Mountainworks, LLC
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January 15th, 2023

2022 Return	October	November	December	Q4	Annual Return	Return Since Inception
Mountainworks	19.1%	11.9%	-0.5%	32.5%	-33.8%	33.2%
S&P 500				2.4%	-14.7%	133.0%

Dear Member,

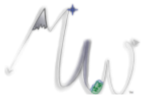
In the fourth quarter of 2022, Mountainworks return 32.5%, versus 2.4% for the S&P 500, dividends reinvested (according to DQYDJ). Since inception (February 2016), the Fund has returned 33.2% against a 133% clip for the S&P 500. Mountainworks has had to endure two difficult years since I started the Fund: 2018 and 2022. In both years, I was down 50%. In both years, I have had to look within, and perform some introspection, without knowing how I would come out on the other side. In both years, my investment process has been fortified by tangible and behavioral changes.

What an interesting place the world of investing can be. In the information age, traders have access to unprecedented amounts of technology and data, enabling faster and more complex decision making. At the same time, however, stocks move in tandem with the prevailing market vision, indicating some sort of behavioral mass hysteria. One would think that with the advent of greater technology, people would be able to make better investment choices with precision and certainty. But strangely, the volatility in markets has gone up, not down.[1] Why is it, then, that with more information, more data, decision making quality goes down? This is the [inner] struggle with behavioral economics I will attempt to dismantle.

Three vices, and the problem with a parlay. Four years ago, it was a compounding of mistakes that caused me to over-bet, and become too concentrated in a few positions. Looking back, it was largely an emotional fault; considering I'm not very emotional to begin with, that was hard for me to handle. But what was it about the prospect for greater returns that drove the concentrated portfolio?[2] Was it pride? Envy? Desire? Presumably all of those are sins of the heart. Pride induces overconfidence

[1] There have been times of relatively low volatility, as measured by the Vix. 2002-2007 would be a prime example. In recent years, the moves in stocks have been higher, measured by percent change in the SPY ETF.

[2] I realize that many legendary investors spurn diversification, and have been very successful with concentrated positions. For example, early on in Warren Buffett's career, he invested nearly 35% of his portfolio in a single security – Sanborn Map Company. In my own endeavors, I have invested over 50% of my portfolio in a single company. That's what I mean by a "concentrated portfolio". It doesn't start at 50%, so the real questions are "how' and "why" it gets to 50%+, and is that in fact worthwhile? After all, if you hit it right, it's a winning lottery ticket.



(“I know what I’m doing”), envy opens the path to bitterness (“why can’t I have that?”), and desire grows the appetite (“I want it now”)[3]. They are three vices that are emotional, and acting upon them causes tangible mistakes. One trap might be described as parlaying the bet.

The first two years of Mountainworks were very successful, being up some 80% over a short time frame. Knowing the power of compounding, and wanting to follow in the footsteps of investing greats, I wanted to parlay the winnings to grow the pot more & more. Given my past performance, I knew I could do it (pride). And I knew if I bet more, I could win more (desire). But what was to stop me from “betting the house”?

After 2018, I wrote down 12 “rules” that embodied my mistakes from the year: one for each month.[4] Moreover, I implemented some tangible changes that reigned in the concentration, and allowed me to use mathematics to help guide my decision making. Two years later Mountainworks was up over 100%, a tremendous comeback. But the worst wasn’t over. Through 2021 I saw the market rising euphorically with almost no rational explanation. I saw others growing rich by way of SPACs, bitcoin, whatever…in my own way, I jealously reached for yield so that I didn’t get left behind (envy). I wanted to parlay being up 100% into being up 200% and 300%. I was just trying to compound money.

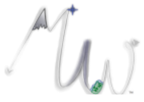
A year later the net result wasn’t very good.

For my part, it is admittedly difficult to distinguish between parlaying and compounding. So as an investor, which stocks am I trying to compound on and which am I trying to bet on? Is there even a difference? To Illustrate, consider an example in which you get the opportunity to invest in Apple at $5.00 per share, circa 2009 (split-adjusted). By the end of 2010, you’ve doubled your money. Having generated a 100% return on investment in one year – with the satisfaction of beating every single money manager on the planet – you now have essentially three choices:

(1) Sell at $10, pocketing a 100% return
(2) Buy more at $10, concentrating your position
(3) Do nothing, and hold

What do you do? Well, knowing the outcome of Apple more than a decade later, hindsight dictates you should have bought more at $10. For that matter, you should’ve bought all the way until you mortgaged the house! You could imagine this as the “parlay” option ad infinitum. In simple terms,

[3] By “appetite”, I’m channeling Aristotle in *Nicomachean Ethics*, when he said, “it is not opinion but appetite that is opposed to right reason.”
[4] These rules can be found in the Mountainworks 2018 fourth quarter letter.



you'd see the winnings, and have a desire to pour it on and bet even more. In doing so, you'd get really rich, really quick!

No doubt at some point in your life you've heard the stories, "I had amazon at $30 and I sold it ten years ago!" or "my friend owned bitcoin at $0.90 and got rid of it!" Besides hearing the investing-tales-of-the-envious, and being a self-described-economist-by-moonlight, I know that rational expectations don't operate in a vacuum. Therefore, the easiest way to rationalize your decision would be to flip the paradigm. Imagine a scenario in which you bought FTX tokens (yes, apropos to the current market news) at $3.00 in late 2020. One year later they trade at $55, and you're up 1700%, with three choices: buy, sell, or hold. If you decide to parlay your winnings and put more in, you'd now be sitting on incredible losses. That's reason enough to sell now and avoid pain later.

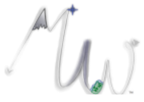
Naturally the risk of loss is an important concept that few rightfully consider.[5] Many brush it off as "sell the losers, buy the winners", and for the most part that is essentially a gambling parlay you could engage in every December to harvest tax losses. Yet it doesn't solve the problem of rational expectations: given a set of information regarding investing, people will tend to make the best, most rational decision, right?

But at the given moment there's no way for you to know what the most rational decision is, if for no other reason than you can't predict the future. You don't know if Apple will be trading at $2 or $200. That said, because our simple example can't operate in an information vacuum, we need to envision outcomes in the subsequent 2nd year of investment.

Returning to our example: you bought Apple at $5, and in a year, it traded to $10. Assume that in another year Apple could either trade further up to $20 or trade down to $5. You now have three choices with six outcomes:

- Sell at $10, Apple trades up to $20 (rational expectations)
- Sell at $10, Apple trades down to $5 (loss aversion)
- Buy at $10, Apple trades up to $20 (house money)
- Buy at $10, Apple trades down to $5 (break-even effect)
- Hold at $10, Apple trades up to $20 (sunk cost fallacy)
- Hold at $10, Apple trades down to $5 (buyer's remorse)

[5] I'm referring to loss aversion, a concept in which it is approximately twice as painful for us to lose than it is to win. That is, losing $10 hurts twice as much as winning $10 creates joy.



Pause and think for a moment: in which scenario(s) would you personally be happy with your decision and the outcome? At this point I'm going to make a startling revelation: I bet you would only be happy in two of them: Buying more at $10 and having Apple stock skyrocket, and selling at $10 only to find that in a year it drops back down to five.

In the other four scenarios, there is mental accounting going on that could make you sick to your stomach. If you sell at $10, and Apple goes to $20, you feel like you missed out (but selling a 100% gain is still rational). If you buy more at $10, then Apple trades lower to $5, you've lost more than you originally invested, and you'll feel like betting more to break-even and recover last year's gains you were "endowed" with. If you hold at $10, and Apple trades up to $20, you're kicking yourself for not buying more. If you hold and Apple trades to $5, you've lost all your gains and are stuck with a 0% return.

This is pernicious to say the least. In a somewhat simplified scenario, I will posit that if you decide to invest in the stock market, you'll only be happy 1/3rd of the time!

It gets even more complicated as time goes on. In our scenario, place yourself in the "you do nothing" basket. You decide to hold…then Apple goes to $20 – do you sell at 300% return (a rational decision in its own right)? What if Apple goes to $5 – do you buy more with the hope of avoiding Gambler's Ruin (dollar cost average/Martingale System)?

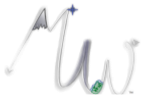
The difficulty with investing is that by engaging in it, you are simultaneously creating the problem you are trying to solve.[6] The attempt at rational decision making to invest for, say, your retirement, leads to compounded decision-making when the stakes are ultra-high.[7] No better truth could be told: the road to hell is paved with good intentions.

> *"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 goes down." -Richard Thaler*

Three virtues. I imagine that if you made it this far without judging my thinking as reductio ad absurdum (infinitely many complex choices), that you could come to the conclusion of "buy and hold". I suspect that combined with efficient market hypothesis, the "buy and hold" investors can just say, "to hell with it" and buy an ETF. The problems I am considering are perhaps why diversification and index

[6] For lack of a better phrase, "how do I get rich?"

[7] Indeed, you only have one shot in your life to save for retirement. How can you expect to be professional in that task, where there's no way to practice it? Moreover, you could go and hire some "expert" financial advisors, retirement planners, or wealth managers, but then the issue becomes, "what expertise do I have at choosing a financial advisor?" More money, more problems…



investing have come to the fore in the modern information age. Why be concentrated in a few Russell 2000 small caps when the risk is so high?[8]

My current predicament has morphed from "how do I make rational choices" to "how do I restrain myself from making bad choices". And believe it or not, those two approaches are incredibly different. The former assumes that we have some sort of information or expert knowledge of the situation – the basis for rational expectations. The latter is built upon the notion that *we will always make bad decisions*, regardless of the circumstances. Human beings misbehave – there's no doubting that. People are dumb (in many cases, *especially the experts*).[9]

From a behavioral standpoint, one would need opposing virtues that combat the vices that are pride, envy, and desire. Humility – the acceptance of fears, faults, and failures – can deter one from hubris. Gratitude helps a person be thankful for what they have, rather than being envious for what they don't. Self-control demonstrates the will power to stay away from temptations and desire. Each virtue seems to make sense; however, I have barely scratched the surface when it comes to applying them in investing practice.

I can honestly say that the past seven years have taught me a lot – at times through raw experience. Similarly, I want to maintain both the tangible & behavioral improvements that two harsh years have ingrained in me. In the year that follows there will be much room for improvement, and more importantly, less hazard for irrational choices.

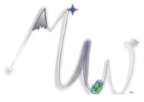
General Stock Market Performance. Following a year in which the S&P was down 15%, the Total Market Cap to GDP ratio stands at 150% - not much has changed in the past three months (when it was at 157%). In late 2021 it stood at 206%. The last time GDP and total stock market value were in parody was 2013: are we in for a long-term, secular downtrend? Along the same lines, the market P/E ratio is at 20.27, above the approximately 100+ year median of 15. The same cause for concern that I mentioned three months ago still holds: be wary of falling prices, lackluster earnings, or both.

Milton Friedman said that inflation was the effect of one great cause: money supply. So, in order to gain perspective on the current path of inflation, we can look at M2 money supply[10], as a percent change from the previous year. In January of 2021, M2 was up 25% from the prior year – that's

[8] I'm referring to Edward Thorp's take on index investing. His point is that passive index investing is much easier than active management, and with less transaction cost. Approximately 43% of all investing is passive. Sharpe's principle implies the remaining 57% who are active must also represent a "passive" fund in its own right. It follows that about half of the active investors beat the market, while the other half loses. So, if you're an active investor who has beaten the S&P, you're in the top 25% of all investors (not easy to do)!

[9] I invite you to explore Thomas Sowell's books, *Intellectuals and Race* and *Intellectuals and Society*. A pertinent interview from the Hoover Institute details the ways in which experts frequently venture outside their circle of competence. Be wary.

[10] Roughly defined, M2 consists of bank deposits along with currency outside U.S. Treasury & Federal Reserve banks, less any IRA or retirement accounts.



an incredible amount of money keeping the economy hot. At present, the latest reading indicates the money supply is slightly negative, at -0.05% over the past 12 months. Based on these statistics, it would seem to me that inflation is beginning to subside. Whether or not that fact should be attributed to the Fed raising rates is up to the reader; naturally, the current discussion across the economic landscape centers around the Fed going too far too fast with rates. It's certainly a possibility, and there are plenty of experts out there expounding their opinions, but you won't find that here. It's an interesting debate that is of little consequence to Mountainworks.

Portfolio Reflections. Despite my misgivings about human behavior and how complex the investing landscape can be, I have hope for our future and a recovery of our assets. But more than that, my process enables us to find profitable situations, and I hope this will prove out in any market dynamic. After all, the goal for Mountainworks is to beat the market, in good times and lean times. Our portfolio has grown in terms of diversification (yes, I'll admit it); at the same time, we still maintain concentrated positions.

At present, our most thrilling caper delves into Sportsman's Warehouse, a nice business that is growing in spite of macroeconomic headwinds. I'll spare you the intricacies for now[11], but as a customer, I have had good experiences at their stores, and I like the natural monopoly that is forming around the hunting business.

Outside of SPWH, we are still investors in Camping World – although rising interest rates have not boded well for RV companies in the past. Even still, the RV industry as a whole has been steadily growing for decades and I see no sign of it stopping. On a personal note, I have noticed more and more RVs in people's driveways around my suburban home: to me the growth trend is still playing out. I have faith in Camping World management that they can weather an economic storm.

As a whole, I have been implementing what I consider to be some statistical arbitrage applications to the Fund – that is the reason for our broader "diversification". But make no mistake, I have no intention of going along with the index crowd. Since enacting both tangible and behavioral changes, I have begun to see the fruits of my labor. Now I have to ramp up, make any necessary adjustments, and in turn Mountainworks will stand the test of time.

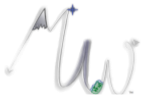
Conclusion. I have to bear the brunt of my choices – my mistakes are my own. I am not an intellectual or expert by any means. Our success can be gauged by a simple measuring stick – market returns, and there's much to do. While I continue to work towards that end, I hope you will follow alongside me. Thank you to Members who have stood with me through the hard times.

[11] A more in-depth analysis can be found at Seeking Alpha

I appreciate your interest in Mountainworks. 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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