MountainWorks, LLC
info@mountainworksllc.com

January 15th, 2020

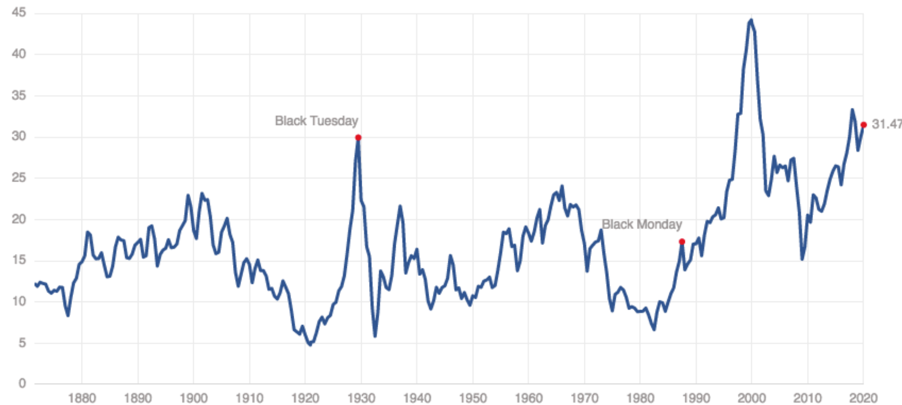
2019 Return	October	November	December	Q4	Annual Return	Return Since Inception
MountainWorks	8.6%	12.1%	7.8%	31.2%	33.8%	0.8%
S&P 500				8.3%	27.1%	81.1%

Dear Member,

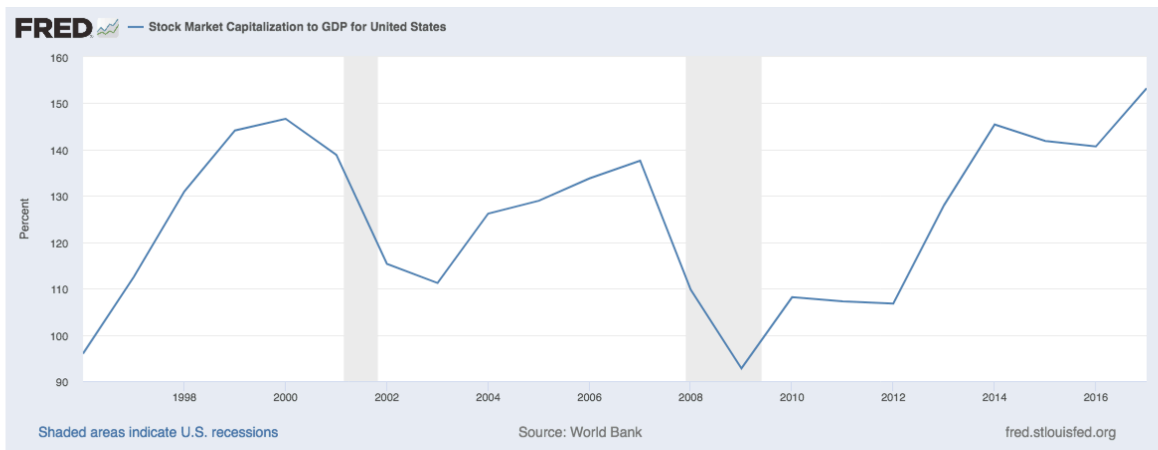
At the close of 2019, MountainWorks returned 33.8% on investment, versus a 27.1% gain for the S&P 500, dividends reinvested (according to DQYDJ). Since inception, the Fund has gained 0.8% of its value, versus an 81.1% return from the S&P 500. This year has had its share of ups and downs. In the first quarter we returned 28% on investment, then lost 1.6% in Q2, and lost 19.1% in Q3, before edging out the S&P 500 and finishing with a strong year. However, I'd be remiss if there was any sort of joy contained within 2019's resolve, as I am back at the beginning, with the Fund only marginally profitable since its inception. Despite my underperformance versus the rest of my competitors, I'm willing to venture an opinion on the general stock market.

General Stock Market Performance. Over the past 12 months the S&P has returned 27.1%. That's worth stating again: 27.1%. Hedge Funds, as a whole, greatly underwhelmed the broader market, returning 10.7%. There were some outstanding performances in select ETFs, with "iShares US Home Construction ETF" (ITB), "VanEck Vectors Semiconductor ETF" (SMH), "Fidelity Select Semiconductors" (FSELX), "iShares PHLX Semiconductor ETF" (SOXX), and "SPDR S&P Homebuilders ETF" (XHB) rounding out the top five and garnering 52.4%, 49.0%, 48.8%, 47.9%, and 42.8% returns, respectively. Clearly, there was a trend in both tech and home construction. From an outside perspective, you were better off investing in a broad ETF or the S&P 500 index than you were putting your money in a concentrated hedge fund or a start-up like MountainWorks LLC. For this reason alone, I thank readers and members for their support in a budding endeavor that has yet to bloom.

Meanwhile, the general market as a whole remains overvalued relative to historical metrics. For your consideration, I present two of them specifically. First, the Shiller P/E Ratio, cyclically adjusted over 10 years. Right now, it is at about 31.5, higher than black Tuesday, and higher than any point since the Internet bubble of 2000.



From a valuation standpoint, markets appear to be overpriced relative to earnings. The other metric we can reference is the total market capitalization of the stock market relative to Gross Domestic Product (Market Cap/GDP), which currently stands at over 150%. In 2001 the ratio was 138%. In 2007, it hit 137%. Today the ratio has never been higher:



It might be ok for markets to trade at, say, 120% of GDP, but at 150%, is it reasonable to assume public companies grow twice as fast as Gross Domestic Product?

For my part, I'll make a few of my own assumptions about the S&P 500, and then engineer some numbers to see just how much the S&P has to grow over the next seven years in order to maintain current levels. Suppose that the historical return on the S&P 500 is 10% per year. That means on average you can expect to double your money every seven years. Further, at a price of $3,282, the S&P trades at about 25x earnings, yielding about $131.28/share in earnings. Given the historical price returns, I'd like the market to go up to $6,564 seven years down the road. That said, let's apply a 15x P/E multiple to my future value of $6,564, in order to achieve earnings of $437.6/share - that's what the S&P needs to earn in seven years.

Now, how fast would the S&P's earnings have to grow in order to match that $437.6/share figure? Assuming 10% return per year for the S&P, earnings would have to grow at 18.7% per year just to keep pace. In other words, for this market to keep climbing 10% every year, earnings must grow at a faster pace: 18.7%. You might wonder, how have earnings grown in the past? Well, since 1950 earnings have compounded at 2.2% per year. Since 1975, it's 2.9%. Since 2000, it's 3.2%. How can we possibly match 18.7% growth per year in just seven years with a history like that?

With the general public eyeing continued gains coupled with future growth, passive investing and ETFs rule the day; they will continue to do so for the foreseeable future. But if earnings won't improve at an 18% clip, the alternative would be to sacrifice price gains in the S&P. Maybe stocks will appreciate at 5% annually, not 10%. Should we reduce our expectations for wealth creation in the markets? Charlie Munger might tell you that the best we can do is…average. Perhaps things won't be so great when the future decides to knock on our door:

> *"Well, my advice for a seeker of compound interest that works ideally is to reduce your expectations. Because I think it's going to be tougher for a while. And it helps to have realistic expectations. Makes you less crazy. I think that…you know they say that common stocks from the aftermath of the Great Depression […] to the present time may be an index that's produced 10 percent. Well that's pre-inflation. After inflation it may be 7 percent or something. And the difference between 7 and 10 in terms of its consequences are just hugely dramatic over that long period of time. And if that's 7 in real terms, but achieved starting at a perfect period and through the greatest boom in history, starting now it could well be 3 percent or 2 percent in real terms. It's not unthinkable you'd have 5 percent returns and 3 percent inflation or some ghastly consequences like that."*
> *- Charlie Munger, 2019 Daily Journal Corporation Annual Meeting*

Essentially Mr. Munger is saying that no longer can we expect 10% returns from the stock market. It seems rather shocking that one of the best investors in the world is clapping his hands and saying, "*ok everyone, that's a wrap*", but it makes sense from both a valuation perspective and how the Federal Reserve sets interest rates. Regarding the former, a P/E ratio for the S&P of around 25 implies about a 4% yield on earnings. Similarly, the Fed's Board of Governors continues to drop interest rates despite GDP growth of about 3% per year. Indeed, the American economy continues to impress while the Fed depresses rates…so why stop there? A rising tide lifts all boats.

But negative interest rates are hiding around the European corner. How long can either (1) the Fed keep interest rates low or (2) S&P earnings can grow at over 10% per year? It is a question that I can't answer, and have been thinking about with concern.

> *"All of the above is not intended to imply that market analysis is foremost in my mind. Primary attention is given at all times to the detection of substantially undervalued securities."*
> *-Warren Buffett, 1958*

Our Current Philosophy. Even though the general market deserves thoughtful discussion, we aren't concerned with the macro perspective, and it's rare that our daily operations attempt to pile on or hedge against general market trends. We are a concentrated fund. At times, I have devoted over 40% of the portfolio into a single security (for what it's worth, one of Buffett's earliest investments circa 1960 was about 35% of the portfolio). Such high concentration carries with it another set of risks: the performance of a single business could dramatically alter our results, opening us up to not just market risk, but company risk. Similarly, with the widespread adoption of Exchange Traded Funds, price fluctuations are much more correlated with market movements as a whole. Selling ETFs causes ETFs to sell, and that makes our job harder. Yet, it is my hope that such concentrations will provide average returns in "up" years for the S&P, and better than average returns in "down" years. To me, that is a more preferable byproduct than simply "beating the market".

> *Our job is to pile up yearly advantages over the performance of the Dow without worrying too much about whether the absolute results in a given year are a plus or a minus. I would consider a year in which we were down 15% and the Dow declined 25% to be much superior to a year when both the partnership and the Dow advanced 20% […] Therefore, the advantage we seek will probably come in sharply varying amounts. There are bound to be years when we are surpassed by the Dow, but if over a long period of time we can average ten percentage points per year better than it, I feel the results have been satisfactory."*
> *- Warren Buffett, 1962*

If we combine Warren Buffett's goals back in the 1960s with what Charlie Munger believes circa 2019, then from the standpoint of investment return, we've got a really tough road ahead of us. Without getting too long-winded or losing the interest of readers, I'll simply state that we are trying to create a *complex system* of investments that is *loosely coupled*, as opposed to an *ordered system* that's *tightly coupled*. In both situations, accidents will happen. But in the first, the failure of one branch (say, event driven investments) does not impede the success of another (say, equity options). Meanwhile, the latter ordered system can succumb to "normal accidents" that compound each other.

I experienced this first hand in 2018, when I invested in NXP Semiconductors as a Merger-Arb. Qualcomm was buying out NXPI, and toward the end of the merger only one challenge remained: Chinese approval. Geopolitical risk always factors into Merger Arbitrage, but I figured it was a done deal. Not only did I buy NXPI stock, I also used options to generate returns over short time periods. For several weeks and months this approach worked like a charm. But as time wore on, the risk grew. Eventually, the merger broke not because of anti-trust or competition concerns (which is an "expected" problem), but because President Trump and President Xi weren't getting along (not "expected", but "normal" geopolitical risk). A confluence of time, politics, and power came together that broke my system. It turned out to be orderly and too closely connected.

Since then, times have changed (or so I hope), and I have done my best to outline my mistakes in detail, so that if nothing else, I have a reference for future decision making. Furthermore, what I have discussed above is my best attempt to describe a distinct problem (how do I make successful investments?) that has a rather abstract solution (create a loosely coupled complex system). Because I don't think it's possible to fully explain my methods in one letter, I invite any of our Members to contact me to discuss our tactics in more detail.

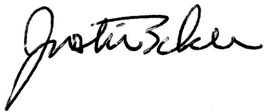
For now, my last effort in this letter will be to recall 12 lessons that I wrote one year ago, so that I do not forget them, and continue to use my experiences with the goal of making better decisions. They serve as my own personal guard against greed (intense and selfish desire), endowment (possessing something that you don't want to give up), and cognitive dissonance (inconsistent thoughts related to decisions). Without further ado:

1) Discounted Cash Flow models are flawed, especially if the analysis focuses on revenues
2) Adjusted EBITDA is not enough to keep a business functional
3) Do not assume the financial case presented by management
4) Have a system that builds fundamental analysis from the ground up
5) Do not buy into a deal when the parent is acquiring troubled assets of the target
6) Chasing losses is the result of the "break-even effect" - bets that seem logical to break even
7) Ignore sunk costs - resources that are already paid for. Accept failure and move on
8) Short candidates should be cheap to short, have declining sales, be leveraged, and earn negative EBIT
9) Know the probability of success and the expected return to use the Kelly Criterion
10) With event-driven situations, wait until the last possible time to invest
11) Shorting volatility is like taking a long position, so keep the cash on hand
12) Find "distribution days" (high volume, low close), and "rally days" (high volume, high close)

In the words of Mr. Warren Buffett, "I have tried to cover points which I felt might be of interest and disclose as much of our philosophy as may be imparted without talking of individual issues." If you have any questions, please do not hesitate to contact me. Two years ago I had the worst year of my professional life. While 2019 was better than before, I hope to manage our investments in a manner that outperforms the general market in down years, and achieves slightly better market returns in good years. I wish you the very best, and I thank you for your support as we move forward into 2020.

.

Yours,



Justin Polce
Managing Member

The information contained in this message is not and should not be construed as investment advice, and does not purport to be and does not express any opinion as to the price at which the securities of any company may trade at any time. The information and opinions provided herein should not be taken as specific advice on the merits of any investment decision. Investors should make their own decisions regarding the prospects of any company discussed herein based on such investors' own review of publicly available information and should not rely on the information contained herein.

The information contained in this message has been prepared based on publicly available information and proprietary research. MountainWorks, LLC nor any of its affiliates does not guarantee the accuracy or completeness of the information provided in this document. All statements and expressions herein are the sole opinion of the author and are subject to change without notice.

Any projections, market outlooks or estimates herein are forward-looking statements and are based upon certain assumptions and should not be construed to be indicative of the actual events that will occur. Other events that were not taken into account may occur and may significantly affect the returns or performance of the securities discussed herein. Except where otherwise indicated, the information provided herein is based on matters as they exist as of the date of preparation and not as of any future date, and the author undertakes no obligation to correct, update or revise the information in this document or to otherwise provide any additional materials.

MountainWorks, LLC, its affiliates, the author, the author's affiliates, and clients of the author's affiliates may currently have long or short positions in the securities of certain of the companies mentioned herein, or may have such a position in the future (and therefore may profit from fluctuations in the trading price of the securities). To the extent such persons do have such positions, there is no guarantee that such persons will maintain such positions. This post may contain affiliate links, consistent with the disclosure in such links.

Neither MountainWorks, LLC nor any of its affiliates accepts any liability whatsoever for any direct or consequential loss howsoever arising, directly or indirectly, from any use of the information contained herein. Nothing presented herein shall constitute an offer to sell or the solicitation of any offer to buy any security.