MountainWorks, LLC
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July 15th, 2020

2020 Return	April	May	June	Q2	Annual Return	Return Since Inception
MountainWorks	35.6%	27.8%	10.3%	91.2%	88.9%	90.3%
S&P 500				17.8%	-4.4%	77.7%

Dear Member,

In the second quarter of 2020, MountainWorks gained 91.2% of its value, versus a 17.8% gain for the S&P 500, dividends reinvested (according to DQYDJ). Since inception (February 2016), the Fund has gained 90.3% against a 77.7% return from the S&P500. No doubt some of you may wonder how or under what circumstances we managed to beat the general market by 73.4% in just three months; some may think that it was some stroke of good luck or one-in-a-million lightning strike. Some may think it came from one of our stocks jumping 500%. Both assumptions would be wrong. The truth of the matter is our performance is the result of processes built within the system that is MountainWorks LLC. In prior letters, I have discussed a "loosely coupled complex system", something that I have strived for in the midst of losing over half of the Fund two years ago. While I encourage you to disregard periods of wide fluctuations - just like this one - it is important to understand the overriding engineering umbrella that I attribute our success to. That umbrella system will be discussed in short order, along with my humble opinion on a general stock market that is fueled by not just the Federal Reserve, but also retail investors that could be a little too speculative for my tastes.

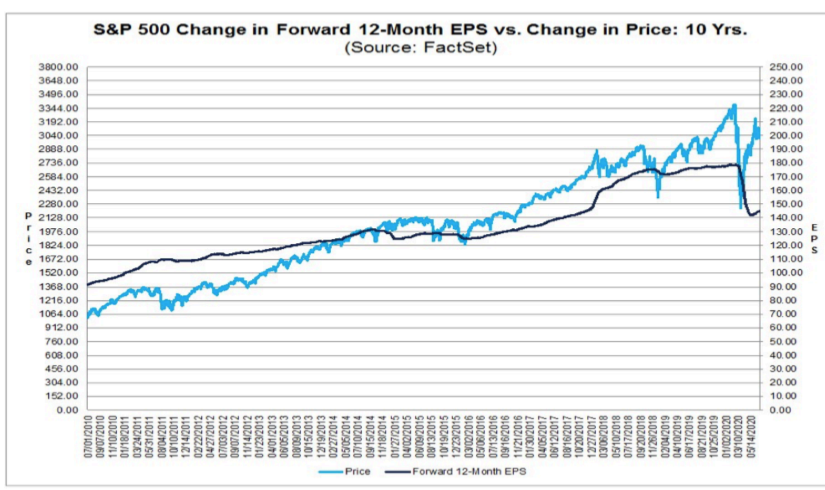
> *"Please keep in mind my continuing admonition that six-months' or even one-year's results are not to be taken too seriously. Short periods of measurement exaggerate chance fluctuations in performance. While circumstances contributed to an unusually good first half, there are bound to be periods when we do relatively poorly." - Warren Buffett, 1962*

Once again, it's important to realize that the outstanding returns we earned in the past three months are unusual, however welcome. While I do not expect to return 90%+ percent on any given year - let alone any given quarter - I do expect the system I have created to perform under periods of market stress. To that end, the Fund performed flawlessly (and yet, I still made several mistakes along the way!). Furthermore, the gains were the result of several strategies within the system, not just one or two branches. More on that later. For now, let's focus on the general market.

General Stock Market Performance. Since our last annual letter, I've been on a "valuation kick" that includes two variables: the Shiller P/E Ratio cyclically adjusted over ten years, and total market capitalization of the stock market relative to Gross Domestic Product (Market Cap/GDP). To keep my letters cohesive and cogent, the same discussion ensues. Three months ago the P/E ratio for the general stock market stood at 26 (just before the pandemic hit full force). At the beginning of the year, it was 31.5 (before the pandemic). Right now, it stands at 29.7. The total market capitalization of the stock market versus GDP stands at 149% (three months ago it was 127%; six months ago it was 150%). Both indicators have reversed upwards to where they were before the pandemic. It is as if the Coronavirus never hit. Strange to think about, and ominous for the future; however, we should not be too quick to call the stock market overvalued, at least not without added color.

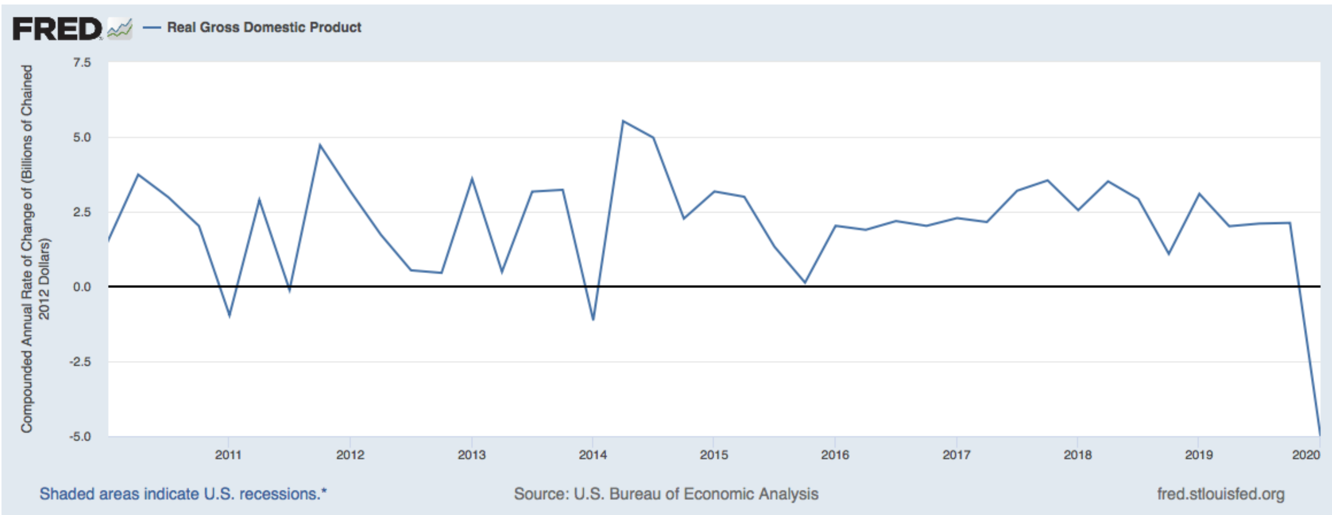
No doubt that I have a contrarian view of the markets - I do believe it's overvalued. Yet, whenever some talking head (I impulsively lump myself in with that crowd) claims to have a contrarian view, the first question you'd have to ask is, "What if your view is the new normal?" In other words, even though the market P/E ratio is at about 30, and it's historically overvalued, what if it perpetually stays at 30? Then no "correction" or market drop would occur, and I'd be perpetually wrong in my analysis. Furthermore, by being eternally wrong I'd be missing out on some tremendous stock market gains. Anyone who stayed on the sidelines throughout the pandemic is singing the same sad tune right now ("we lost 10%, but the S&P is down 5%, so we feel good"). That said it's important to take any macro-economic perspective with a grain of salt. If I had been drinking my own Kool-Aid, as an investor you'd probably be taking your money over to Robinhood and joining the millennial retailers.

Even still, the market is overvalued by historical standards. To further this point, consider an "Earnings Insight" report by FactSet: As of July 2nd, analysts have cut estimated earnings by 37% for 2020 Q2. That's the largest earnings estimate decline since Q4 2008; the analysts are predicting a 37% drop in earnings, a precipitous drop no one has seen since the financial crisis. Along with the grim predictions, only 17% of the S&P 500 companies have reported Q2 earnings, and only 49 companies have actually issued guidance. It seems that uncertainty is an understatement. Take a look at the chart below, which shows the S&P 500 forward 12-month earnings estimate versus the change in S&P 500 price, over the past ten years:



On the right-hand side of the graph, it's clear that there is a significant divergence between forward earnings estimates and price of the stock market. The graph supports the argument for stock market overvaluation. So why is the market trading at a 29.7 P/E? It might be because only 85 companies have reported earnings in Q2, and the future has yet to come.

Consider another supportive graph, this time from the Gross Domestic Product angle. Below is a chart of Real GDP, compounded annual rate of change, as a percentage, since 2010 (quarterly figures), courtesy of the St. Louis Federal Reserve FRED database:



The chart above represents the same exact timeline as the FactSet chart. Eerily similar, aren't they? What's more, the graph only shows up to Q1 2020. Q2 2020 GDP isn't even reported yet! GDP data gets forecasted, and then revised multiple times for accuracy. The current estimate (as provided by the CBO) calls for a 40% annualized drop, and the U.S. Bureau of Economic Analysis won't have hard data ready for release until October. Suppose that on a conservative basis I estimate a 10% drop in GDP for the year 2020. That actually *increases* the overvaluation of the Market Cap/GDP metric by 16% (it changes from 149% to 165%). Similarly, a conservative 10% drop in earnings would result in the P/E ratio rising to 33 (an 11% higher overvaluation). By the end of the year, we could be looking at a market that stays at the same price with less earnings or a market that corrects by about 10% and still remains historically overvalued.

What happens next is anyone's guess. But remember, don't let the talking heads convince you of their future predictions. Being right about the stock market is largely a function of time…in one month you're a genius, but the next finds you wearing the dunce cap. All I can do is rely on history, and hope that my diligence when it comes to individual market securities wins out. And that brings us to a discussion of our current philosophy.

Our Current Philosophy. The gains we experienced in the Fund were the result of our "loosely coupled complex system" withstanding the impact of a "normal accident". Charles Perrow, author of *Normal Accidents: Living With High-Risk Technologies*, wrote that normal accidents inevitably occur in tightly coupled complex systems. With this in mind, my idea has been to create a loosely coupled system. As it relates to MountainWorks, consider the multiple strategies we employ in order to achieve success:

Chapter 11 Bankruptcies
Corporate Reorganizations, Liquidations, & Tenders
Kelly Investments
Merger Arbitrage
Pre-Arbitrage
Short Investments
Speculative Investments

Traditionally, at least at the hedge fund level, down markets (like the one we've experienced in 2020) are opportune times for Chapter 11 Bankruptcies, Corporate Reorganizations, Merger Arbitrage, Pre-Arbitrage, & Short Investments. In good times, Kelly Investments and Speculative Investments shine, and rise with the general stock market. However, Mergers, Shorts, and Bankruptcies also occur in times when the S&P slopes upward, indicating some overlap among the strategies - this in turn adds to the complexity of the Fund. As a result, there must be some loose coupling that allows for errors, so that the system doesn't succumb to a normal accident.

The Coronavirus pandemic in 2020 is a perfect example of such a normal accident. The S&P was at an all-time high, but once the prospect of global disaster hit the markets, almost every hedge fund strategy led to losses (examples of our positions indicated in parentheses). Companies filed for Bankruptcy (Hertz, Valaris), CEOs and Boards brushed aside Corporate Tenders and Mergers (Genworth, L Brands), the general stock market crashed some 31% (Camping World, Netflix, BGC Partners, Ulta Beauty), Pre-Arbitrage mergers never took the next step (Quorum Health, Condor Hospitality), and Speculative investments were abandoned (Bitcoin Cash). All of the correlations went to one, and no strategy was safe - except the short investments.

Over the first six months of 2020, virtually all of our shorts were profitable, and our realized gains represent some 39% of the entire realized gains for the Fund year to date (Apache, Community Health, Hertz, L Brands, Rite Aid, Tesla, and Valaris; I failed with T-Mobile). Of all the strategies I employ in the system, 39% came from one branch. And therein lies the loose coupling that kept the Fund from disaster. Then, once the Federal Reserve and Federal Government stepped in, we were in good position to participate in the recovery.

I am being deliberately specific with some of our positions (indicated in parentheses), and at this point I'm hoping you noticed that our largest positions - Camping World and Netflix - did not help us when the pandemic hit. It was only after the market rebound that each business rightfully shined. My reason for pointing this out is to demonstrate that our system (loosely coupled & complex) has performed very well year to date, and that our successes have not been the result of simply one or two positions that skyrocketed. While it is nearly impossible to calculate down to the penny, I can reasonably estimate how much our two largest positions have contributed to the successes so far in 2020. Since January, Camping World has contributed to the Fund's 89% rise by some 34%, and Netflix has contributed some 22%. That means there's another 33% that we gained through other means. While some readers might attribute our gains to just one or two stocks, such figures underscore my effort to create processes that can thrive in most any market environment.

I must pause for a moment…I would be remiss if I didn't interject that so much of our faith lies with the managers of our various businesses - we would not be here without them. I am grateful for their efforts in building successful companies that have thrived even in the harsh conditions of the pandemic. Notably, Marcus Lemonis (Camping World), Reed Hastings (Netflix), Mike Salvino (DXC Technology), Mary Dillon (Ulta Beauty), & Howard Lutnick (BGC Partners) all demonstrate great business sense, and their approach parallels our ambitions. Our assets - and future - lie in their hands. To them, I give both my trust and gratitude.

If the above discussion seems complex, well, it ought to be. Complexity is not a vice. Don't get me wrong, I don't mind being lucky here and there, but it's difficult to explain a 91.2% gain to a reader and say "it's not all just luck". Indeed, the system is a combination of many factors that in the end help us achieve our goal: finding profitable ventures. If you need more convincing, it might help my reasoning to proclaim that Warren Buffett in his early years had much the same approach:

> "*Our avenues of investment break down into three categories. These categories have different behavior characteristics, and the way our money is divided among them will have an important effect on our results, relative to the Dow, in any given year. […]*
>
> *Sometimes these [generally undervalued securities] work out very fast; many times they take years. It is difficult at the time of purchase to know any compelling reason why they should appreciate in price. However, because of this lack of glamour or anything pending which might create immediate favorable market action, they are available at very cheap prices. A lot of value can be obtained for the price paid. This substantial excess of value creates a comfortable margin of safety in each transaction. Combining this individual margin of safety with a diversity of commitments creates a most attractive package of safety and appreciation potential." - Warren Buffett, 1963*

I invite you to think of "avenues of investment" as our differing strategies, the "margin of safety" as our loose coupling, and the "diversity of commitments" as our complexity.

Conclusion. My goal throughout this letter has been two-fold. First, to provide a measuring stick that is the general stock market, and second, explain how we are approaching the challenge of finding successful investments against the stock market. I want to emphasize that we are different. We are not a typical mutual fund, ETF, or hedge fund of any sort. We are eccentric business owners.

Furthermore, my most important point is that our achievements would not be possible without the Members who have faithfully devoted their hard-earned dollars toward a cause that is MountainWorks. To them, I give my utmost thanks and appreciation. To those Members: the Fund is still open for investment, and you may contribute at any time. To future Members: The Fund is open for membership, please contact me at any time if you are interested. To all readers: I hope that my discourse helps you as much as it enlightens me. We like to keep it interesting - so please don't hesitate to visit our "under construction" website, www.mountainworksllc.com, or contact me at Justin@mountainworksllc.com. I hope everyone is doing well, and I look forward to hearing from you.

Yours,

Justin Polce
Managing Member

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