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

January 15th, 2024

| 2023 Return | October | November | December | Q4 | Annual Return | Return Since Inception |
|---|---|---|---|---|---|---|
| Mountainworks | -16.7% | 42.2% | 32.5% | 57.0% | 45.2% | 93.5% |
| S&P 500 | | | | 7.0% | 22.0% | 183.4% |

Dear Member,

In the fourth quarter of 2023, Mountainworks returned 57% of its value, versus a 7% gain for the S&P 500, dividends reinvested (according to DQYDJ). Since inception, the Fund has returned 93.5%, against a 183.4% clip for the S&P 500. Toward the end of the year, inflation expectations subsided, treasury yields dropped, and the market is forecasting Federal Reserve rate cuts throughout 2024. It is clear that yields have been driving the market – this is not unusual, nor unanticipated. Generally speaking, large macro trends are easy to spot; taking advantage of them through investing is another story. Perhaps luckily, we were in a good position to ride the fourth quarter wave. But we were only in this position because we never left. We have been and remain both invested and concentrated in equity positions. That said, we can experience the roller coaster effects on the way up and the way down. To wit, we experienced our second best year since inception, and all of the gains occurred in the fourth quarter. A welcome outcome for sure, but in truth the past few months have likely been another exercise in irrational thinking. Were stocks really undervalued by 10% going into November 2023? With all the professionals out there gathering up perfect information, what went wrong? Is it really reasonable to think that markets are efficient, given what we have observed over the past two months?

**An Exercise In Human Rationality.** With the general market near all-time highs, the current market cap to GDP ratio sits 171.8%, and is historically overvalued. The market P/E Ratio, presented as the Shiller P/E Ratio, is at 31.77, a point eclipsed only twice in history: 1999 and 2021. We are either living in a period of tremendous growth, or witnessing how human beings can behave quite irrationally, assuming there are visceral motivations. Indeed, several of my past letters have focused on virtue and vice as they apply to the stock market: this could be a case of pride (*"I know what I'm doing"*), envy (*"why can't I have that?"*), and desire (*"I want it now"*) taking over.[1] To explore the

[1] I'm referencing the Mountainworks 2022 Q4 Letter, in which a short discussion of "three vices" ensued. I consider these vices quite dangerous, and one year later in writing this letter, I find myself re-reading past notes to remind myself of the pernicious nature of them. It is as if one successful year is all it takes to forget these vices entirely. The challenge then becomes how to

nature of the market, it might help to peruse recent headlines. Below is a list of 10 news headlines from varying publications, between October 25th and December 15th, 2023. Consider the differences in opinion that can coalesce over the course of mere weeks[2]:

"*S&P 500, Nasdaq end sharply lower as Alphabet disappoints, Treasury Yields Bounce".* October 25th. Reuters.
*"Profit Cuts Signal More Bad News for S&P 500 After October Slump".* October 30th. Bloomberg.
*"Why so down, S&P 500?"*. October 31st. Financial Times.
*"Jobs Report: Softer Hiring, Unemployment Increase Keep S&P 500 Rally Going"*. November 3rd. Investor's Business Daily.
*"S&P 500, Nasdaq Extend Win Streaks"*. November 8th. Wall Street Journal.
*"Stocks Open Higher, as S&P 500 Chases Longest Winning Streak Since 2004"*. November 9th. Barron's.
*"S&P 500, Nasdaq snap winning streaks after Powell, Treasury auction"*. November 9th. Reuters.
*"Fed Chair Powell Fails to Quiet Rate-Cut Talk; S&P 500 Rises As Treasury Yields Tumble"*. December 1st. Investor's Business Daily.
*"Resurgent S&P 500 Crests new 2023 closing high after roller-coaster year"*. December 3rd. Reuters.
*"S&P 500 posts longest weekly winning streak since 2017; finishes flat on day"*. December 15th, Reuters.

There are two thoughts that come to the fore: first, the mind of the market (as represented by various news authors) is extraordinarily short-term. It's a day-to-day rationale that follows the trend, with minimal critical thinking. I'm willing to grant that news reporters and talking heads have incentives built on this type of behavior: instant gratification for the sake of more views and less thought. Yet on the whole, this is the irrationality of the human experience taking the spotlight. If you read the market news every day, will it make a difference with your investments 6 to 12 months down the road? I would scarcely believe it, and so the conclusion to be drawn is that navigating the instant gratification surrounding us requires some sort of self-control ("I can wait").

Second, the emphasis on rising markets is palpable. In searching for news headlines, I found it quite easy to find S&P headlines promoting jubilation as opposed to cynicism. For circumstantial evidence, just look at the wording of headlines: *Rally, Win, Streak, Win, Streak, Streak, Rises, Resurgent, High, Win, Streak…*the implied momentum behind such headlines tells me this is the house

prevent them from sneaking up on me again. I suspect this is the reason why so many great writers across history have endeavored to tackle virtue and morality.

[2]Take note that there was only one repeat author for the linked news articles: Jed Graham of Investor's Business Daily. All other authors were different.

money effect in full swing![3] I'm sure that my natural skepticism is showing, but it seems to me that everyone loves the trend. However, going with the flow isn't always the best choice. In particular to the most recent euphoria, had you invested in the market circa December 15th, you would have missed just about all of the rally. Being the first one to the party is incredibly difficult - perhaps at this point some humility ("Maybe I'm wrong") would be proper, but it's not enough to say, *"I missed the move"*; one must also avoid the temptation to get in and join the party when it's too late.

Once again, temporal choice becomes a huge factor when it comes to investing. How does one know when it's too late? Though we have been successful throughout 2023, keep in mind that December 31st of each year is simply a day in time. It is a marker which over the course of many moons means nothing.

You can look every day at the rhapsody that is the stock market, and grow more & more jealous with every percentage point. Because in your head, you know that someone else is making money, and you're not.

There's no shortage of envy in this world – I know this from personal experience. It's too easy to look at the other side, and see the successes of others, while self-diminishing your own life. This is especially true when people flaunt their success with almost no thought to unintended consequences & morality.[4]

Envy causes us to question our own path, our lives, and our decisions. But just because someone else is doing better doesn't mean choices aren't important. Rather, there are constantly times in life when choices are incredibly significant, yet we have little to no practice in making them.[5] In a certain sense, this my attraction to the markets, and a life devoted to investing. The idea of saving is a fundamental bet with your future. It is a behavioral challenge of the human experience. One should be grateful for the things one has already, and be present while also saving for the future. Gratitude ("I appreciate it") can be a beautiful thing, especially when it comes to intertemporal choices. I have the ability to invest – that in and of itself is a start.

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[3] Briefly, Richard Thaler and Eric Johnson explain the house-money effect as "risk seeking in the presence of a prior gain" in their paper, *Gambling with the House Money and Trying to Break Even: The Effects of Prior Outcomes on Risky Choice*. In my own paraphrasing, when you win, you want to parlay and double up. The same is true if you lose. That is, if you lose a bet, you have the urge to double down, thinking that the next bet will turn out in your favor. Of course, this is the fallacy behind the Martingale betting system.

[4] If I could be callous for a fleeting moment: instant jealousy comes from watching reality shows like "Real Housewives". I mean, who the *hell* is watching that crap? And how the *hell* are these women making money? I salve my envy by thinking that their children are probably spoiled rotten.

[5] I will again reference Dr. Richard Thaler & his book, *Misbehaving*. In it, he describes the idea that as the stakes get higher, decision making quality goes down. How many times in your life will you purchase a home? Pick a college? Or get married (hopefully just once)? It is another irony of irrationality in that we get very little practice when it comes to making big decisions.

> *The world is not driven by greed; it's driven by envy. So the fact that everybody's five times better off than they used to be, they take that for granted. All they think about is somebody else having more now and it's not fair that he should have it and they don't. That's the reason that God came down and told Moses that he couldn't envy his neighbor's wife or even his donkey. I mean, even the old Jews were having trouble with envy. So it's built into the nature of things… -Charlie Munger, 2022 Daily Journal Annual Meeting*

Given the depths of pride, envy, and desire that nearly overwhelm people in the present day, we can try to shoot for some sort of behavioral edge. In a practical sense, it helps to speak simple phrases of virtue: "Maybe I'm wrong." "I can appreciate it." "I can wait."

**Maybe I'm wrong.** A troublesome laggard for our portfolio has been Sportsman's Warehouse. For some added color (perhaps self-deprecation too), below are a few of my comments regarding the company:

*"At present, our most thrilling caper delves into Sportsman's Warehouse, a nice business that is growing in spite of macroeconomic headwinds." -January 2023*
*"In particular to our situation, Sportsman's Warehouse might be the perfect exemplar of the predicament between intertemporal choice and temptation." -April 2023*
*"As expected, but not necessarily welcome, SPWH shares dropped to below $7 per share […] That was a big part of my underperformance […] I've been using the opportunity to pick up shares on the cheap. Once again, it represents a highly concentrated position in the portfolio, and is a microcosm of my existence somewhere between want and self-control." -July 2023*
*"I was wrong to think that a broken merger-arb like Sportsman's Warehouse would pop back inside of one year […] this is a case of envy and desire, requiring more gratitude and self-control on the part of the investor." -November 2023*

Do I sound anything like a market news reporter? When the stock is rising, I feel good. When the stock is falling, it's a disaster. Here's the point: maybe I was wrong with Sportsman's Warehouse. Sure, the company could perform well over time, and lest we forget, Cabela's/Bass Pro[6] was willing to pay $18/share for the business. Moreover, I estimate that Sportsman's Warehouse could trade anywhere

[6] That is, Great Outdoors Group – the parent company of Cabela's and Bass Pro Shops, among others

between $1.55/share to $25/share, under relatively moderate valuation multiples.[7] A sampling of selected transactions in the outdoor retail space reveals a multiple of about 10.3x, which translates to roughly $20.70 per share.[8] Together the estimates corroborate a thesis of undervaluation. However, the actual performance of the business has deteriorated. Inventory levels are high, and the typical customer at Sportsman's Warehouse remains under inflationary pressures, in turn lowering discretionary income. The valuation is right, but as of late, the growth is negative. While I still have a position in SPWH, I could very well be wrong on its prospects.

**I appreciate it.** I have been working hard on not just the investment process, but also the efficiency. As such, it has been quite worthwhile to discover some organic ideas that played out nicely. One such idea has been Generac Holdings, Inc., a good business built on engineering and energy technology. We can talk about the "megatrend" of backup energy all we want, but in the end, it is not my job to present the CEO's case[9]. Rather, it is my job to find opportunities where the maddening crowd doesn't wander.

I have been watching GNRC for some time now, and have seen how the company got caught up in the solar market downturn while management worked through elevated inventory levels. As primarily a backup generator company that is branching into power walls, solar, and integrated home technology, Generac utilizes a vast dealer network and distribution channel in order to promote sales leads and eventually close on product sales. In this way, residential electric & HVAC contractors serve a symbiotic relationship with the company.

I like the idea of a dealer network getting your message out there, but that's not the primary cause for investment here. The financials are strong; Generac has consistently grown revenues, earnings, and equity over the long term. Only last year did GNRC produce negative cash flows, due in part to high field inventory of backup generators that weren't getting installed in residential homes.[10]

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[7] Historical EV/EBIT multiples from 2018 through 2023 yielded a minimum of 1.5x and a maximum of 24.1x, implying about $1.53/share to $32.28/share. However, the highest trading multiples occurred after the pandemic, in which the outdoor lifestyle became the new trend.

[8] See page 61 of the Definitive Merger Proxy for Sportsman's Warehouse and Great Outdoors Group, in which Baird compared 15 merger transactions to SPWH/GOG. Note that the 10.3x multiple is LTM EBITDA. Per my own valuation, I am utilizing fiscal 2022 financials to calculate Enterprise Value and EBITDA. For example, I'm assuming $40 million in earnings – yet understand that the company won't come anywhere close to that in 2023, and will likely lose money for the year.

[9] See Generac's 2023 third quarter conference call transcript.

[10] To be more specific, Generac was manufacturing the home standby generators, but due to a shortage of workers at the dealer level, some customers lost interest (resulting in cancellations/delays). Furthermore, higher interest rates make big-ticket items harder to justify, translating into a disappointing 2022 for the business. Whether or not that is a one-off event remains to be seen. But recently, the inventory levels have decreased.

Similarly, based on past valuations, it is not unreasonable to see $240/share in the medium term future. It is perhaps one of the most undervalued companies in the S&P 500.

Toward the end of 2023, we had a great opportunity to pick up shares at attractive prices (under $100). Subsequently, the late fourth quarter market rally played to our favor, and we were able to take advantage. One could call it a little bit of luck, but I'd like to think there's some consequential knowledge involved too. The investment process was successful, and I can take a moment to appreciate the fruits of labor.

**I can wait.** To me, deferring gratification is one of the hardest behaviors to master, and it is also one of the most determining factors when it comes to finding success. Having self-control is a daily experience, and requires practice in order to achieve it. On an investment level, the test of will power is magnified – to a certain extent our success (thus far) with Generac is a perfect example.

But what now? At this point we can discuss the macroeconomic forces behind the market. We have inferred that listening to news and reading headlines is enough to incite madness. However, it is worth noting that macro trends are easy to spot. For instance, the rise of inflation could be seen everywhere circa 2022, enough so that the logical conclusion was to expect higher interest rates. While the rising interest rate environment dominated the headlines for most of last year, an obvious arbitrage presented itself in the form of inverted yields. While the situation has persisted, there is now talk of cutting interest rates over the course of the next 12 months. Is it reasonable to assume there will be six rate cuts in 2024? Probably not, but I think it will be more than 1.

How Federal Reserve policy will tie into stock valuations is anyone's guess. In the meantime, treasury rates between the 10-year and the 2-year are still inverted.[11] Even though the spread has decreased, the opportunity for bond arbitrage remains. Why buy a 10 year bond when you can get more return in 2 years or less? It's a financial fruit fly that has flown by, but won't last for long. Specific to our investments, we have employed the use of a bond ladder since November 2022. It is simple, and it is easy.

But when the yield curve reverts, I don't know what will happen. One guess is that equity valuations will fall, making for some good buying points. That would be the most straight-forward response to higher interest rates, yet there's no sign of impending doom.[12] Of course, I could be wrong, and the froth around high-flying stocks could persist. Either way, I can wait.

[11] A recent check on 10 year & 2 year treasury notes yields 4.0% and 4.4%, respectively

[12] We all know the history of yield curve inversions as a preamble to recessions. Since 1978, there have been five distinct inversion periods (including today). In four of them a recession followed **after** the yield curve reverted. The current period is the longest inversion since the tumult of 1978-1981, when the curve inverted in September 1978 and recession hit in September

**Conclusion.** Much of what I have embarked upon over the past year has been self-reflection, and this letter is no different. Make no mistake, I am attempting to play moneyball, and looking differently at what others take for granted. We will do what others cannot do, and sift through as much information as possible with relative efficiency, in order to make better decisions. In doing so, I hope to gain a behavioral advantage over the competition, that leans on humility, gratitude, and will power. A humble knowledge helps minimize prideful mistakes. Being grateful for the opportunity to succeed helps deter envious betting. Will power prevents a proclivity for quick-buck trading.

Of course, I am most grateful to Members, and thankful to readers. 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

of 1981. Compared to today, the 10/2 curve inverted in July 2022, and is approaching two years. A weak projection for incoming recession would be the 2nd half of 2024 (emphasis on *weak*).

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