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| 2018 Return | October | November | December | Q4 | 2018 | Return Since Inception |
|---|---|---|---|---|---|---|
| MountainWorks | -21.0% | -0.1% | -29.0% | -43.9% | -58.6% | -24.7% |
| S&P 500 | | | | -19.0% | -10.5% | 29.2% |

Dear Member,

In the fourth quarter of 2018, MountainWorks lost 43.9% of its value, versus a 19% loss for the S&P 500, dividends reinvested (According to DQYDJ). Year to date, the Fund has lost 58.6% of its value against a 10.5% loss for the S&P 500. Because of the losses in 2018, the Fund's value is now 25% lower than the inception date nearly three years ago. It has been by far the worst year of my investment career - professionally and personally - and so as I reflect upon 2018, there are many mistakes to learn from, and only one direction to go: forward.

Below will be a walkthrough of how the year went, from successful short positions to broken merger-arbs, as well as a few lessons from certain events that are to be learned from in earnest. In such a time of volatility for the Fund, the thesis for investing must remain steadfast: we are in search of businesses with a durable competitive advantage, that demonstrate strong balance sheets, income statements, & cash flows, and that have event-driven catalysts or opportunistic valuations to warrant investment.

However, in not so small terms, I am telling you that the investment landscape is difficult to traverse. Hopefully this will be made clearer as you read through the 2018 recap. For example, three big mistakes that I have made include bankruptcies with Aralez (ARLZ) & Airborne Wireless Networks (ABWN), and broken merger arbitrage with NXP Semiconductors (NXPI). These mistakes all cost me dearly - in upwards of tens of thousands of dollars - and all could have been prevented. That said I invite you to read through this letter and be wary. Take heed, it is a cautionary tale. For my part, my own progress and career have been set back several years. Do your part, and be on the lookout for over-confidence, chasing money, and inexperience. Be vigilant, for when it comes to investing, what one man gains another man loses. Be aware of just how costly failure can be: to a man, his life's work, his friends, his family, and his relationships. Warren Buffett once said,

*"One of the things you will find - which is interesting and people don't think of it enough - with most businesses and with most individuals, is life tends to snap you at your weakest link. The two biggest*

*weakest links in my experience: I've seen more people fail because of liquor and leverage - leverage being borrowed money."*

This year is one that reads as a grocery list of what not to do. It is filled with failures. Read carefully, and you will see that I have lived it. I have been a failure. And yet, it is so much a part of life that we cannot avoid, this failure. Michael Jordan knew it, when he said, *"I've missed more than 9,000 shots in my career. I've lost almost 300 games. 26 times I've been trusted to take the winning shot and missed. I've failed over and over and over again in my life. And that is why I succeed."* Indeed, failure is a part of life, just as is success: I have been questioned on investments, I have been challenged on methods, and I have been told that I am changing…presumably for the worse. And in between all of it, the word "easy" is nowhere to be found. And so I present twelve investment lessons from one of the worst years of my professional life. They vary in topics that include investment analysis, portfolio management, and behavioral economics. I hope you find them worthwhile, as they are the few silver linings from a year I'd prefer to forget. Before delving in, I'll leave you with a third quote, one that is most important to me, and I do so for one reason: there's no other direction for me to go but onward.

*"A bend in the road is not the end of the road, unless you fail to make the turn."*

**Lesson 1.** When January 2018 came around I was brimming with confidence. The Fund was up over 80% in less than two years, and I had some good trades in the works. I sold a REIT spinoff - Gaming and Leisure Partners (GLPI) for a 20% gain, and the timing was right (post-spinoff and before interest rates would start increasing, which has a negative effect on high-yielding REITs). Even though January went well, some of the bad seeds were starting to form…I did some heavy lifting on Cumulus Media (CMLS), which at the time declared bankruptcy and filed for Ch. 11 reorganization. I used a discounted cash flow analysis - pretty common in the mainstream financial world - and figured the senior debt (which was trading at about $20, an 80% discount to par) was worth at least $48. So I began to load up on defunct bonds. It wasn't going to work out well. *Lesson 1: Discounted Cash Flow models are flawed, especially if the analysis is focused on revenues. Over the course of say five years, margins on a business can change. Even more so when it comes to a corporate event like a Ch. 11 reorganization.*

**Lesson 2.** By the time February came around, volatility had returned, with the S&P dropping over 8% inside of two weeks. Meanwhile, I was getting involved with shorting equities - this turned out to be a fortunate decision, as over the course of 2018, <u>all</u> of my short positions were closed at gains: *all of them*. It turns out that for 2018, I earned about 10% for the Fund with the short positions. Had I not engaged in them, my performance for the year would have been far worse than it was: and considering just how awful my 2018 performance was, that is really saying something about the opportunity

surrounding good short candidates. My early successes in this realm came with Overstock.com (OSTK) and Community Health Systems (CYH) - more on shorting later.

And then, there was another bad idea, and I was about to reap what I had sown. I was still buying shares in Aralez (ARLZ), which was a microcap biotech based out of Canada, pinning their hopes and dreams on a single aspirin-omeprazole pill called Yosprala. It was supposed to be an innovation on heart health care, but with both aspirin (think Bayer) and omeprazole (think Pepcid-AC) as over-the-counter drugs, hopes would be dashed, along with the funds I was pouring into ARLZ shares. The company was showing increased revenues, but reporting positive adjusted EBITDA. Again, I had done my diligence on the company, but used a discounted cash flow model that was flawed and would eventually break to my demise. *And so, Lesson 2: Even though a DCF model can project profits out five, even ten years down the road, it cannot account for changing margins. Adjusted EBITDA, as it were, is not enough to keep a business functional. Depreciation & Amortization are very real expenses. So, even though a company reports positive EBITDA, declining business metrics and bankruptcy are not out of the question*.

**Lesson 3.** March was full of mistaken chickens that would soon come home to roost. But strangely enough, I was still capturing realized gains via shorts and optimal put writing. I earned gains on shorting Community Health Systems (CYH) and Barclays IPath S&P VIX Short Term Futures ETN (VXX). I also had a nice trade on Pandora Media (P), which would eventually be taken over by Sirius XM. Similarly, I would take a position in Monsanto (MON), the company behind the blockbuster herbicide RoundUp that would soon be acquired by Bayer.

However, I continued to buy Cumulus Media Senior Notes (CMLS) while still going through Ch. 11, I added to a position in Airborne Wireless Networks (ABWN), and I added to the position in Aralez (ARLZ). These defunct assets were slowing becoming core positions in the portfolio, due to my brazen theses and belief in the value of my own research: valuable time and effort that would turn out to be simply wrong. In addition, I began to build a large position in Akorn (AKRX), which was a merger-arbitrage play that would eventually break with the buyer (Fresenius Kabi) walking away. So too would AKRX prices; when the merger broke, AKRX shares plummeted from $30/share down to $18 in a single day. Again, these chickens would come home to roost, but for now, I will point out that Aralez's CEO would buy 500,000 shares on the open market as a show of support for the company (and its falling share price). I took this as not just a buy signal, but also hard evidence that my thesis would eventually play out - wrong on both counts. *Lesson 3: Do not always assume the financial case presented by management. In multiple examples, such as Aralez, Cumulus Media, and Chicago Bridge & Iron, management made presentations on how to achieve financial stability & success. In each case, a DCF model proves sufficient criterion for investment, but we cannot assume everything management is saying will come to fruition.*

**Lesson 4.** No bad ideas came out of my mind in April. In fact, the shorts continued to perform well. What did come out of April, though, was a realization that my focus on microcap stocks was

coming to an end. While the microcaps - such as Aralez, Airborne Wireless, 22nd Century (XXII), Acuity Ads (ACUIF), and others are interesting companies, none of them have shown demonstrable growth, not to mention any tangible profits. And although I earned good returns on some of these microcaps, there is a question of portfolio sizing that needed to be addressed: When you come up with a really great idea for investment - in 2017 it was Bitcoin; 2018 themes included budding marijuana stocks - how much of your assets do you allocate to this wonderful idea? Furthermore, ask yourself: *is it a wonderful idea, or a wonderful business?* Any tendency toward the former is reason to reject the investment. Any tendency toward the latter is reason to assume the investment is wrong. Then, your job becomes proving the assumption itself wrong through research. In this way, you can obtain both a "wonderful business at a fair price" (Thank you for the terminology, Charlie Munger and Warren Buffett). Put another way, you need to have a *system* in place:  a process that filters through financials, sifts through trends, and identifies meaningful opportunities. At this point, I am going to digress into investing as a house of cards. In my mind, there are three potential levels for establishing investment criterion. The base level lies in the financial statements: the balance sheet, income statement, and cash flow statement. By looking at several years' worth of past financials, one can begin to ascertain whether or not a business has a "durable competitive advantage" (thank you for the terminology, Charlie Munger). Next comes the valuation. Right now, I trust discounted cash flow models far less than I used to, but nevertheless there is a necessity for some sort of valuation methodology: something that gets you to "intrinsic value" (thank you for the terminology, Warren Buffett). Once the durable competitive advantage is established, one can move to growth and value, linking future value discounted to present value in order to demonstrate a viable intrinsic price. Finally, the top level includes the event-driven catalysts, which can vary widely in degree, from spinoffs & merger arbitrage to capital structure, options, technical analysis, or insider ownership. So why picture a house of cards? Well, quite simply, if one of the cards falls, you risk failure of the entire investment. *Lesson 4: Have a system & investment process in place, one that builds fundamental analysis from the ground-up. This will help minimize the impact of your bad ideas, and enhance the value of your good ideas. In order to build a system, read. Read a lot. Then back-test. Then read even more. Then learn from experience, and adapt, and change.*

**Lesson 5.** In May, both Aralez and Airborne Wireless Networks capitulated. The loss on Aralez accounted for over 31% of the realized losses in 2018. The loss on ABWN represents just over 8% of the realized losses for the year. Neither was easy to stomach: the lesson on microcaps, EBITDA, and discounted cash flows had sunk in. But not coincidentally, I was about to shift my spoiled hubris toward another not-so-grand idea: NXP Semiconductors, and Qualcomm's pending acquisition of the company, which hinged upon Chinese regulatory approval, and was taking place right in the midst of President Trump's trade war and tariff exchange. My fleeting attempt to recapture lost money was about to get far worse.

Meanwhile, a third investment in which I performed substantial diligence on was McDermott International's all-stock acquisition of Chicago Bridge & Iron. At the time, Chicago Bridge & Iron had four rough projects that were dragging down its margins, and in an effort stay solvent, sold itself to MDR. I had successes on the options side of the trade, writing puts and collecting premium; however, some of those puts were assigned, and I ended up owning shares when the deal went through. By my own admittance, I thought the deal was a good one…I used management's presentation (mistake #1, Lesson #3) and formed a discounted cash flow analysis (mistake #2, Lesson #1) and assumed management's EBITDA and margins (mistake #3, Lesson #2). In short, I had hopes and dreams of MDR management solving CBI's problems. It was not the case.

After the merger, MDR traded from $22/share down to near $7/share. And in fact, I wised up toward the end of the year by selling the MDR position entirely and taking the loss (another 8% of the realized losses), because shortly after I sold and MDR reported quarterly financials, the stock dropped 40% in a single trading day. I managed to save some face, but not without taking steep losses. And so, *Lesson 5: Do not buy into a deal when the parent is acquiring troubled assets of the target. Especially in a stock deal, you'll end up owning shares in the new company, and in turn owning those same troubled assets you wanted to get rid of. These dysfunctional assets could end up bringing down the whole company. Prime examples of this type of M&A include McDermott International's acquisition of CBI, Community Health Systems' acquisition of HMA, and Camping World Holdings' acquisition of bankrupted Gander Mountain.*

**Lesson 6.** While I didn't know it at the time, June & July were about to teach me a stern lesson on portfolio sizing - a subject I have yet to touch upon. I had a successful merger-arb close in Monsanto, but it was only about 3% of the portfolio. At the same time, I was building a massive position in NXPI, while the company awaited approval from China's State Market Regulatory Administration ("SMRA"). I had done all the due diligence required on the deal, and was convinced the obstacles were surmountable. I was both buying NXPI stock and writing puts (and at times getting assigned shares). By the end of my NXPI accumulation, I would have over 30% of the portfolio riding on a binary merger-arb outcome, and it would end up costing me dearly. It was clear to others, but not so much to me, that I was chasing the money, trying to recoup losses. But I figured it was a different strategy, so it was all right…it wasn't an investment in a small cap, or a biotech with no profits…it was a merger-arb. Besides, another hedge fund manager (and I gather several others) had huge positions in NXPI - some held as much as eight figures worth of money in NXPI, so why couldn't I be correct right along side them?

It's an easy lesson to learn, but only after you've been burned by it. You cannot base your decisions off of other outside influences - in this case, what the so-called "smart money" was doing - because you simply aren't in their position. Maybe they had proper hedges and were insuring themselves (I was not). Maybe they were short the position without disclosing it (I was fully long). But that is not even the true crux of the matter. Truth be told, I was chasing the money because of what

Dr. Richard Thaler refers to as the "break-even effect" in mental accounting. To briefly explain this behavioral phenomenon, I will describe a bet. Imagine yourself making the bet, and which option you would choose:

Consider a scenario in which you have just lost $30, and you are offered two choices: (1) a 33% chance to win $30 and a 67% chance to gain nothing, or (2) be given a sure $10. Which would you pick?

Mathematically the expected outcome of these two choices is identical. That's right, identical! Any person with a mathematical or economic background would certainly choose the $10. Yet, as Thaler points out, studies show that people tend to choose option (1) more than option (2). In other words, with a chance to break even, people will often choose to gamble when they shouldn't be waging at all! Before getting to my personal lesson, let's hear how Dr. Thaler explains it:

> *Gambling when behind in an effort to break even can also be seen in the behavior of professional investors. Mutual fund portfolio managers take more risks in the last quarter of the year when the fund they are managing is trailing the benchmark index […] to which their returns are compared. And, much worse, many of the rouge traders that lost billions for their employers were taking on ever increasing amounts of risk at the end, in a desperate effort to break even. This behavior may have been rational from the point of view of the rogue trader, who stood to lose his job or worse if he did not recover his loss. But if true, that means management needs to pay close attention to the behavior of employees who are losing money […] A good rule to remember is that people who are threatened with big losses and have a chance to break even will be unusually willing to take risks, even if they are normally quite risk averse. Watch out! (Misbehaving, pg. 84)*

So, here is the lesson: *Lesson 6: Chasing losses is the result of the "break-even effect", in which people can make poor decisions based on mental accounting that might seem logical at the time. While most people are hurt by losses twice as much as they are helped by gains, that does not impact brash decision making when there is an opportunity to chase the money. That said, in order to help prevent the break-even effect, one must ignore sunk costs. Further, the system & process used to make these decisions must have some built-in way to counter-balance any decision-making. That is, use mathematics. Use probabilities and expected value. Use portfolio sizing.*

**Lesson 7.** When July hit, I wasn't nearly ready to handle it. NXPI and Qualcomm mutually walked away from the merger, and NXPI shares crashed, along with the funds I allocated to it. Once valued at $127.50/share, NXPI trades near $80/share. The day that the merger broke, I sold the shares, with the idea of not turning a trade into an investment, but it wasn't that simple…I still had put contracts written on NXPI that were long-dated, and I was now responsible for owning up to thousands of dollars of NXPI stock when the contracts came due. So even though I didn't own any of the stock,

writing the put contracts amplified the losses (this is when Warren Buffett's quote on leverage hit home on me). It took me several months to fully unwind the NXPI trade, and the results were simply horrific. All told, NXPI represented over 56% of the realized losses for the entire year. It was catastrophic, and I had failed. I didn't ignore sunk costs, and I had succumbed to the mental accounting fallacy of the "break-even effect". That brings me to my next economic realization: how to ignore sunk costs. I had heard about sunk costs, read about them, and knew about them…the lesson comes relatively quickly in beginner's economics class. However, I had never really experienced the effect of sunk costs. And so, if you'll allow me, here's a brief personal anecdote.

The losses from the NXPI merger began to seep into my entire life - affecting my relationship in addition to friends and family. In economics, a sunk cost is a resource already spent - like money invested in a merger-arb, or concert tickets already paid for. An econ-thinker needs to ignore sunk costs. But it is hard to do in practical application. To demonstrate, below is a small example that provides three scenarios for dealing with sunken concert tickets. Read it, then take a moment and decide which choice represents the best course of action:

Suppose that you cannot attend a concert because your girlfriend's father got bit by a strange dog, and your girlfriend's father's dog, because of the ordeal, ended up in the vet hospital. With both your girlfriend and the concert in limbo, you are now presented with three choices: You can (a) sell the tickets, which, however, leaves you unable to console your girlfriend, (b) go to the concert without your girlfriend, and at her insistence, take a friend with you instead, or (c) abandon the tickets, and go to be with your girlfriend. Which do you choose?

Most, if not all people, see that there is some residual value in the tickets at resale. However, the correct answer is: abandon the tickets…because it's a sunk cost. You can't go to the concert, so it's no use trying to sell them. In fact, they're already paid for, so you should disregard the initial cost of the tickets entirely. Your original thesis was to go to the concert with your girlfriend. Once that option became unavailable, the thesis was broken. Accept it, and ignore the tickets. Does it seem counter-intuitive? It was a hard lesson to learn, but learn it I did. *Lesson 7: Ignore Sunk Costs. A sunk cost is a resource that's already paid for. So if you lose the resource, accept it as failure (or otherwise) and move on. Else, you risk changing the very thesis you stood by in the first place. Note that in my personal experience this lesson applies equally well in relationships as it does with investments. And by the way, it took me the greater part of five months to figure it out. Hopefully you will not be in as dire a situation as me when it is your turn.*

**Lesson 8.** August was a recap of Ch. 11 reorganization misgivings. In an effort to consolidate and concentrate the portfolio, I sold the shares in Cumulus Media I obtained as a result of the Ch. 11 re-org. It turns out post-reorganization, the Senior Notes I held were now in an awful position, and I got skewered when CMLS began publicly trading again. Although I had done mountains of research on

it, and read the book *Distress Investing*, I still was not enough prepared for the outcome. In Chapter 11 reorganizations, keep in mind that the process favors bankers, lawyers, and management, leaving investors & creditors all the more disenchanted.

Because of the poor decision-making throughout 2018, with a focus on sunk costs & the break-even effect, I knew that I had to re-vamp not just my valuation process, but also my whole investment system. That meant building up from the ground level, the bottom of the house of cards: the financial statements. What I did was both swift and profound. I finally did some reading that lent itself to Warren Buffett's analytical methods, mostly concerning his concept of an "Equity Bond" whose payments on the principal grow over time. Using this methodology, and tuning it a little bit using texts from both Phil Town and Joel Greenblatt, I managed to build a process that favors companies with a "durable competitive advantage" that I could own with a "margin of safety". Eventually, throughout July & August this led me to Netflix (NFLX) and Camping World Holdings (CWH). Both companies demonstrate a durable competitive advantage, and both companies trade at a discount to intrinsic value (depending on how you define "intrinsic value"). As the calendar turns toward another year, it is this system that is currently forming the basis for the portfolio.

I need to discuss a lesson, and I have not touched upon the shorts in a while, which by this time were still coming through with success (notable August shorts included Weatherford (WFT) and Canopy Growth Corporation (CGC)), and so here are a few notes regarding viable short candidates. *Lesson 8: Short candidates should be stocks that are cheap to short, and meet certain criterion. Namely, (1) a decline in sales year over year, (2) highly leveraged capital structure (interest expenses cannot be covered by earnings), and (3) negative EBIT (possibly indicating that the only reason the company is still surviving is through positive EBITDA).*

**Lesson 9.** When September rolled around, the other shoe had dropped, and I was looking for both a reason why I bet over 30% of the portfolio on a single merger-arb (the "break-even effect") and how I could prevent future repeat occurrences (a mathematical solution to portfolio sizing). The former I found through Richard Thaler's studies in behavioral economics. The latter I found in an unusual yet fitting place: Berkeley Heights, NJ.

John Kelly, Jr. was a researcher at Bell Labs in New Jersey, when he stumbled upon information theory and how it applied to telephone lines. It was the 1950s, and Bell had a monopoly over the phone lines across the nation. This natural monopoly had the effect of bringing together some of the best minds in the world (Claude Shannon & John Kelly Jr. being two of them) together at the same place (Bell Labs). Some described it as a university devoted to research, without the need for teaching. As a result, John Kelly was able to ruminate on Claude Shannon's ideas about Information Theory. He then applied those ideas toward logarithmic utility and developed what is referred to as the Kelly Criterion.

As a small example, consider an investment "A" that will yield a 50% return after one year (the odds being 3:2, with the return on investment being 1/2), with a 75% change of doing so (the edge). A

"Kelly investor" would be prompted to ask the following question: what is the optimal percentage of the portfolio to invest in such an endeavor? The answer is given by

$$f^* = \frac{pb - q}{b} = \frac{\left(\frac{3}{4}\right)\left(\frac{1}{2}\right) - \left(\frac{1}{4}\right)}{\frac{1}{2}} = 0.25$$

Where "f*" is the optimal portion of the portfolio to invest in "A", "p" is the probability of success, "q" is the probability of failure, and "b" is the return on investment. In other words, with a $100 portfolio, this particular investment should theoretically demand $25, and by the end of the year, you will get back $37.50 (150% of the original $25 investment).

While not an exhaustive discussion, it remains astonishing nevertheless that logarithmic utility behaves so well inside of a concentrated portfolio. Perhaps not coincidentally, this notion of concentrated portfolio allocation falls in line with Warren Buffett's thinking.

In Edward Thorp's article "Understanding the Kelly Criterion", first appearing in A Mathematician on Wall Street in *Wilmott Magazine*, and also on pg. 511 of *The Kelly Capital Growth Investment Criterion*, Thorp describes a Q&A session between Buffett and several business students. Thorp references that Buffett operated mostly with **five positions**. Only five. And, at one point in time he put up to 40% of the portfolio in a single position! Reading this, I knew that a concentrated portfolio had the potential for achieving outsized gains. But how much of the portfolio should I allocate to one, two, three, four, or five positions?

With the Kelly Criterion, I would be able to assign assets to certain opportunities with the ideal percentages requires. What's more, it is worth exploring what kind of probability of success the Criterion demands. Just for the sake of argument, I'll look at the possibility of 100% portfolio allocation. According to the Kelly Criterion, what would the probability of success "p" have to be in order to put all of your eggs in one basket? Well,

$$1 = \frac{pb - q}{b} = \frac{(p)\left(\frac{1}{2}\right) - (1 - p)}{\frac{1}{2}} => p = 2$$

Which is impossible. So, under the circumstances, at no point would you be putting all of your money in one investment. Finally, the converse question would be: what is the minimum necessary probability "p" to warrant any investment at all? By setting f* = 0, we obtain

$$0 = \frac{pb - q}{b} = \frac{(p)\left(\frac{1}{2}\right) - (1 - p)}{\frac{1}{2}} => p = 0.67$$

So, under the circumstances, the minimum required probability for success in the investment "A" must be 66% or higher. Otherwise, the investment must be avoided in its entirety! *Lesson 9: The Kelly Criterion provides insight into optimal portfolio allocation. That is, how much of the portfolio can be allocated to one position, assuming you know the probability of success and the expected return on investment. Both variables should be taken into consideration before an investment is warranted. Any investment research you perform should have one of two goals: either to (a) establish a probability of success or (b) determine an expected return on investment.*

**Lesson 10.** Speaking of probabilities, when October came around, I was still holding onto some shares of Akorn (AKRX) and waiting for the Delaware Court of Chancery to rule on whether or not the buyer - Fresenius Kabi - could walk away from the deal and essentially claim buyer's remorse. It turns out that the Delaware court dismissed Akorn's claim, siding with Fresenius, and I fell on the wrong side of a deal…again. And again, Akorn shares plummeted, this time from ~$12/share down to $6/share. I finally bowed out, and logged 34% of my realized losses for 2018. Now that there's some background on the lessons I've learned throughout the year, I can begin to circle around and say: first, I held onto an investment past the point of the original thesis (Lesson 7) and second, I sized the position too large (Lesson 9).

I said this lesson was about probabilities, so here it is: roughly estimating, about 90% of all merger & acquisition deals go through. It's the 10% broken arbs that can crush you. Furthermore, AKRX traded as high as $32/share (the deal was for $34/share), then broke to $18/share, and then broke to $6/share all in one single year. Even without a proper M&A background in probabilities, one could use the market-implied probability to draw the conclusion that AKRX was likely not worth an investment (at $18/share, a $34/share buyout, and a pre-deal price of ~$15/share, the market-implied probability of deal closure stood at about 15% - Lesson 9 again). So, here is a lesson on M&A: *Lesson 10: When dealing with special situations, tender offers, M&A deals, and the like, wait until the last possible time before entering into a position. Otherwise, you are more exposed to risk of deal failure. The timing and conditions to a deal are extraordinarily important, and M&A tie-ups follow a timeline of a similar structure. In the case of Akorn, the longer the deal took the more unlikely it was going to be consummated. Other examples include Blue Bird Bus Company (BLBD), in which management canceled a provision of the tender offer days before expiration (crushing the position by over 20%), and NXPI, which was canceled by both parties because the Chinese government sat on their hands. Know the timeline of deals. Know when the shareholder vote is. Read the definitive merger agreements, study the background of the deal, and adhere to strict maximums of portfolio allocation. In my case, this is no more than 5% of the portfolio at any given time, and more practically closer to 2%.*

**Lesson 11.** October, November, and December were at the crux of my failures in 2018, and when the volatility returned once again, the Fund was very nearly insolvent. I came very close to selling my best positions due to margin calls (Lesson 4, and Warren Buffett's views on leverage), but just barely managed to hang on. The essential problem was a very large short against volatility; one that I

had been successful with in the past, but was now a troubling position: VXX. By taking a large short position against volatility (about 25% of the portfolio) and simultaneously taking a similar-sized long position in Camping World, if the two were to deviate from one another, the Fund would be hit twice as hard. Well, that is exactly what happened in the 4th quarter. CWH shares dropped 40% from $20/ share down to $12, and VXX shares increased 56% from $32/share to $50/share. It was the equivalent of having 50% of the Fund drop by 40% - in one month (which incidentally, accounts for most of the performance in December). I need to do better than that. And although the positions have recovered since, I was getting pinched more that I care to admit. So, here is a lesson on shorting volatility: *Lesson 11: Shorting a volatility fund is in actuality like taking a long position, because of the nature of the VIX itself. So, while I can be more versatile in the sizing - as much as 25% of the portfolio via longs, versus a 5% position as a short - there* <u>*absolutely must*</u> *be enough cash on hand in order to cover the volatility short at any time. This is essential, because contrary to a traditional short, if the markets go down, an ETN like VXX will go up, squeezing the portfolio twice as hard (as opposed to a short position, which gains value in a market downturn).*

**Lesson 12.** The impact on the portfolio over the past quarter led me to reflect upon not just the volatility in the markets (from a macro perspective) but also the volatility in the portfolio. I realize that concentrating the Fund's assets in a relatively succinct sphere of stocks has the propensity to create volatility when it comes to measuring monthly and quarterly returns against the S&P 500. Even still, my goal remains the same: to generate returns greater than the Risk Free Interest Rate using multiple value-based strategies that create high velocity-of-money, intertwined with event driven outcomes. And I feel it is important to accept my failure to achieve the objective in 2018. The velocity of money was there, but drastically in the wrong direction. That said, I must work to cure two ills that act as a sickness to the Fund's health: first, stop losing money on my trades and investments, and second, restrain the volatility in the portfolio itself. The former can be solved using a sound system and a strong process that is resistant to over-valuation - the lessons in this discussion help to outline some of the themes behind such a system. The latter requires a little more attention to technical analysis, something I have not concerned myself with in the past. I have chosen to be price sensitive and time insensitive, as opposed to the converse, which Richard Thaler refers to conveniently as "narrow framing" (without going into too much detail, we can define narrow framing as this: the more you look at your portfolio over a given time frame, the more you will notice losses; whereas in the long term, your portfolio will most likely be fine, and perhaps even outperform).

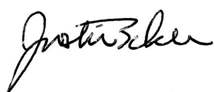
Even still, I have read about technical analysis in just about every investing book I can find (except those in which the main character was Warren Buffett), and it seems to me that there is a place for it, and I have found my own place for technical application from a small, seemingly novice book, *21 Essential Lessons for Investment Success*. Written by William O'Neil, the book is an introduction to investing intended for new-to-the-market investors (and also one big advertisement for Investor's Business Daily), and so it was a very fast read. However, I managed to find the most

pertinent interpretation of volume I have ever found in a text. I will try to paraphrase it here, with the goal of finding tops & bottoms in the market.

*Lesson 12: In order to find tops, look for market "distribution days". From a supply and demand perspective, this indicates institutional investors that are selling into the market, or "distributing" their shares to the market. High volume w/ high selling indicates a market top. Look for these days when you look at charts and volume patterns. In order to find a bottom, look for a rally day, then, surprisingly, wait. A rally day will be indicated by higher volume on a higher close. From a supply & demand perspective, this indicates institutional buying, and there will be less shares available to buy later one. Don't buy back on the rally day. Wait for it to follow through.*

**Summary.** These short anecdotes tell the story of how I have experienced the worst year of investing in my life. It was difficult to endure, not just because I have put forth so much time and effort into what is now a losing proposition, but also because it has affected my life and my relationships. While I have worked to improve myself, there remains much work to be done. Will I give up? No. What can I do next? Move forward. Did I make poor decisions due to overconfidence, the "break-even effect", and sunk costs? Undoubtedly. What lies beyond 2018? Something better than before.

Best,



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Managing Member

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