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To My Partners:

The performance of our portfolio for the second quarter of 2021 and since inception is summarized below.

| | 1578 Partners, LP | | S&P 500 |
|---|---|---|---|
| | Gross | Net | Total Return |
| 2021: | | | |
| Q2 | -6.51% | -6.86% | 8.55% |
| Year-to-Date | 17.06% | 16.19% | 15.25% |
| | | | |
| Since Inception (08/01/15): | | | |
| Annualized | 19.80% | 18.01% | 15.09% |
| Cumulative | 191.02% | 166.25% | 129.55% |

If you are having problems with your WiFi router, turn it off, turn it back on again and those problems go away. It would be nice if the economy worked the same way, but it is becoming clear that the exact opposite is true. Reopening the economy after having shut significant portions of it down to control the spread of the virus has created a whole host of problems.

Most of these problems fall under the headline of supply struggling to keep up with surging demand. Despite a labor market that is still far from fully recovered, employers struggle to fill open positions. Shipping containers are piled up everywhere except where they are needed. And manufacturers face shortages of various raw materials and components whose production was curtailed after the pandemic hit. Although households and businesses seem eager to ramp up their spending back towards pre-pandemic levels, they are limited by the economy's ability to produce what they want to buy.

Fortunately, most of the supply disruptions will prove temporary. After peaking in May at more than four times its price at the end of 2019, the price of lumber has fallen by more than 60% as sawmills have ramped up production, for example. Temporary can be a long time though. One of the most impactful shortages in the economy right now is the shortage of certain types of semiconductors, most notably those that go into cars. The CEO of Intel recently suggested the semiconductor shortage might not be completely resolved until the first half of 2023.

The combination of surging demand and shortages of labor, transportation capacity, components and raw materials as the economy reopens is leading to surging prices. The core Consumer Price Index, which excludes volatile food and energy components, in June was up 3% compared to its level in December, or roughly 6% on an annualized basis over that period. Some of these price increases will eventually reverse as the underlying supply shortages are resolved, but others, like wage increases to fill open positions, may prove to be stickier. Notwithstanding the startling headline inflation prints over the past few months, financial markets continue to price in longer term inflation in-line with the Fed's goals.

The outlook for the U.S. economy has also been slightly dimmed by the accelerating spread of the more infectious Delta variant of SARS-Cov-2. Relatively high rates of vaccination in many parts of the U.S. should make this wave less disruptive than prior ones, but the current spread of the Delta variant may nonetheless restrain the pace of the economy's recovery to some degree.

After sprinting out of the gate in the first few months of the year, our portfolio ceded ground to the S&P 500 over the course of the second quarter. Nonetheless, the mark-to-market performance of our portfolio still came in ahead of that of the S&P 500 for the first half. A number of our positions that had performed well to start the year gave back some of those gains in the second quarter. The most notable of those was our position in Sleep Number Corporation common stock (NASDAQ: SNBR). SNBR fell 23.4% during the second quarter, bringing its year-to-date gain from 75.3% at the end of the first quarter to 34.3% at the end of the second. No developments during the quarter altered our investment thesis for any of our positions in any materially negative way. The portfolio as a whole continues to be worth far more than the mark-to-market value at which it began the quarter.

## Performance Attribution

Positions that had a material impact on the portfolio's mark-to-market performance for the quarter and year-to-date are outlined below.

| Performance Attribution | | | |
|---|---|---|---|
| 2Q 2021 | | YTD 2021 | |
| Alphabet | 3.20% | Sleep Number | 7.52% |
| Northeast Bank | 1.09% | Alphabet | 6.90% |
| Interactive Brokers Group | -1.70% | Northeast Bank | 2.88% |
| Covetrus | -2.12% | Interactive Brokers Group | 1.48% |
| Sleep Number | -7.17% | Covetrus | -1.56% |
| | | | |
| Other | 0.20% | Other | -0.16% |
| Gross Performance | -6.51% | Gross Performance | 17.06% |

## Portfolio Composition

The composition of the portfolio at the end of the quarter is depicted below.

| Portfolio Composition | |
|---|---|
| Equities – Long | 99.8% |
| Equities – Short[1] | -9.9% |
| Cash[2] | 10.1% |

During the quarter, we did not make any material changes to the positions in our portfolio. At the end of the quarter, our portfolio included nine long equity positions, one short equity position, a long position in out-of-the-money calls that hedges the short equity position and cash.

[1] Reflects the combined delta-adjusted exposure of a short stock position and a long position in out-of-the-money calls that hedges the short stock position.
[2] Includes cash collateral related to short positions.

## Select Portfolio Updates

The portfolio updates for this quarter cover the two largest contributors to our mark-to-market performance for the year-to-date, Sleep Number Corporation common stock (NASDAQ: SNBR), a special situation investment, and Alphabet Inc. Class C capital stock (NASDAQ: GOOG), a compounder.

*Sleep Number Corporation (NASDAQ: SNBR)*

Sleep Number designs, manufactures and sells a range of premium, air chamber-based mattresses under the Sleep Number brand. Due to the unique nature of its mattresses, the company has developed a vertically integrated business model focused on direct-to-consumer sales through approximately 600 company-operated stores, an ecommerce website and a toll-free phone number.

We initiated our position in SNBR in early June 2020. The essence of our thesis was that – contrary to the consensus of market participants at the time – Sleep Number's performance would not be harmed by – and might even benefit from – the pandemic as the impact of a drastic shift in the composition of consumer spending outweighed that of a decline in the overall level of consumer spending.

With the benefit of 14 months of hindsight, our original thesis has proven to be spot on. Demand growth for Sleep Number's products has steadily accelerated each quarter since the onset of the pandemic. After collapsing in March and April of 2020, demand for Sleep Number's products whipsawed to high-single-digit year-over-year growth in May and June of 2020. From there, it accelerated to high teens growth in the back half of 2020 and on to more than 40% growth for the first half of 2021. As the company is beginning to lap the strengthening demand it experienced last year, our alternative data continues to show year-over-year demand growth.

Demand has been so strong that Sleep Number has struggled to keep up. The initial whipsaw in demand in the second quarter of 2020 caused the company to fall behind on deliveries to the tune of $30 million. Steadily accelerating demand over the back half of 2020 made it difficult for the company to catch up. Winter storms in Texas earlier this year disrupted production of certain chemicals used in manufacturing bedding materials, further exacerbating Sleep Number's supply chain challenges. In the past few months, the company has faced other materials shortages at two third-tier suppliers and a pandemic-related labor shortage at a first-tier supplier based in Europe. Instead of catching up on the elevated backlog that began to develop a year ago, Sleep Number has steadily fallen further behind.

Accounting rules require Sleep Number to recognize revenue only when it delivers a product, not just when it receives an order or upfront payment. As a result, Sleep Number's supply chain challenges have weighed on its reported results. Although the company's reported results over the past several quarters have been strong overall, those results would have been even stronger if the company had been able to service all of the demand it experienced in a timely manner. Fortunately, Sleep Number will get caught up on its deliveries eventually. When it does, its reported results will be turbocharged.

The pandemic has not only provided a shot in the arm to demand for Sleep Number's products, but also forced Sleep Number – along with virtually every other business – to fundamentally rethink its operations, especially the contact-intensive portions of those operations. In the process of doing so, Sleep Number has uncovered new ways of doing business that are far more cost efficient than the pre-pandemic status quo. From 2016 through 2019, Sleep Number's operating margin ranged from 5.8% to 6.6%. Despite achieving 9% compound annual growth in revenue over that period, it failed to achieve much leverage on its largest expense line item by far, sales and marketing. Sales and marketing expense consistently clocked in at around 45% of revenue. The changes Sleep Number implemented in its sales and marketing functions as a result of the pandemic have fundamentally changed that dynamic though. Sales and marketing came in at 41.5% of revenue in 2020 and 38.7% of revenue for the latest 12 months, allowing its operating margin to rise to 10.0% and 13.5%, respectively. In other words, Sleep Number should be a meaningfully more profitable business going forward than it was prior to the pandemic.

Although SNBR is currently up roughly 180% from what we paid for it 14 months ago, the stock continues to offer further upside. When Sleep Number recently reported results for the second quarter, management provided EPS guidance for 2021 of "at least $7.25," up meaningfully from its initial guidance of "at least $6.00" at the beginning of the year. This guidance floor should ultimately prove to be conservative, especially if Sleep Number makes any meaningful progress working through its bloated backlog this year. All things considered, including a normalization of consumer spending patterns and the significant drag Sleep Number's backlog build may exert on reported results for 2021, Sleep Number should be able to grow its earnings in 2022 relative to the company's current guidance floor for 2021 earnings. Moreover, there is room for multiple expansion with SNBR currently trading at just 13.4x management's guidance floor for 2021 EPS.

Sleep Number's management and board of directors seem to feel the same way. During the first half of 2021, the company repurchased $267 million worth of SNBR shares. That amounts to more than 10% of the company's current market capitalization. Virtually all of those shares were purchased at prices above where the stock is currently trading. The company continued to buy its shares hand-over-first even as SNBR approached its 52-week high earlier this year of $151.44.

*Alphabet Inc.*
*(NASDAQ: GOOG)*

Alphabet is the holding company for Google, one of the preeminent businesses in the world, as well as a collection of other, smaller companies, such as Access (broadband internet), Calico (life sciences), Capital G (late-stage growth venture capital), GV (venture capital), Verily (life sciences), Waymo (autonomous vehicles) and X ("moonshot factory"), among others. We purchased our initial position in GOOG in August 2017 and added to it in March 2018.

Shortly after the onset of the pandemic, I wrote the following in Hinde Group's 1Q20 partner letter:

> *As the global economy's performance rebounds over time, so too will Google's growth — returning to something resembling its prior trend. The flexible, performance-oriented nature of Google's ad products makes it easy for advertisers to quickly cut spending on them when economic activity slows. It also means Google's advertising revenue tends to recover quickly as economic activity begins to improve.*

That has certainly proven to be the case. Revenue for Google Search and other Google-owned properties came in at $35.8 billion for the second quarter, reflecting compound annual growth of 23.1% versus the second quarter of 2019. It grew 15% for all of 2019. Similarly, YouTube's advertising revenue grew 39.4% on a 2-year compound annual basis in the most recent quarter compared to 35.8% growth for all of 2019. The same story holds for Google's advertising network revenue (20.3% 2-year CAGR in 2Q21 versus 7.7% growth in 2019) and its "other" revenue (27.4% 2-year CAGR in 2Q21 versus 21.0% growth in 2019), which includes revenues from Google Play, hardware sales and YouTube's subscription offerings among other sources. Although the economy has not yet fully recovered, Google's business has not just snapped back to its pre-pandemic trajectory; it is doing even better.

At least part of the acceleration Google has seen in its business relative to the business's pre-pandemic trend comes down to the impact of the pandemic. The pandemic forced most people to accelerate the adoption of online technologies, such as online shopping, streaming entertainment, and cloud-based communication and productivity tools. As the pandemic first hit, Google actually saw soaring engagement across a wide swath of its products, but the sudden evaporation of advertising budgets meant Google could not effectively monetize that windfall. Now that advertising budgets are flowing once again, the value of that accelerated adoption and increased engagement is manifesting itself in Google's reported results.

Google's impressive performance during the pandemic has come alongside improved disclosures about the revenue and profitability of the different pieces that comprise Google, most significantly YouTube and Google Cloud. Part of what gave us the opportunity to purchase GOOG at such attractive prices in 2017 and 2018 was the difficulty many investors faced when analyzing and valuing the different parts of Google based on limited disclosures at the time. With increased disclosure about YouTube and Google Cloud, more investors have come to appreciate their value and impact on Google's consolidated performance.

Our investment in GOOG has delivered excellent results thus far. The market price of GOOG has tripled since our initial purchase in August 2017, and the position has delivered an internal rate of return of approximately 33%. Notwithstanding GOOG's strong performance thus far, it continues to offer attractive prospective returns based on the established and developing businesses it owns today. It also offers highly compelling potential value from the development and commercialization of applications of artificial intelligence in the years and decades to come.

There is a broader lesson to be drawn from our investment in GOOG. Although we can now talk about the position and the returns it has delivered thus far in glowing terms, that was not always the case. During the period of stress in financial markets at the end of 2018 – a little over a year into our holding period – the mark-to-market based internal rate of return on our investment in GOOG sat at a measly 1.8%. Two years into our holding period, the investment might have still seemed a dud by our standards. The 13.2% internal rate of return implied by GOOG's market price at the time was below our 15%+ hurdle rate. Sometimes it can take the market a long time to appreciate what we appreciate in our investments and begin to ascribe a more reasonable market price to those investments. While the wait can be frustrating, all that really matters are the cash flows from our investments – primarily from when we buy and sell – not the market quotes in between.

This lesson applies to most of our investments to some degree, but it is especially relevant to our positions in Interactive Brokers Group, Inc. Class A common stock (NASDAQ: IBKR) and Covetrus, Inc. common stock (NASDAQ: CVET) at the moment. Both positions have delivered sub-standard internal rates of return over our holding period to-date and have weighed on the overall portfolio's mark-to-market results. Yet I expect each of those positions to deliver good, if not spectacular, returns when all is said and done.

I remain highly enthusiastic about the positions that comprise our portfolio and their potential to deliver returns for us over time. Thank you for your continued confidence and support.

Regards,

Marc Werres
Managing Partner

## Important Disclosures

The performance figures depicted herein relate to 1578 Partners, LP. This account serves as the model account for the taxable accounts Hinde Group manages. The performance of investor partner accounts may differ from the figures depicted herein for several reasons, including, but not limited to, cost basis differentials, the timing of account inflows, and tax considerations. 1578 Partners, LP's gross results reflect the deduction of trading commissions and other fees charged by Hinde Group's broker. Net results reflect the hypothetical deduction of management fees (1.5% of AUM per annum billed quarterly in advance).

1578 Partners, LP's inception date is August 1, 2015.

The statistical data regarding the performance of the S&P 500 was obtained from the website of S&P Dow Jones Indices. The S&P 500 returns shown do not represent the results of actual trading of investible assets/securities.

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