WHAT IS ON YOUR PLATE?

JUNE 30, 2018

DEAR FELLOW PARTNERS & FRIENDS,

The second quarter of 2018 looked a great deal like the first quarter of 2018 with extended volatility in most asset classes, including now, the foreign exchange markets. The common theme seems to be rising interest rate differentials between the United States and its trading partners, caused by an apparent divergence between growth prospects here and abroad. This divergence is something we mentioned as a distinct possibility in our fourth quarter letter titled *Idiosyncratic Portfolios*, though the ground-level evidence we gather from our bottom-up work does not yet provide confirmation. On the contrary, when it comes to bottom-up results we still see strong earnings in most of our companies here and abroad. This may change for some of our multinationals if dollar appreciation persists, but by-and-large the year's volatility is also blamed on macro themes which may or may not play out. What will the Federal Reserve do? Negotiation with NAFTA? Trade war with China? Emerging market and currency weakness? Is the bond bull market over? Will Italy wreck the Euro? Breaking the Iran nuclear deal? North Korea? Last but not least, this year's midterm elections. In market environments like this, where "Macrosaurs" battle each other above us, we continue our daily work on the ground appreciating that in the end, business fundamentals usually win out. I know it may be tempting to try a hand at both macro trading and bottom-up investing, but for my style of investing there is no magic pill for that.

On that topic, my wife and I recently watched a documentary called *The Magic Pill* and it opened my eyes about the human diet and its reliance on glucose, which the body converts to fuel from carbohydrates. The documentary points to the many new studies that show the overconsumption of carbohydrates, especially sugar and grain-based foods, which is encouraged by the FDA food triangle. This overconsumption is directly related to the epidemic of diabetes, high blood pressure and other precursors to unnatural death in the developed world. Of course, the natural contrarian in me is drawn to the supposition and I am trying it out. For many different reasons, this one makes some sense to me, but it also reminds me of the current obsession with ETFs and index funds (bet you did not guess that was coming). Are they actually the investment equivalent of sugar? A quick and easy shot of energy? As those vehicles compete over cost to gain market share in investor portfolios, could investors just be metaphorically eating ever cheaper chocolate bars, possibly overindulging for a short-term sugar high at the expense of their long-term portfolio health? I think it is possible as I have seen these obsessions before. It reminds me that it is a good time to check one's risk "appetite" and make sure there is a balanced mix of protein and vegetables on your plate, not just dessert.

"We are 'getting paid to wait' for the first time in a while. It may sound crazy, but there are people alive today that do not realize that a bank is supposed to pay you interest on your deposits!"

Getting Paid to Wait

Regardless of whether there is macro noise or daunting headlines, I know that our bottom-up approach is easier said than done. It is also no wonder that many investors are taking a hard look at 2-3% yields on cash. The Centerstone Investors Fund's (CENTX) reserve basket* is itself yielding approximately 2.5%. As we have noted in previous communications, we actively manage cash by investing mostly in high-grade paper with maturities of up to two years. Currently, with a relatively flat yield curve, we have been shortening duration to below two years. There is less need to take even modest interest rate risk with short-term yields close to two year yields. As illustrated on the next page, the Investors Fund's current exposure to the various reserve components is 9.1% in Treasury notes yielding approximately 2.4%, 6.6% in short-term corporates yielding approximately 2.9% and 5.2% in money markets yielding approximately 1.7%. We are "getting paid to wait" for the first time in a while. It may sound crazy, but there are people alive today that do not realize that a bank is supposed to pay you interest on your deposits!

* Cash & cash equivalents, treasury securities, short-term high quality bonds and preferred stocks.

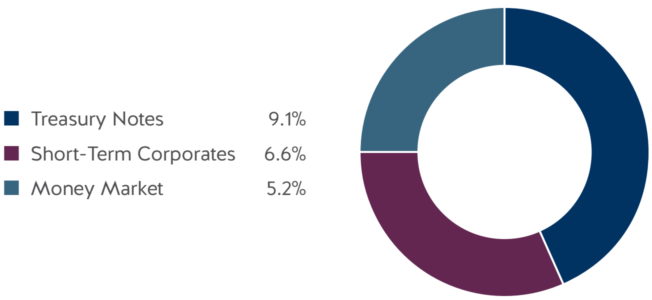
CENTERSTONE INVESTORS

WHAT IS ON YOUR PLATE?

JUNE 30, 2018

CENTERSTONE INVESTORS FUND

RESERVE MANAGEMENT COMPONENT



While we wait we are still finding interesting new ideas. To recall, Centerstone Investors' primary aim is to provide equity-like returns with less equity market risk over a full market cycle. We will mostly invest in equities to reach for that goal, but we have the latitude to invest in non-equity securities as well. One recent example from year-end is when we picked up the defaulted General Obligation bonds ("GOs") of Puerto Rico during the panic selling that occurred after the tragedy of Hurricane Maria, which devastated the island. The island had been in bankruptcy for a while before the hurricane hit and with that fatal blow, its finances were seriously impaired. Full recovery for the bonds seemed unlikely even before the hurricane and as the financial and human cost of the hurricane became apparent, it seemed obvious to us that full recovery, even for constitutionally protected bonds such as the GOs, would be impossible. Though an unfortunate outcome for debt holders, they certainly knew what risks they were taking when lending to a territory whose financial liabilities (debt and pension) exceed 130% of GDP. On the flip side a haircut on debt obligations provided that public pensions participated, would help rightsize the island for the longer term, providing some much-needed relief to the residents of the island. In any case, judging the potential recovery value proved troublesome because there have not been that many cases like this. We looked at the few precedents there were and settled on a fair value range of between 40 and 80 cents on the dollar for the GOs. That is clearly a huge range, but the bonds eventually traded at 24 cents on the dollar and this is where we initiated our position. At roughly half under the bottom end of the range, we thought there was ample protection. There has been enough progress in the case that our bonds traded to 45 cents, near where they remain as of this writing and we consequently sold them. I did not realize we would exit so soon, but it is critical to maintain discipline in these cases of elevated uncertainty.

Earlier this year we bought the perpetual cumulative preferred securities of Pacific Gas & Electric ("PCG") subsequent to the Northern California fires. The devastating fires caused extensive damage to large parts of the region including California's wine country and due to a "unique" law, PCG is potentially on the hook for the entire liability and is not yet able to recover it through its rate base. Insurance claims total almost $13 billion and bankruptcy is a mild concern in the market because the company has gone through bankruptcy before. However, our analysis indicates that the worst-case scenario is a serious hit to their finances, not another bankruptcy. That said, they have halted dividends on the common and preferred securities and some of the perpetuals have fallen to the low $20s. Our view is that the dividends will be reinstated within two years, that our securities could rise to par (i.e. $25) and that we will receive our accumulated, but not paid dividends. This combination would result in a modest return without too much risk. We thought about buying the equity too, but they may have to issue stock and we did not want to potentially suffer dilution from an equity offering.

The Puerto Rican GOs and PCG are examples of non-equity positions we identified and were able to invest in due to our size. Like the equities that we own, I believe that such instruments can provide us a decent return and in a non-correlated manner. These may not be sugary treats, but healthy greens are always welcome on our plate.

> *"The Puerto Rican GOs and PCG are examples of non-equity positions we identified and were able to invest in due to our size. Like the equities that we own, I believe that such instruments can provide us a decent return and in a non-correlated manner."*

Sugar High

The team and I are hard at work to find new ideas and are reminded why it is best to ignore headlines and many times conventional wisdom as well. Probably the funniest thing that we saw this quarter was when Amazon announced a partnership with Sears, whereby customers could purchase tires on Amazon and have them installed at Sears. Like one of my kids after eating Pixy Stix, the stock price of Sears soared by as much as 25% that day, while those of the auto parts retailers (including holding O'Reilly) fell as much as 5%. To explain the price movements, one of the headlines read "Auto Parts Retailers Fall as Sears Partners with Amazon on Tires." About 10 minutes later, one of our analysts sent a simple email to the team stating "FYI: O'Reilly does not sell tires. The same is true for Autozone." The disruption-related hysteria and ongoing "shoot first ask questions later" attitude at first was simply a profit opportunity but now has also morphed into a source of comedy for us at the home office.

Last summer, as Grainger's stock price plumbed the depths of a seven year low, the gloom-and-doom headlines stated that "The Amazonian Nightmare is Only Just Getting Started for Distributors of Industrial Odds and Ends." The stock price was around $150 at the time—never mind that they sat on $4 billion worth of non-core assets, that management had a stellar capital allocation track record, the balance sheet was strong and the core business was valued at 5x earnings. It felt like the market was just behaving by the logic: "Hey, Amazon is getting into the business, therefore sell." Meanwhile, the reality was: "What's that? Amazon's been in the business already for many years without much to show for it? Let's just forget that." The fear was so entrenched that even many value investors either passed up the opportunity or sold their positions entirely. On top of that, the stock had a 20% short position. All those factors did make me a bit hesitant, however, I relied on my experience and our fundamental analysis. Just a few short months later as the shares touched $300 the headlines read "Grainger Results Shrug off Amazon as Shares Touch All-Time High." That is right, from a seven year low to an all-time high in six months. This is also comedic to us, but I like it when we double our clients' money in six months. We are not going to tempt fate and instead fall back on our intrinsic value estimate. We have trimmed our position closer to a seed size from it being our largest position, as the margin of safety has rapidly shrunk.

> *"It may be prudent to think about what is on your plate. At Centerstone, we will continue to focus on the fundamentals–balance sheet quality, management quality, business quality and to ignore the macro noise."*

Hopefully, these examples serve to reinforce our distinct Centerstone approach. We understand the temptation offered by ETFs and index funds, but most everyone has at one time or another experienced the after-effects of a sugar high. It may be prudent to think about what is on your plate. At Centerstone, we will continue to focus on the fundamentals—balance sheet quality, management quality, business quality and to ignore the macro noise. We will also attempt to avoid taking undue risks. Most importantly we will continue to bring our differentiated, objective and disciplined approach to bear on this uncertain world.

Thank you for your trust and interest in Centerstone.

Sincerely,

A. Dn

Abhay Deshpande, CFA
CHIEF INVESTMENT OFFICER

Centerstone Investors • 135 Fifth Avenue, Suite 3 • New York, New York 10010 • 212.503.5790 • **centerstoneinv.com** • in

Risks and Disclosure:

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The Centerstone Funds are new and have a limited history of operation. An investment in the Funds entails risk including possible loss of principal. There can be no assurance that the Funds will achieve their investment objective.

Value investing involves buying stocks that are out of favor and/or undervalued in comparison to their peers or their prospects for growth. Our value strategy may not meet its investment objective and you could lose money by investing in the Centerstone Funds. Value investing involves the risk that such securities may not reach their expected market value, causing the Funds to underperform other equity funds that use different investing styles.

Investments in foreign securities could subject the Funds to greater risks including, currency fluctuation, economic conditions, and different governmental and accounting standards. Foreign common stocks and currency strategies will subject the Funds to currency trading risks that include market risk, credit risk and country risk. There can be no assurance that the Fund's hedging strategy will reduce risk or that hedging transactions will be either available or cost effective. The Funds use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments.

Domestic economic growth and market conditions, interest rate levels, and political events are among the factors affecting the securities markets in which the Funds invest.

Large-Cap Company Risk is the risk that established companies may be unable to respond quickly to new competitive challenges such as changes in consumer tastes or innovative smaller competitors. Investments in lesser-known, small and medium capitalization companies may be more vulnerable than larger, more established organizations.

In general, a rise in interest rates causes a decline in the value of fixed income securities owned by the Funds. There is a risk that issuers and counterparties will not make payments on securities and other investments held by the Funds, resulting in losses to the Funds. The Funds may invest, directly or indirectly, in "junk bonds." Such securities are speculative investments that carry greater risks than higher quality debt securities.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Centerstone Funds. This and other important information about the Funds are contained in the prospectus, which can be obtained by calling 877.314.9006. The prospectus should be read carefully before investing. For further information about the Centerstone Funds, please call 877.314.9006. The Centerstone Funds are distributed by Northern Lights Distributors, LLC, Member FINRA/SIPC. Centerstone Investors, LLC is not affiliated with Northern Lights Distributors, LLC.