MountainWorks, LLC
info@mountainworksllc.com

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2021 Return	January	February	March	Q1	Annual Return	Return Since Inception
MountainWorks	-1.0%	3.5%	-6.4%	-4.0%	-4.0%	120.2%
S&P 500				10.4%	10.4%	135.1%

Dear Member,

In the first quarter of 2021, MountainWorks lost 4% of its value, against a 10.4% gain for the S&P 500, dividends reinvested (according to DQYDJ). Since inception (February 2016), the Fund has gained 120.2% against a 135.1% swing from the S&P 500. Our outsized returns from 2020 were tremendous, yet with an underwhelming first quarter, we are only about on par with the S&P – though I continue to believe our 2020 returns will pay great dividends down the road. Of course, I encourage you to take one quarter of performance with a grain of salt…At the same time, most if not all the losses we incurred during the winter months were singularly my fault. More on that later.

Before my impending self-deprecation, I want to point out two facts. One, there will be no 2020 fees charged to any members, despite our 100% outperformance against the general market. While fees would be commensurate with 2020 results, if you take a look at the table above, we are still not beating the S&P 500 over the long-term. If I'm no better than a general market ETF, then there's no reason to charge you a fee. That's just not my style. Instead, I want to achieve a high-water mark of greater-than-average returns, before any members incur any fees. Second, we'll keep in mind the stock market indicators I've discussed in the past, to demonstrate an overvalued market that refuses to come back down to Earth.

General Stock Market Performance. Quickly, I'll revisit two variables that serve as market indicators – The Shiller P/E Ratio, cyclically adjusted over ten years, and Market Cap to GDP. When viewing either data set, the conclusion is straight forward: the stock market is overvalued. There's just no getting around it. The P/E ratio of the market – currently 37 – is almost as high as it was during the dot-com bubble. The total market cap of the stock market is two times greater than U.S GDP. Even when adjusting for the $7 trillion in assets held by the Federal Reserve, the market remains overvalued relative to GDP by some 48%.

However, in no way does the data imply a 48% drop is in the cards. I'm reminded of the infamous Keynes remark that "markets can remain irrational longer than you can remain solvent". To a certain extent, that's exactly why I lost 4% in the first quarter. In a seque toward irrational exuberance, investors are flocking to high-flying ETFs like Cathie Wood's Ark Funds; it is as if they are moths to the flame. And why not? ARKK, the $18 billion Innovation ETF, returned 152% last year beating out MountainWorks by a considerable margin. Adding irrational insult to my insolvent injury, Ms. Wood offered an explanation via twitter as to why the 200% S&P Market Cap/GDP ratio isn't so scary. She uses the 1800s as a historical reference point: a time when the market was trading at a 300-400% premium to GDP. In short, Wood believes the market could skyrocket even further.

Naturally, with 11% of her fund in TSLA, it benefits Ms. Wood greatly to reinforce the stock market valuation with confirmation bias. Ark has received billions in ETF inflows from retail investors lately, and If the market keeps going up, ARKK will follow (disclosure: we are short ARKK). While Wood continues to demonstrate her prowess, the less-well-known Christopher Bloomstran posted a captivating reply that basically threw Wood's 1800s hypothesis out the window. Who do we believe?

I have a great amount of respect for Wood, Bloomstran, and any other investment manager out there cutting their teeth. Yet seeing so much attention given to Cathie Wood and her ARK ETFs also draws my ire. Why? Because with the markets at such high levels, why are people continually attracted to ARKK and TSLA, with so little regard for valuation? What are they expecting for the future? For a glimpse into why I haven't invested in Tesla, take a stroll down the road not taken in a previous letter. As far as Cathie Wood's Funds, one might consider that over a 30 year period, the average retail investor has earned only 5% returns – half of the S&P 500 – because of trading and poor market timing. Simply put, there's an awful propensity for people to hop on the gravy train just as it's coming to a halt.

The extraneous reading sourced above is up to you. The key point I am trying to make is that there is a lot of noise out there, and it's hard to filter out information from the noise. That's the problem we are trying to solve. I mentioned this in a previous letter but it bears repeating: there is a lot of noise for want of distraction. Should we listen to Cathie Wood? Should we follow Elon Musk? For me, the short answer is no. The longer answer is that we should rely on a loosely coupled complex system like MountainWorks. The methodology has not only produced returns, but also saved us from my personal mistakes. Unfortunately, you are about to read why I am my own worst enemy when it comes to trading, noise, and the information problem.

"If my conclusions are not accepted, I will blame it on noise." -Fischer Black, 1986

A Short Short Story. I'd like to set the stage by first saying that I have performed terribly over the first three months of the year. Being down 4% in the first quarter is a remarkable achievement, given I have personally made mistakes to the tune of 20%. In other words, had I sat relatively still for three straight months, MountainWorks would've been up 16%, not down 4%. My only saving grace was the system that I have put in place, that forced me to cut my losses, and not compound the problem. I don't quite know where to start, so I'll just come out with it – I was short L Brands, Inc. (LB).

In the second quarter of last year, I began to build a short position in LB, mainly due to the pandemic. I figured that with malls and retail stores closed, LB's two businesses – Bath & Body Works and Victoria's Secret – would be in trouble. The company was laden with debt, and my hunch was that the bad balance sheet would amalgamate with falling revenues and force the stock downward. To a certain extent I was correct, but being right in the investment business is largely a matter of timing. When I first started the position, LB was trading at $12/share.

Throughout the rest of 2020, things started to turn for LB. At first, Bath & Body Works showed great resiliency, partly because the stores were selling hand sanitizer by the boat-load, and partly because of customer retention for the brand. Kudos to management – they built BBW to compete, and it was growing sales by some 20% while Victoria's Secret was shrinking.

Demand for BBW products, combined with new management execution and federal stimulus to boost retail sales, was enough to send LB stock up to $37/share at the end of 2020. Remaining unconvinced, I stayed short. It is worth noting that the majority of my short was in place by July 2020. While not much of a consolation, I was able to cut off the trade and let it sit, because of the sizing in the portfolio. That turned out to be a feather in the MountainWorks cap that saved me from extreme losses. From July through March, I added minor positions to the short, did my best to hedge, but LB's rise was inevitable. The damage was done.

In the end, when I closed the position I was down some 100% on it. That translated to about a 20% loss to the portfolio. Believe it or not, my process on taking losses managed to help. I could have cut my losses earlier, but hind sight is always 20-20. The fact remains that as of today, By cutting off the trade I saved myself from another 10% in losses (and a 2-3% added loss to the portfolio). Once again, that's no consolation, but it does tell me that the system I have in place serves its purpose.

To draw a few conclusions, recall that noise is a problem. In this particular case, the covid pandemic, the federal stimulus, the closed down malls and retail stores all turned out to be noise. They were macroeconomic variables that definitely impacted LB, but didn't tell the LB story. They turned out to be distractions that prevented me from seeing the flaw in my analysis. So think for a moment: what is the only thing I missed with LB that caused the stock to appreciate 500% from its low of $12 to now $66 in less than a year?

I missed one key piece of information…

Bath and Body Works was growing at 20%.

Although L Brands is composed of both Victoria's Secret and Bath & Body Works, only one of them needed to perform well in order for the stock to increase five-fold. In addition, there is a bias in my own thinking I'd like to mention: the *endowment effect*. My actions that cost us so dearly in the first quarter are the result of not only information asymmetry, but also from our gains in 2020. Certainly, the 130% increase we experienced last year were welcome, and for my part, I did not (nor do not) want to lose them. With a great amount of success, I admittedly had a fear of loss. Essentially, the endowment effect states that people have a tendency to stick with what they have, because they are averse to losses. In the case of L Brands, it wasn't necessarily that I was "risk-seeking" to make lots of money, but that I didn't want to lose money, if the market turned downward because of the economic impact behind covid (again, that macroeconomic noise).

Conclusion. Success, to a certain extent, is about failures. We learn best from our failures, and that is why much of this letter focuses on noise, information, and mistakes. Faithful readers have become accustomed to behavioral economics that decorates my narrative; therefore, if you are interested in learning more, I humbly suggest Dr. Richard Thaler's book, *Misbehaving*, as well as *Noise*, an essay by Fischer Black. On the investment side, I continue to employ several motifs. We are eccentric business owners with concentrated investments, using a loosely coupled complex system and conservative thinking.

I want to thank the Members for entrusting me with hard-earned capital. It is my great hope that one day you can work just a little bit less, and let MountainWorks compound your earnings. Similarly, I haven't forgotten about the invaluable CEOs whom our fortunes are tied to. They have done such fantastic work through 2020 – one of the toughest years of our lives – and I know their achievements will continue. To all readers: I hope that this letter helps you as much as it enlightens me. If you would like to discuss anything, please don't hesitate to reach out: Justin@mountainworksllc.com

Yours,

Justin Polce
Managing Member

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