawnbrokers, EZPW included, where credit quality is irrelevant because all loans are fully collateralized.

Financial services funnel



Economic cycles cause the funnel to flex in reverse. During booms, financial service providers flex *down* the funnel – offering their services to lower credit quality customers than they would normally target. They do this because conditions are good, customers are paying back their loans and there is general optimism for the economic outlook. Perhaps counter-intuitively, booms make for challenging times for pawnbrokers because their customers are being offered access to financial credit by providers who normally wouldn't extend them credit. Competition rises during booms.

During busts, financial service providers flex *up* the funnel. These providers cease extending credit to speculative/low credit quality customers in their demographic stratum, restricting access to only higher end customers. The competitive environment for lending softens. In this stage of the cycle, pawnbrokers benefit. Their customer demographic is no longer being offered credit from Lease-to-Own or Buy Now-Pay Later providers. Their demographic is served almost exclusively by pawnbroking.

For the past two years, the credit cycle has been easy. Predictably, financial service providers flexed down the funnel. The effect was exacerbated by a wave of VC funding for Buy Now-Pay Later firms incentivized to show extraordinary transaction growth. They did so by extending credit to customers who would not normally be offered their services. Pawnbrokers suffered. Concurrent with soft demand for pawnbroking due to stimulus checks, competition became fiercer than ever.

The cycle has begun its reversal. Interest rates are rising, financial service providers are tightening, and funding for Buy Now-Pay Later companies is disappearing. The result is less competition for pawnbrokers just as inflation and depleted savings at low-income households is causing demand to heat up.

The country's largest Lease-to-Own provider, Progressive Leasing, confirmed the tightening of lending conditions only three weeks ago:

> **Progressive Leasing (June 16th, 2022):** "Because the Company anticipates a challenging and volatile macro environment for the remainder of the year, it has further tightened its lease decisioning."

Finally, on valuation, earnings and what the market is pricing in, we see a favorable risk-reward in EZPW. Shares are trading like a cyclical asset spiraling into recession, not a counter-cyclical seeing demand growth. The market is currently asking a valuation of just 4.5x EV/EBITDA and 9x EPS, comparing favorably to a historic average of 8x EV/EBITDA and 15x EPS. This at a time when revenue growth is accelerating and margins improving to above normal-cycle earnings.

Two more points on valuation leave us constructive:

- First, EZPW's debt is financed through convertible notes bearing low interest rates. GAAP accounting practices require companies with convertible note debt to report on an 'as-converted' basis, treating the notes as equity even though it is highly unlikely noteholders will convert into shareholders. The effect is EZPW's reported share count is artificially inflated and therefore EPS artificially depressed. EZPW's 'true' earnings per share is approximately 33% higher than what it reports. Its P/E multiple is therefore really closer to 6x.

- Second, EZPW is back in the market repurchasing its shares. We are avid investors in companies who choose to invest right beside us by buying back their own shares. Concurrent with its most recent earnings update, the company authorized a $50m share repurchase program, which covers more than 10% of its market capitalization at current prices. We expect the company will generate sufficient free-cash-flow to buyback at least $25m of its own shares annually, while continuing to invest in the business. Doing so would increase our ownership by ~5% every year, without us having to purchase another share.

Outlook

On the business side of things, we warmly welcomed Joseph Dyke as a summer intern this month. Joseph will be working on a single company project and is already adding great value.

As Charlie Munger notes, investing isn't meant to be easy. These past 12 months haven't been. However, patience and persistence are probably more important than any other trait in achieving long-term success. We continue to believe the environment provides strong opportunity for patient investors.

Thank you for your trust and support. We are humbled that you have decided to invest a portion of your assets with Great Ocean Road Advisors.

Sincerely,

James O'Brien
Managing Partner & Portfolio Manager
Great Ocean Road Advisors