	Arch Capital Investors Fund	**S&P 500 Total Return Index**
Returns Year To Date	(3.53%)	30.02%
Returns Since Inception (2/1/21)	(3.53%)	30.02%

**The fund opened on Feb. 1st, 2021, so our 2021 fiscal year excludes the month of January. All future years will start on Jan. 1st. Year-to-date returns and cumulative returns will be the same in 2021. Fund returns are net of realized and estimated fees. Returns may differ based on the timing of entry into the limited partnership.*

Contact archcapitalmanagement@gmail.com with any questions.

Dear Limited Partners,

We'll be frank: the fund's performance in 2021 was not up to our standards. Through the first 11 months of the partnership, the fund has returned (3.53%). The S&P 500 Total Return Index, our core benchmark, returned 30.02% over that same period.

While this year was disappointing, our strategy is not one we think can be evaluated on a time horizon of fewer than three years, and more ideally one longer than five years. Holding a concentrated basket of companies is bound to have volatility in the short run. This is not where our attention is focused. Instead, we focus on evaluating how a business is progressing in growing free cash flow per share (FCF/s), which will determine the performance of our holdings over the long run. Our companies made significant progress in this regard in 2021.

One thing we've focused on this year is refining what we look for in identifying a potential new investment. For us, **future cash generation is king**. Here are three questions we ask ourselves before making an investment decision:

1. How much cash will [X company] generate for shareholders over the next 3, 5, 7, and 10 years? How confident are we in our estimates of future cash flow?
2. What price do we have to pay for this future cash flow right now?

3. How confident are we that management will act rationally with the cash that is given to them?

Why do we care so much about cash flow? Because the cash flow generated by our companies will determine the total returns of the fund over the long run, which translates into the returns you will get as limited partners. The best metric for evaluating how much cash a company is generating is free cash flow yield, which is calculated by dividing annual free cash flow by the market value of a stock. More simply, it is free cash flow divided by enterprise value (FCF/EV). If you own a business in its entirety, this is the amount of cash you'd be able to take home at the end of each year. If FCF/s grows, the free cash flow yield (relative to your cost basis) on the stock grows with it.

Now, management can do one of four things with this cash flow. They can reinvest it back into the business (which technically means it's not free cash flow anymore, but stay with us), pay it out as a dividend, repurchase shares, or let it sit on the balance sheet. We are not going to be in a position to tell a management team what to do with its cash balance. At least, not anytime soon. This highlights why finding quality executive teams is so important to our process. It's not only important to find stocks trading at high free cash flow yields and/or growing FCF/s at a high rate, **but to pair them with management teams that will make rational decisions with that cash**.

Adjusting for portfolio weighting and including our cash balance (which we'll count as a yield of 0%), the Arch Capital Investors Fund currently has a free cash flow yield of 15.42%[1]. Excluding **Harbor Diversified**, which has a trailing free cash flow yield of 202%, the fund has a trailing free cash flow yield of 6.7%.

The S&P 500's current earnings yield is estimated to be 4.49%[2], with its free cash flow yield slightly under that. Over the long run, the S&P 500's free cash flow yield should match fairly closely with its annual earnings yield. Over the next five years, we believe our group of companies (especially once you exclude Harbor Diversified) can grow FCF/s in aggregate at a higher rate than the market average.

This combination of a higher free cash flow yield and better prospective growth in FCF/s gives us confidence in one of our core goals with the fund: Outperforming the S&P 500 Total Return Index. Why do we have this goal? Because for our partners, who are all individuals or families, the S&P 500 Total Return is available essentially for free in the form of a low-cost index fund. If we can't beat an index fund, there's no reason we should be in business managing your money.

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[1] Based on stock prices after the market close on January 14th.
[2] Source: https://www.yardeni.com/pub/sp500earnyield.pdf

Having this goal doesn't mean we put all our attention on evaluating or predicting what the market will do in a given year. Far from it. Instead, we look at the available data for historical long-term returns of the S&P 500, which is slightly north of 10%. Given the market's low earnings yield at the moment, it is unlikely that 10% forward returns for holders of the S&P 500 are in the cards. However, we want to be aggressive with our benchmark expectations, so we think 10% is a fine expectation for forward returns. Going up against the expected benchmark returns, we set our hurdle rate for portfolio investments at 15%. This means that we only make an investment for the fund if we have confidence in an asset's chances to put up 15%+ compounded returns for shareholders over the next three to five years and beyond.

This first annual letter focused on the broad strategy of the Arch Capital Investors Fund, and the basics of our investing strategy. In future years, we plan to write about more specific items relevant to our investment philosophy.

Portfolio Review

An update on some of our core holdings. In future letters and quarterly updates, we plan to discuss other fund positions. Our holdings and allocation are posted monthly to our website, which you can find here: https://www.archcapitalfund.com/holdings.

Spotify:

Spotify remains one of our top holdings, as we are incredibly optimistic about its future as a global audio platform. In the Fall of 2021, we released a report on Spotify outlining our thesis, which is still relevant today. You can download the report here: https://www.archcapitalfund.com/letters.

Sprouts Farmers Market:

Given its strong performance to close out 2021, Sprouts Farmers Market finished the year as the largest holding in the fund. We are confident in Sprouts' business potential and believe many investors are misguided by the current negative same-store sales numbers it has posted. These should abide in 2022 with COVID-19 impacts gone and further distance from 2019, when management decided to cut the cord on unsustainable customer discount programs.

Sprout's has room to grow its store count by 10%+ a year (its stated plans) for the foreseeable future, has improved its operating margins each year since 2019, and is rapidly reducing its share count through share repurchases. The stock trades at a free cash flow yield between 8% - 9% with a path to steadily grow FCF/s each year. Even with shares up 40% in the last year, we still think there is plenty of opportunity for Sprout's stock over the next five years plus.

We wrote a report on Sprouts Farmers Market this summer, which goes into more detail on our thesis for the stock. You can find the report here: https://www.archcapitalfund.com/letters

Nelnet:

Nelnet is our third-largest holding, sitting just below Spotify as of this writing. Nelnet is a small-cap conglomerate headquartered in Lincoln, Nebraska with a market cap just north of $3 billion.

The company is in a unique situation, as it used to be a major student loan originator, holding loans on its balance sheet that would generate steady amounts of cash flow. However, around a decade ago the federal government took all student loans in-house, leaving Nelnet unable to originate new loans. Since student loans are very long-term, Nelnet still has billions of loans sitting on its balance sheet, which generates cash for the company.

With that cash, Nelnet management has greatly diversified the business. These include three wholly-owned subsidiaries (loan servicing, education technology, and Nelnet bank) and many minority investments with a focus on venture capital, real estate, and solar energy. We won't go through the details of our analysis here, but if you ex-out minority investments (most of which are held at cost and likely undervalued on the balance sheet) and cash, Nelnet has a free cash flow yield of ~18%.

To be clear, a lot of the source of current cash generation will run dry as the student loan book winds down over the next decade. But with management's track record of capital allocation that has seen book value per share grow at 17.3% through the end of 2020 (a relevant metric for a financial/investment company), we are confident the value of this business will grow despite the student loan business winding up.

At such a high free cash flow yield and with seasoned capital allocators at the helm, we are very comfortable holding a large position in Nelnet stock. Unless shares get egregiously overvalued, this is a compounder we can own for many, many years.

Take-Two Interactive:

Take-Two Interactive is an American video game publisher of franchises like Grand Theft Auto (GTA), Red Dead Redemption (RDR), and NBA 2K. It is currently one of the larger positions in the fund at an 8.3% allocation.

We are bullish on Take-Two because we believe the company has competitive advantages that will keep its franchises relevant for many years. First, its games have distinct network effects that keep it insulated from competitors. Multiplayer online games are only fun if others are also playing them, creating a winner-take-all effect that has specifically benefited GTA and NBA 2K over the last decade.

On top of network effects, Take-Two has decades of developmental expertise and over 5,000 developers across its divisions, giving it semi-strong economies of scale that insulate it from most competitors. Yes, large competitors like Microsoft or any mega-cap company could invest the dollars to get to this developer count, but it is impossible for a smaller studio to make games as immersive and at as quick of a pace as Take-Two does for its customers. They just don't have the scale.

It also doesn't hurt that analysts expect the video game industry to grow at 10%+ a year for the foreseeable future. This is a secular tailwind Take-Two's business can ride over the next decade [3].

Take-Two Interactive recently announced a large acquisition of Zynga. The deal hasn't closed, but if it does it will have a big impact on this business moving forward. Zynga is a major mobile game publisher, something Take-Two has struggled with in the past. It is early days, but we hope Zynga can add value to Take-Two by helping bring its top franchises (GTA, RDR, and NBA 2K) to mobile in a big way.

We purchased Take-Two at ~$145 a share back in September, or at an enterprise value of ~$14 billion (this is before the Zynga merger). This doesn't look cheap relative to Take-Two's guidance for less than $400 million in cash flow this fiscal year. However, given the lumpiness of the business, we believe Take-Two is poised to start generating north of $1 billion in cash flow a year sometime in the near future (again, without considering the addition of Zynga). If the company can execute how we expect it to and the Zynga merger works out, we are confident our 15% annual return hurdle can be met over the next three to five years.

Match Group:

In conjunction with this letter, we have published a report on Match Group. You can find it here: https://www.archcapitalfund.com/letters

[3] Source: https://www.globenewswire.com/news-release/2021/10/28/2323064/0/en/Video-Game-Market-Size-is-Predicted-to-Expand-at-a-CAGR-of-14-5-from-2020-to-2026-Report-by-Market-Research-Future-MRFR.html#:~:text=According%20to%20a%20comprehensive%20research,rate%20of%2014.5%25%20by%202026.

Harbor Diversified:

Our position in Harbor Diversified (HRBR) is the most unique in the fund, so we thought explaining our thesis would be helpful. The fund started a position in HRBR in late 2021 at an average cost of $1.96 a share and as of this writing, it sits at $2.14.

Despite a muddled past, Harbor Diversified is now the parent company of Air Wisconsin – a regional air carrier operating routes to 36 cities all departing from or arriving at Dulles International (Washington DC) or O'Hare (Chicago). While we don't love the economic characteristics of airlines generally, regional air carriers at least tend to possess better profit margins than major airlines due to outsourcing costs to larger airline partners.

As for Air Wisconsin specifically, the company is roughly two years into its amended three-year capacity purchase agreement with United Airlines. In this arrangement, United pays Air Wisconsin to conduct flights exclusively on their behalf. This means it's Air Wisconsin's responsibility to provide the aircraft and the crew, while United designs the routes, sells the tickets, and pays for the fuel (among other costs).

While Harbor Diversified's business model admittedly lacks the qualitative characteristics we typically look for in an investment, its valuation forced us to adopt a different approach – If it's cheap enough, we don't care what it is.[4]

As of the time of our investment, Harbor Diversified had a fully diluted market cap of $138.5 million. At that same time, the company was carrying $107.5 million in net cash on its balance sheet, leaving an enterprise value (market cap minus net cash) of **$31 million**. Keep this number in mind.

Air Wisconsin and United Airlines have roughly 12 months left in their capacity purchase agreement, at which point United intends to phase out the number of flights it sells on small-body jets (this jet type comprises most of Air Wisconsin's fleet). This leaves five quarters of earnings between now and expiration. In that period, we believe Air Wisconsin should generate roughly $50 million in free cash flow. For reference, the company earned $95.8 million over the last 12 months, albeit aided by payroll support loans.

Put simply, as investors, we're laying out $1 today for $1.65 in cumulative cash flow over the next 15 months ($50M in FCF/$31M EV). This assumption also bakes in no extension of profitable operations beyond February of 2023, which we view as an unlikely scenario. Whether

[4] Source: https://www.netnethunter.com/essential-guide-peter-cundill-investing/

it's a renegotiated contract with United, a sale to another airline, or a variety of other outcomes, any additional profits are cherries on top.

We hope everyone had a nice holiday season, and look forward to communicating more with everyone in 2022.

Sincerely,

Brett, Brady, and Ryan

Fund Holdings

Company (Ticker Symbol)	% of Portfolio
Sprouts Farmers Market (SFM)	16.0%
Spotify (SPOT)	12.4%
Nelnet (NNI)	12.2%
Electronic Arts (EA)	9.5%
Nintendo (NTDOY)	8.7%
Take-Two Interactive (TTWO)	8.3%
Autodesk (ADSK)	5.7%
Wix.com (WIX)	5.7%
Match Group (MTCH)	5.2%
Harbor Diversified (HRBR)	4.5%
Swedish Match (SWMA)	4.3%
ConsorcioARA (ARA)	3.1%
Intellicheck (IDN)	2.5%
Cash	1.9%