*Mountainworks, LLC*
*info@mountainworksllc.com*

April 15th, 2022

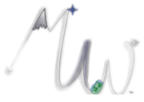
| 2022 Return | January | February | March | Q1 | Annual Return | Return Since Inception |
|---|---|---|---|---|---|---|
| Mountainworks | -21.1% | -9.4% | 18.3% | -15.5% | -15.5% | 70.2% |
| S&P 500 | | | | -10.1% | -10.1% | 145.8% |

Dear Member,

In the first quarter of 2022, Mountainworks lost 15.5% of its value, versus a 10.1% loss for the S&P 500, dividends reinvested (according to DQYDJ). Since inception (February 2016), the Fund has gained 70.2% against a 145.8% clip for the S&P 500. As stated in the previous quarter, I ended up taking my lumps regarding some of the "growth" investments made – Netflix, Zoom, FuboTV, and I have since sold off all of those positions. While we are still very much profitable since inception, the recent results trouble me greatly. On the road to successful returns, lumpy quarters do happen, but that does not mean I gloss over personal failures. I hate losing money, and I hate when members have to endure losses from Mountainworks. That should never be part of the process. Know that these setbacks fuel my resolve.

I started Mountainworks in 2015, and looking back over the ups & downs we've experienced, there are two major reflections regarding the current state of my investment theory. First, I have little exposure investing in a rising-interest-rate environment. Even though I have been buying stocks since high school, the time frame isn't long enough and Mountainworks has operated in a persistent pattern of low interest rates. The Great Moderation and post-financial crisis have been times marked by historically low volatility. Given the "easy money" cycle I have experienced for so long, the idea of "growth over value" began to creep into my mind. This manifested itself in my investment choices, like Zoom and Fubo. It was not all failure, mind you: for several years we profited off of Netflix as one of the best compounders in the past two decades.

The ebbs and flows in growth investing had consequences, in my thoughts and in my actions. Investing – like life – tends to snap you at your weakest link. When the winds began to change, high flyers like NFLX, ZM, and FUBO saw precipitous drops to the tune of 50%, 70%, and 80% in less than a year. That brings me to my second reflection: my results are cause for changing the paradigm. Since the beginning, our investment objective has been to achieve outsized returns using a loosely coupled complex system and multiple value-based strategies. That statement standing alone has not changed, and it will not. To a large extent, that philosophy is what kept Mountainworks from ruin when I got



snapped at the beginning of the year. Certainly, I have been and will always be intent upon finding what works, whether it's mergers, value, growth, spinoff, tender offer, chapter 11, pre-arbitrage, or any other strategy that comes to mind. However, this letter is about fending off Gambler's Ruin, and I must now add the caveat that in many cases, investing is fraught with danger. As I have experienced, it is very easy to get caught up in the general market, only to find the S&P rising while my concentrated portfolio bites the dust. You might think of it this way: there are three outcomes when investing in stocks, and two of them are bad. Even assuming a 50-50 chance of your investment going up, most of the time you will not beat the market. In a moment you'll see why.

> *"Doing better than the market is not the same as beating it. The first is often simply luck; the second is finding a statistically significant edge that makes sense, then profiting from it." -Edward Thorp*

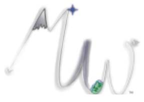
**Sharpe's Principle.** In his book *A Man for All Markets*, Professor Edward O. Thorp describes indexing – essentially just buying SPY – as a way to beat most investors. As an active investor managing Mountainworks, and knowing that Thorp ran Princeton Newport Partners from 1969 to 1988 and returned 19.1% per year (against the S&P's 10.2%), I found his suggestion curious. Why tell investors to be passive, when he himself was active and beat the market? The answer is what he refers to as Sharpe's Principle.[1]

Consider for a moment that any investment which mimics the general stock market is "passive". As of December 2021, approximately 43% of all investing is passive; we're talking mutual funds and ETFs that track the general market. Sharpe's principle – according to Thorp – states that the remaining 57% who are "active" investors (Mountainworks included) must also represent a single "passive" fund. That is, all of the combined holdings of all active investors replicates the index.

There are serious implications in the above statement for anyone out there managing their own money. For one thing, active investors generally suffer from two expenses: the cost of transactions and taxes. If you are making trades more than once per year in a stock, the cost of the transaction is the bid-ask spread, and you're likely to end up paying short-term capital gains taxes, as opposed to the long-term investor who holds in perpetuity (think Warren Buffett & Charlie Munger) and never pays taxes until the sale.

But more importantly, if say 50% of investors are in passive ETFs (the 43% figure referenced has been growing for years), and the other 50% of active investors pooled together represent an ETF, then

[1] Named after William Sharpe, a colleague of Thorp's circa 1970



it must follow that *half of the active investors beat the market, while the other half loses*. This intuition holds true given recent statistics: in 2021 hedge funds returned 10.4% while the S&P gained 26.9%. The hedge funds are putting up dismal numbers, and there are clearly winners & losers in the active trade. My point is this: any active investor who beats the market is by default in the top 25% of all managers. Given my recent history, there was indeed a time in which I was one of the top performers. However, it isn't sufficient for Mountainworks to be good only some of the time. We have to be *great* at investing. How can this difficult task be achieved? Considering the small amount of assets we have, little resources available to me, and imperfect information I possess, there is a lot of adversity headed my way. These reflections are blunt and brutal, and right now my only weapon against defeat is the ability to think. Said differently: play chess when others are playing checkers.

**General Stock Market Performance.** My King's Gambit is that perhaps now, with the Federal Reserve acting as a headwind to bonds & equities, investors will relent, resulting in increased volatility that is sustained over a long period of time. The past few years have made for extraordinary returns to the passive investor, with 21.2% annual growth since 2020. Is it possible that the streak is over? If so, there is a chance we can use volatility to our advantage.

With the Total Market Cap to GDP ratio at 183% (last quarter it was 206%), and the market P/E ratio is 34.6 (last quarter it was 39), it is possible to interpret the roughly 10% drop in the S&P 500 as just the beginning of a long & slow decline. Other rough macroeconomic signals – the highest inflation rate we have seen in decades, rising yield curves, and high commodity prices, to name a few – seem to be sharing the same sentiment. Collectively, the market is telling us: be careful what you invest in.

> *"In the abstract, life is a mixture of chance and choice. Chance can be thought of as the cards you are dealt in life. Choice is how you play them." -Edward Thorp*

**Portfolio Reflections.** That brings me to our specific circumstance, in which I have recently failed along with the market, along with the hedge funds, and along with the active investors over the past two quarters. Usually cognizant of past performance, there have been extraordinary gains (Camping World)[2] as well as calamitous losses (FuboTV)[3]. Therefore, I found Professor Thorp's quote very apropos of our current situation. That is, what has worked in the past, may not work well now. Investing, as I have come to know it, is much like a house of cards. It takes five or six parts of a thesis to

[2] For a more in-depth look at Camping World, see the 2021 Q2 Letter.
[3] For a more in-depth look at FuboTV, see the 2021 Q3 Letter.

be correct for an investment to pan out, but if only one of the pieces falls, the whole thing comes crumbling down.

Pardon the cliché reference, but when the chips are on the table, you need an edge to keep from total collapse. Being well aware of the Gambler's Fallacy[4], and concerned about other investing pitfalls I have yet to encounter, we have managed to side step catastrophic events, and even thrive in the face of uncertainty. Indeed, I have worked to build a system that prevents ruination. Rich thought and hard reflection help keep the wheels greased. We are investing through a complex system; you might think of it another way: we're making a random series of fortunate bets.

In case you haven't noticed, this letter is mainly about thinking. Moreover, the idea of "favorable bets" in the investing world might seem strange to the droves of passive investors who wait on index funds, ETFs, and the general market. Similarly, up to this point there has been mixed results for Mountainworks. At times we experience volatile swings; other times, the system serves a tremendous purpose of minimizing downside with unlimited upside. Of course, time will tell, and as always, I encourage readers not to focus on one or two lumpy quarters. If I were to sum up my thoughts in a few words: learn from mistakes, but don't dwell on them.

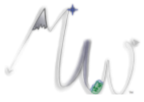
**Conclusion.** For better or worse, I am excited to see what the coming year will bring. Similarly, I hope that you find the discussion worthwhile and thought provoking. Notably, I have not mentioned any securities we are currently invested in. If any Members would like to inquire about current positions, just let me know. For my part, I am focused on a few "special situations" that I would certainly consider favorable bets.

Thank you for your time & attention. If you would like to discuss anything, please don't hesitate to reach out: Justin@mountainworksllc.com.

Yours,

Justin Polce
Managing Member

[4] Gambler's Fallacy is a betting scheme in which a bettor doubles his bet with each successive event, with the hope of eventually winning one hand. In the end, the bettor will lose all of his money.



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