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April 15th, 2019

2019 Return	January	February	March	Q1	Annual Return	Return Since Inception
MountainWorks	28.0%	-6.1%	6.5%	28.0%	28.0%	-3.6%
S&P 500				12.7%	12.7%	60.6%

Dear Member,

In the first quarter of 2019, MountainWorks earned a 28% return on investment, versus a 12.7% return for the S&P 500, dividends reinvested (according to DQYDJ). Since inception, the Fund has lost 3.6% of its value, against a 60% return from the S&P 500. After my worst investment year ever in 2017, there has been a nice recovery during Q1, but more work remains. Last quarter, in not less than 13 less-than-joyful pages, I outlined 12 lessons (one for each month of the year) that grew out of hard experience:

Lesson 1: Discounted Cash Flow models are flawed, especially if the analysis is focused on revenues
Lesson 2: Even though a DCF model can project profits out five, even ten years down the road, it cannot account for changing margins
Lesson 3: Do not always assume the financial case presented by management
Lesson 4: Have a system & investment process in place, one that builds fundamental analysis from the ground-up
Lesson 5: Do not buy into a deal when the parent is acquiring troubled assets of the target
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
Lesson 7: Ignore Sunk Costs
Lesson 8: Short candidates should be stocks that are cheap to short, and meet certain conditions
Lesson 9: The Kelly Criterion provides insight into optimal portfolio allocation
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
Lesson 11: Shorting a volatility fund is in actuality like taking a long position, because of the nature of the VIX itself
Lesson 12: In order to find tops, look for market "distribution days". In order to find a bottom, look for a rally day, then, surprisingly, wait

Although a 28% return through three months is outperformance by any general standard, I must be candid in my motivation for greater success as well as my humbleness with ever-present failures. And therein lies the great balance between entitlement and humility. Entitlement, to me, sounds like a terrible thing. It festers with the over-privileged, and goads them into believing they are better than everyone else. Teaching in an upper-class town in Berkeley Heights, I see it almost every day - the student "wants an A+", as opposed to "earning an A+". The former deals with entitlement, the latter encompasses humility. All too often, economic stature breeds entitlement, and when it does, those in the privileged class end up confusing truth-to-power. How to reverse power with truth when someone believes they are right? That's a whole different story.

In my self-motivation for success, I want to embrace humility, and be cognizant of the 12 lessons I have learned from. When success comes, I will know that it was earned through hard work. Should you need more convincing of my resolve, look no further than President Abraham Lincoln, and his view of entitlement I am brazenly subscribing to:

"You cannot help people permanently by doing for them, what they could and should do for themselves."

Well said. I deserve nothing - I <u>could</u> throw in the towel, and state that holding an S&P 500 ETF for three years would outperform every investment decision I have made. I <u>could</u> easily write that I cannot make the big decisions. I <u>could</u> say that I'm not made for the investment business. Yet what I <u>should do</u> is: refine the process, improve my decision-making skills, and embrace the value of mistakes. In the end, I want to learn humility in order to earn success, rather then believe I am entitled to it just because I think I deserve it.

Refining the Process. While the market has sorely beaten me since 2016, it is not without a curiosity for perils that lie hidden underneath the veil of diversification. As it turns out, I am not the only one that sees ETFs, index funds, and diversification as growing mongrels of investment ignorance. In February, Charlie Munger - Chairman of the Daily Journal (DJCO) - attended the Corporation's annual meeting in California. He spoke for about two hours on various topics, one being index funds and the other being diversification. Below are some comments regarding the latter:

> *"The idea of diversification makes sense to a point if you don't know what you're doing and you want the standard result and not be embarrassed, why of course you can widely diverse. Nobody's entitled to a lot of money for recognizing that because it's a truism, it's like knowing that two plus two equals four. But the investment professionals think they're helping you by arranging diversification. An idiot could diversify a portfolio! Or a computer for that matter. But the whole trick of the game is to have a few times when you know that something is better than average and to invest only where you have that extra knowledge. And then if you get just a few opportunities that's enough. What the hell do you care if you own three securities and J.P. Morgan owns a hundred? What's wrong with owning a few securities? Warren always says that if you lived in a growing town and you owned stock in three of the best enterprises in the town, isn't that diversified enough?*
>
> *The answer is of course it is…if they're all wonderful places.*

And that Fortune's Formula which got so famous which was a formula to tell people how much to bet on each transaction if you had an edge. And of course the bigger your edge, the more close the transaction was to a certain winner, the more you should bet…And of course there's mathematics behind it…But of course it's true. It's perfectly possible to buy only one thing because the opportunity is so great and it's such a cinch. There are only two or three. So the whole idea of diversification when you're looking for excellence is totally ridiculous. It doesn't work. It gives you an impossible task. What fun is it to do an impossible task over and over again? I find it agony. Who would want to do it? And I don't see a way…"

To those members who received the holiday gift at the end of last year, I hope you've been reading…I can tell you that Mr. Munger has.

For my part, I don't want to diversify, I don't want the standard result, and I don't want to be stuck with market returns. At the same time, I've been embarrassed. Yet oddly enough, I feel that I know what I'm doing, and part of that deals with refining the process, operating in a small space, and not trying to do too much. So is it entitlement or humility? I would argue that the lessons I've learned have helped me refine the process in order to improve my decision-making ability.

Improving the decision-making. My best efforts toward improving decision making have come from researching behavioral economics, most notably *Misbehaving* - the excellent work by Dr. Richard Thaler. In it, he explores different human actions that seem contrary to rational "common sense". Some of those behaviors deal with topics like ignoring sunk costs (concert tickets), the break-even effect (chasing the money), the house money effect (precipitates bubbles), or loss aversion (people are hurt by losses twice as much as they enjoy gains). These are just some of the rewarding thought processes that I've discovered - and realized I've been a victim to - and look forward to applying in the future.

At times I ask myself, "How can I avoid making the same mistake twice?" For example, what if I find a marijuana stock [insert ticker symbol here] that looks really sexy, but turns out to be a dud - and what if I invest in it because the stock popped 30-40-50 percent, but the company's worthless? Would I make that mistake? To me, the answer seems to be a matter of experience. It's kind of like getting burned by a hot plate - someone tells you the plate is hot, but yet you touch it anyway. It seems like natural human behavior; and of course, after you get burned once, you know not to do it again.

But what about the big decisions? What if it becomes a question of going to college, or buying a house, or ever-bigger still: what to invest in? Well, Dr. Thaler has some keen thoughts on those behaviors too:

"[Suppose that] I [wrote] a list of products on the blackboard that varied from left to right based on frequency of purchase. On the left I started with cafeteria lunch (daily), then milk and bread (twice a week), and so forth up to sweaters, cars, and homes, career choices, and spouses (not more than two or three per lifetime for most of us). Notice the trend. We do small stuff often enough to learn to get it right,

> *but when it comes to choosing a home, a mortgage, or a job, we don't get much practice or opportunities to learn. And when it comes to saving for retirement, barring reincarnation we do that exactly once […] Because learning takes practice, we are more likely to get things right at small stakes than at large stakes […] If learning is crucial, then as the stakes go up, decision-making quality is likely to go down."*

I'm supposed to be writing about the first quarter of the year, so here it is: in January, I was reading *Misbehaving* and wondering about these decisions. In my April update to directors, I referenced a note-worthy Barrons article: "*Education debt held by U.S. Households went up more than six fold from 2001 to 2016, with families headed by someone age 40 or older representing the biggest jump"* (*-How Your Kids Can Ruin Your Retirement - and How to Make Sure They Don't*) Now, about those people holding the six-fold increase in debt: did they make good decisions about college? About family? I can't say that I have the answer. Can you?

The Barrons write-up provides just a small example of what Richard Thaler is talking about, how I'm thinking, and why my devotion to the decision making process has increased substantially from last year. In fact, now that I am older and well past my college years, I can say with almost absolute certainty that I could have done it better. My college experience, as it were, was a mistake on my part - and a big one at that. But how could I have known? All those years ago, what should have I done better to avoid the mistake? It begs the question, "Will I make an even greater mistake when it comes to investing?"

Value in mistakes. That brings me to the third improvement I've been learning about over the first three months of the year. Something that has been a crossover between my teaching career and my investing aspirations has been learning the way people learn. They seem like two totally different topics, education and investing, but in truth they are not that far off. And in fact, the best way to master a concept - as it were - is by teaching it.

So what I have learned through taking classes in social emotional learning and fixed mindsets versus growth mindsets has been straight-forward: mistakes make our minds work harder. They expand our thinking and are much more conducive to critical thinking than the typical right & wrong repetition of problems. Most high school and college classes focus on fixed problems with little application and even less critical thinking. Consider a small fixed-mindset example: If I were to ask you, "what is the circumference of a circle with radius 5 inches?" you might respond with 31.4 inches; or, if you were so inclined, you could say, "10π" (and I'd be impressed with your answer in terms of Pi!). However, by changing around the question a tiny bit, I could encourage some interesting critical thinking. Suppose I were to ask, "What is the circumference of the Earth?" Would you just Google it, or would you wonder how Eratosthenes figured it out over two thousand years ago? (Carl Sagan wondered how, just like I did).

What does this have to do with mistakes? Some of the most respected thinkers in society have started out by making mistakes. Walt Disney was fired early in his career for lacking creativity. Steven

Spielberg was rejected from film school - three times. And one of my favorite examples of failure: Michael Jordan was cut from his high school basketball team. These individuals achieved great accomplishments, but not without overcoming their setbacks. Personally, I think there is value in making mistakes, as long as one doesn't compound them.

But can someone make the big decisions, things like college, a house, or in my case, large-scale investments, without making the big mistakes? To me, making a big decision that comes along infrequently seems a bit like hitting a golf shot. When you hit a golf shot, there is an automaticity that is involved, it's something that's been repeated thousands of times. And yet, every shot you hit is different. Then, when it comes to the big choices, the big moments, and the big actions required, you need only realize that it's the same decision, the same action you did thousands of times before, only the circumstances are slightly different. What Michael Jordan said about failures, I voraciously believe about connecting mistakes to decision making:

"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."

Words that I always want to keep in mind, and so they are included at the end of my monthly updates. Tying in mistakes, decision-making, and the investment process, I can say that today I am relatively certain that I will make a mistake down the road. I can also say that my processes are better, thanks in part to the twelve lessons I've learned, reading about behavioral economics, taking education classes, and listening to a 95-year-old Charlie Munger pontificate for two hours. No kidding, if you have some time to spare, listen to Charlie Munger speak at the 2019 Daily Journal Corporation Annual Meeting - it's some of the most worthwhile discussion I've ever heard in my life. There are about 1,500 page views on YouTube, and a dozen of them belong to me. Cheers to time well spent in 2019.

Best,

Justin Polce
Managing Member

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