

January 1, 2020

Figures are rounded to save time.

This was my first full year of stock picking. It went better than I could have hoped. Making 91% in a year is not remotely normal. Clearly I got lucky. Eventually I will lose a few quarters in a row. When that happens, I hope people remember that times can be good.

Part 1: Fourth Quarter Review

1. Results for September 30th - December 31, 2019

SP500: +9.5%. Max Drawdown 3%. Sharpe 3.7.

Fund: +19.7%. Max Drawdown 14.5%. Shape 2.3.

Currently we're 160% long and 90% short. I closed some losing long positions for the tax loss before year end, otherwise that would be 175% long. I will re-enter after 30 days, the minimum required by wash sale tax rules. I expect to be back to 100% net long this month.

Long:

We're up about 14% on the long side, slightly behind the market adjusted for leverage.

The biggest loser was Sterling Bancorp (SBT) which I wrote an article about. Their main loan program, 80% of loans originated, was essentially shut down by regulators. Customers made large down payments so there shouldn't be credit risk; they just couldn't meet pesky regulations. I thought it was unlikely that regulators would suddenly step in when 1. loans are healthy and 2. business had been going on for a long time.

I figure SBT's long run return was 18%/year based on return on equity and growth. For comparison, most healthy banks return 8-12%. I also thought downside risk was limited. Even though 80% of their business was shut down, i.e. the bad outcome happened, shares only dropped 20%. This is a lot different than betting on a bank with large credit risk, which means the downside is easily -100%¹. That risk wouldn't be worth an 18%/year return. Despite SBT having a bad result, I'd make a similar bet today. The risk:reward still seems good. Avoiding results oriented thinking in these spots is an advantage I have from my poker background.

¹ Banks use leverage when lending to people. For every \$1 they have, they might lend out \$10. If 10% of their loan portfolio goes bad from making reckless loans, the bank is worthless.

I quit because regulators will likely force them to run like a normal bank in the future, with normal returns. This was a large position and cost us 1.5% this quarter.

The biggest winner was once again Flexshopper (FPAY / FPAYW) which I wrote a follow up article for. If someone wants access to my articles, just ask. We won 7%. Up here the risk:reward doesn't seem great anymore so I will quit the position soon. There is still an edge but this doesn't fit the profile of companies I normally go long.

The next biggest winner was Grupo Aeroportuario del Centro Norte (OMAB), an owner/operator of Mexican Airports. Airports are strong monopolies since there's generally one per city. They charge high retail rent because foot traffic is so high. Most of the business comes from the Monterrey airport which has 65% utilization. The rest of their airports have 20% utilization. Low utilization means the business can grow without much additional investment. People continue to travel more which is a nice tailwind. The main risk is political/regulatory but the government just extended concessions for at least another 5 years. I'll hold this long term, hopefully forever. We won 1.5% and this is a medium position.

Short:

We're up 5% on the short side. Many shorts spiked hard with the market this quarter plus I made a mistake. However, enough things went incredibly well that we still had a great net result.

The mistake was Nio (NIO). They're a Chinese electric car company that loses \$74,000 for each car sold. Pause and think about how insane that is. They have posh stores called [Nio Houses](#) where customers hang out on the investor's dime. These and the cars look nice but the economics aren't there. The company loses about \$1.5 billion per year. The credible CFO recently left and was replaced by a low level analyst. The stars are aligned: in the medium term, Nio will most likely go out of business. The problem is that this bet is too obvious. Short sellers have to pay 60%/year for the privilege of shorting NIO. For comparison, for many shorts I'm actually paid 2%/year². To successfully short NIO, someone has to get the timing right, not just valuation. Mistakes are unforgiving with this high borrow cost.

The mistake I made is that Chinese companies do not play by the same rules as US ones. Q3 results were released three months late. That whole time I thought they had no cash. But it turns out they closed a \$100m loan in Q3 - about a month's cash burn. They've hinted at securing another loan in Q4. That's unclear, too. Companies are required to update investors when they complete new financing. However, I doubt regulators will do anything. Bigger picture: China's GDP supposedly doubled last decade but shares of their large cap index somehow [traded flat](#). That doesn't make sense, either. I think it's best to stay away from Chinese "investments". Lesson learned. We lost 7.5%, half of which was through

² Shorting is market based. When few people want to short a company, you only have to pay .25% interest to borrow the shares. You then sell them to someone else, and you collect a couple percent interest on the cash collateral they pay you. For uncrowded shorts, the wind is at your back with this extra 2%/year.

monthly put options where I risked 2% at a time. We won 2% right at the end of last quarter, so really this bet cost us 5.5%.

The biggest winner was Intelsat (I) which I wrote a follow up article for. We won 17%. The news had been getting grim yet the price stayed strong. At the top, I bet 1% that shares would collapse over various time frames using put options. This basket paid 7:1. In addition, I shorted another large position after the FCC chairman decided to run a public auction rather than allow Intelsat to sell the spectrum. Somehow, shares held for a couple hours while the market decided what to do:



That was a stressful couple of hours. Lots of second guessing, discussing the thesis over and over again in chat. “The market really isn’t reacting? Are we missing something?” Thanks to [Grant](#) for the sanity checks. I love working with that guy.

I should mention a few bankruptcy plays that went well this quarter. In all three cases the thesis was incredibly simple, “The company itself is saying they will probably declare bankruptcy and the common shares are probably worthless.” The hard part is finding them.

McDermott International (MDR) which my mentor helped find. +2.5%

Melinta Therapeutics (MLNT) which [JC](#) found. This was a slam dunk. +3%

Dean Foods (DF) which I discovered and my mentor reaffirmed. +.5%

2. Notable Positions

This amusing account gives contrarian left wing perspectives. My initial reaction of course was, "leftist propaganda!" but after mulling it over I think this is partially true:



Existential Comics @existentialcoms · Nov 9, 2019

Bill Gates made his money by extinguishing free software and forcing us to pay him a tax just to turn our computers on. This was only possible because the State was ready to violently enforce his "intellectual property".

He didn't create a computer revolution, he destroyed one.

288 8.9K 29.8K

Existential Comics @existentialcoms · Nov 9, 2019

Zuckerberg made his money in the exact same way, of course – by destroying a free social network. A social network was bound to emerge, what Zuckerberg did was prevent it from following open protocols, like email, so just anyone couldn't set up a server to socialize with anyone.

35 1.4K 6.6K

Existential Comics
@existentialcoms

To say these people added value to the world and therefore "deserve" their billions is absurd. They subtracted value, an enormous amount of value, and stymied progress to seize control and extract wealth. Computers and the internet would be more advanced if they had never existed.

3:05 AM · Nov 9, 2019 · Twitter Web App

With even further thought, I decided I should invest in an operating system.

Our largest long position is currently Google (GOOG) at 10%. The earnings multiple is much higher than I'm normally interested in. However the growth potential, quality of business and difficulty for anyone to compete makes it worth it. They're in two great businesses: operating systems and search engines.

Nobody has been able to compete with Microsoft's Windows (MSFT) for decades. I had to "upgrade" to Windows 10 even though it's inferior to Windows 7. This view is common. For comparison, say a car company made a worse model than last decade. Most people wouldn't buy it. See the contrast with Windows 10? *Why* are operating systems such robust businesses? Companies design their software for Windows because everyone uses it. And everyone uses Windows because it has all the software. That's a convenient, vicious cycle. Microsoft pulls levers to maintain this dominance. For example, new games play optimally with the latest version of DirectX, which only works on the latest version of Windows. People get used to Windows over many years; switching has a learning cost. I like comparing Android to Windows because I think both will play out the same way. Android seems better since people increasingly use phones/tablets compared to PCs. Unlike Windows, people don't buy Android. Instead, Google takes a cut on all software sold in the app store. This seems like a fine way to extract value. I prefer Google to Microsoft because Google's other businesses seem promising to me, plus Google is cheaper.

Search is another wonderful business. I've tried competing engines DuckDuckGo, Yandex and Bing. They yield vastly inferior search results. Google had the best team working on this for a couple decades and continues to optimize. This game is winner takes all - can someone realistically catch up? I doubt it. In addition, my internet marketing friends tell me that ad prices will double in 5 years. That's a nice tailwind. Google has many levers to further increase profitability. Recently on maps I noticed new advertisements. How might they better monetize images? Aren't they working on self driving tech? Et cetera.

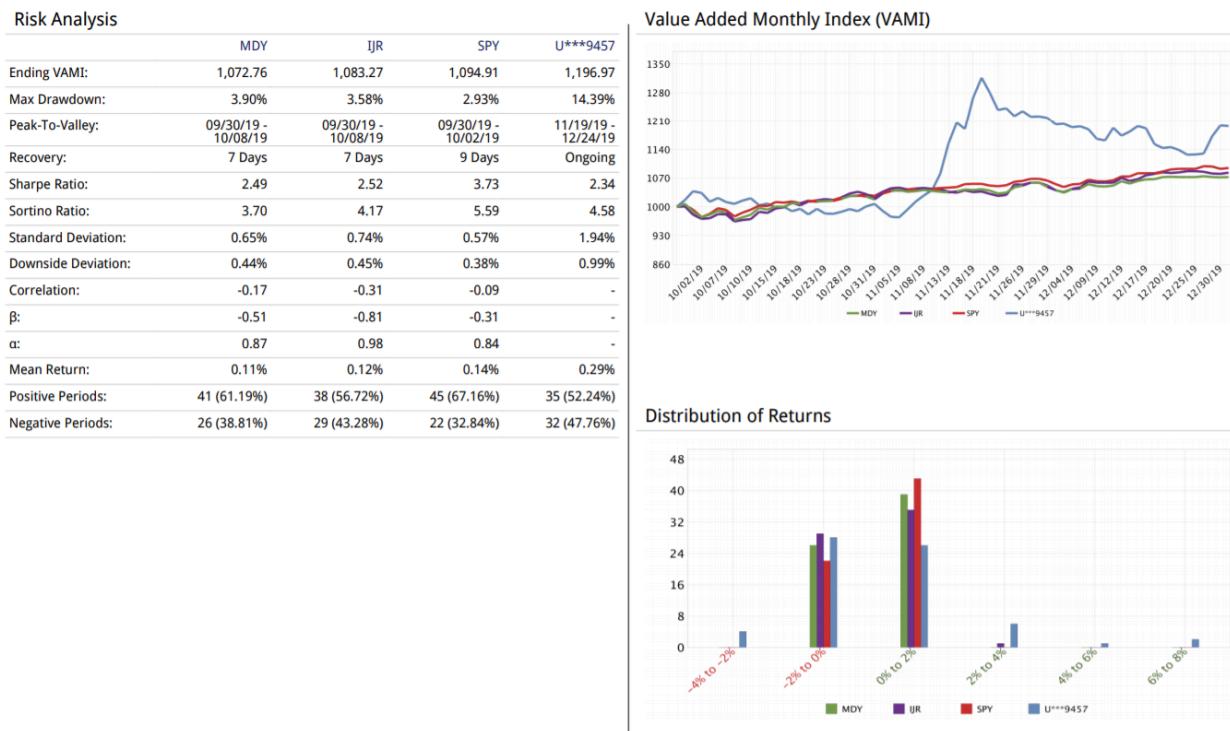
Optimal portfolios should include some hold forever investments. The edge won't be extreme, but the investment is stable with a solid return. Google fits the bill. The only way I'd sell is if it traded up to an obscene valuation like tech companies did in 2000.

Our largest short position is Mallinckrodt (MNK) at 6%. The thesis is simple. They intentionally got millions of Americans hooked on opioids to make a buck. The legal liability is unknown but possibly very large. The high confidence part: it doesn't really matter if Mallinckrodt can win the case or not (though it seems unlikely). Bonds come due April this year and nobody should refinance given the large, unknown risk. There just isn't enough time for the legal issues to resolve over many states. Some bonds

are trading at 40 cents on the dollar which indicates the common stock will be worthless in bankruptcy³. Thanks to [Mako Research](#) for introducing me to this and many other great ideas.

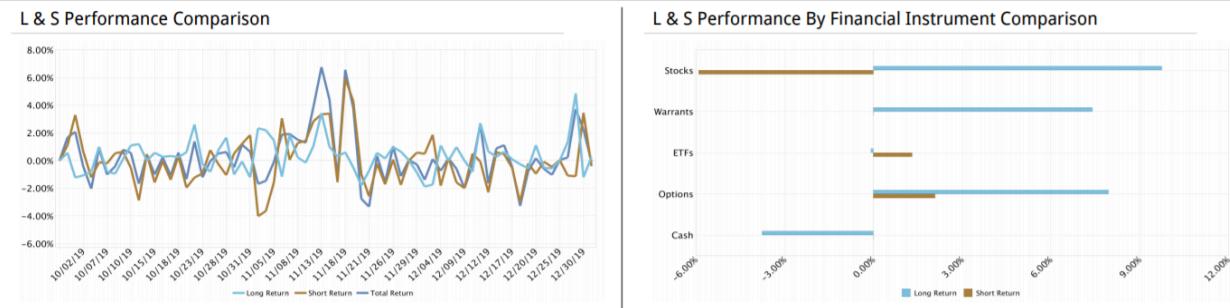
3. Broker Report

Risk Measures Benchmark Comparison



Note: For options, even though it says long return, mostly that is long puts. This is actually a short return. A little confusing.

Performance by Long & Short



³ In bankruptcy, creditors are paid before shareholders. If the market thinks the bonds are only worth 40 cents, they'd have to be more than 150% wrong for shareholders to get any recovery. This seems unlikely.

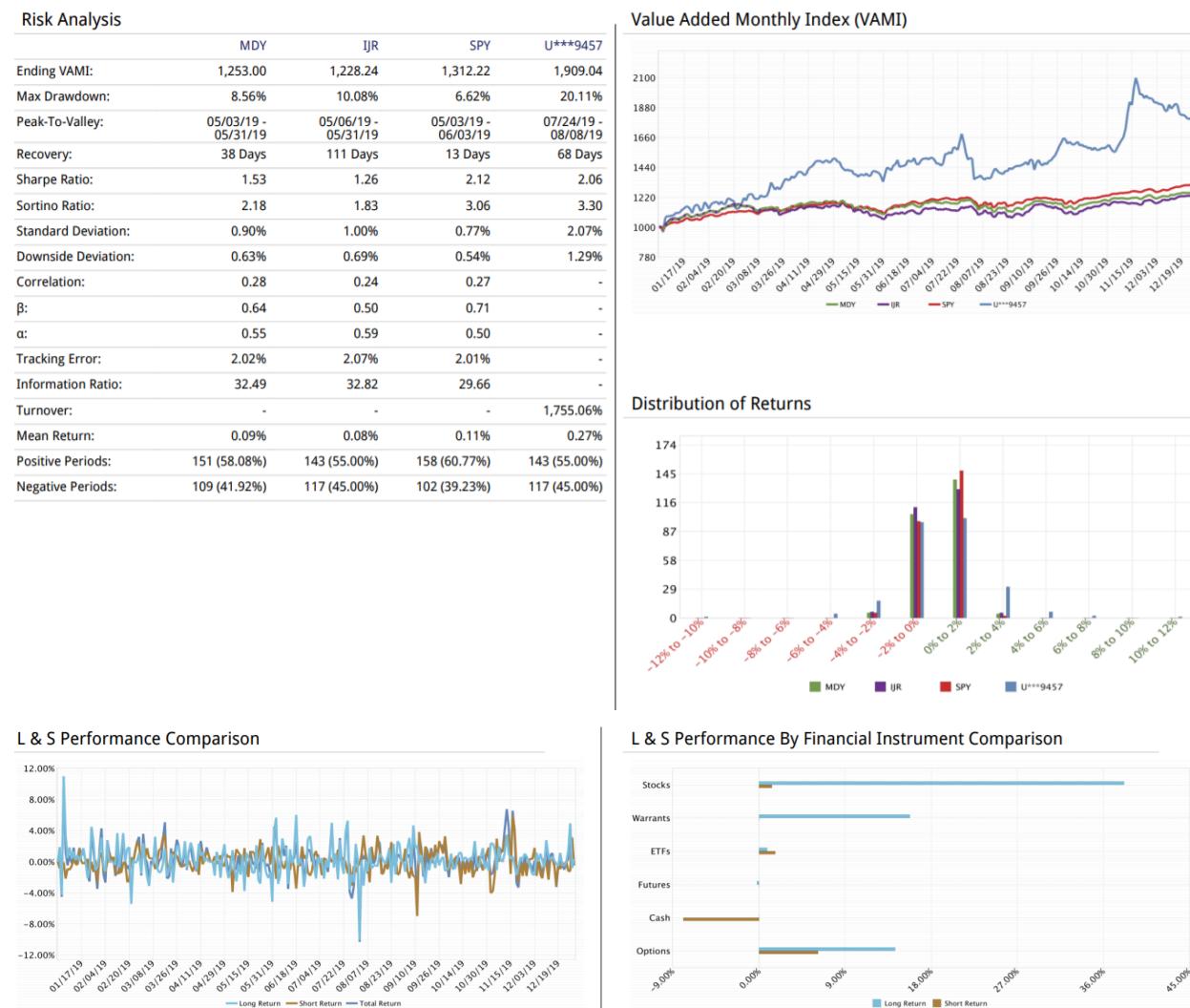
Part 2: Year 2019

1. Full Year Results

SP500: +31.2%.

Fund: +90.9%. Long +58%, Short +21%

I made 400 bets spread over 300 companies. Next year I will make fewer bets as I experiment less. FPAYW wouldn't have fully scaled with a \$10m portfolio, the amount of money I will start a capped fund with. On the other hand, I wanted to short Wework bonds but the minimum bet was \$100k so I couldn't. Adjusted for these factors, I would have made 10% less this year. Smaller accounts have a huge edge. A \$10m portfolio similarly has a large edge on a \$100m portfolio, and so on.



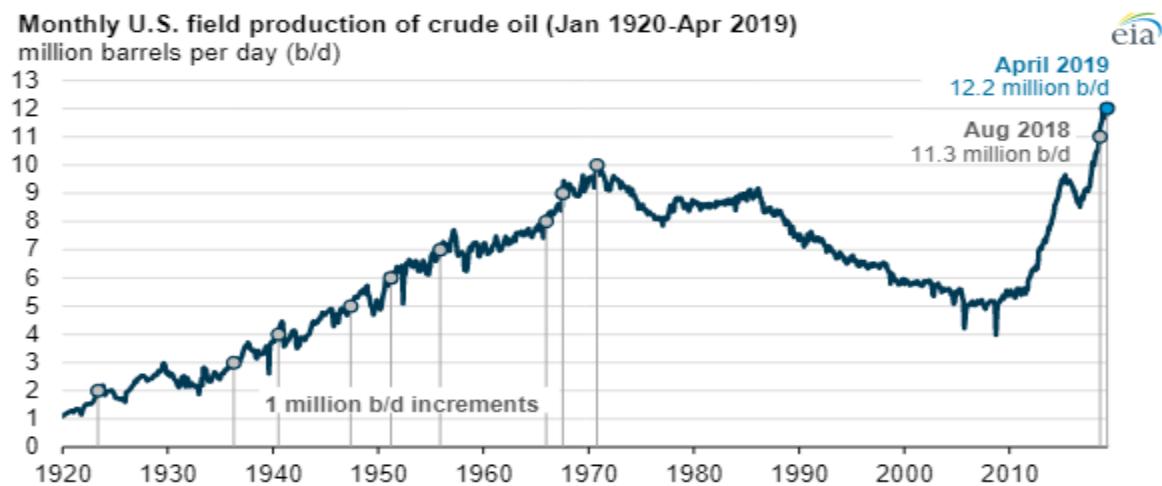
2. The Great Marijuana Bubble and Offshore Oil's Debt Death Spiral

Each quarter I update with the largest drivers of performance. However, some bets play out gradually but contribute a lot to the fund's performance over the whole year. Short bets on marijuana and offshore oil were like that.

Marijuana stocks are a bubble. At its peak, the market cap of North American marijuana farms exceeded \$100 billion. That's a staggering number. 360 million people live in the USA and Canada. About 15% of them use Marijuana, knocking that down to 54 million. [Data indicates](#) that ~10% of users consume about 2/3rds of all marijuana⁴. These enthusiasts might consume \$250/month worth. Do the math and 5.5 million people consume \$3k/year of marijuana for a total of \$16b. If that's 2/3rds of the pie, then there's about \$25 billion of marijuana consumed per year in North America. What's the profit margin on commodity agriculture? Most have ~5% margins so the annual net profit of marijuana farms might be ~\$1.25 billion. Compare that to the \$100b market cap. There are more pitfalls but this is the main thesis.

Last year we made 4% shorting this bubble. I mostly shorted the MJ etf. I plan on selling calls against this ETF throughout this year but the edge will be smaller as time goes on.

Starting in the 2010s the US underwent the shale revolution. Clever people figured out how to extract oil in the mainland USA for \$35-80 a barrel. Production ramped up and somewhere in the mid 2010s OPEC lost its ability to control the world oil price. Prices collapsed from \$100+/barrel to the midpoint of shale extraction costs, about \$55/barrel. This is why gasoline and flight prices got so cheap. US onshore oil output continues to grow and there's probably a 100+ year supply. Other countries might start producing with similar methods. So much for peak oil.



⁴ I've seen similar figures for genetic predisposition to addiction. This is also a pareto distribution, which says that 20% of people do 80% of X. Pareto distributions arise because individuals have different preferences. The more someone likes something, the more they do it.

With lower oil prices, many offshore extraction locations are no longer economical. Many rigs went idle:



Active rigs run just above break even cost. Crew, maintenance, transportation and equipment are expensive. There are too many offshore rig companies; collusion to keep prices high isn't possible. It's an extreme renter's market. Meanwhile these companies are loaded with debt and continue to lose money. Idle rigs rust. Compound interest works in both directions and this is a death spiral.

What could turn things around? A major political event. Something like an Elizabeth Warren presidency where she follows through banning shale oil. I think advisors would explain that oil prices would go to \$120+/barrel and that, no exaggeration, millions of people would die worldwide. I don't think someone actually pulls the trigger on that decision but it's possible with a strong enough green ideology⁵. A major war involving Saudi Arabia is *possible*? Other countries don't produce enough to make up the difference. If such an event clearly occurs, I will switch from short to long.

We made 2% shorting a basket of these companies: NE, PACD, TDW, VAL, DO. I juggle positions a bit. These will take a few years to fully play out, great since I can gradually add to the short as time goes on. I might also catch some nice bankruptcy drops along the way.

⁵ For anyone interested in part of the other side of the green debate, I suggest this post:
<https://lt3000.blogspot.com/2019/11/contrarianism-esg-investing-coal-and.html>

3. Macroeconomic View

It's easy to write about the broad market/economy and sound intelligent, original and contrarian. Many funds market these narratives and successfully raise significant money. If I was in the marketing business like them, this is what I would do. I don't think there's real value, though. I agree with [Peter Lynch's take](#)

"If you spend 14 minutes a year on [macro] economics, you've wasted 12 minutes."

Instead, with these reports I will continue to 1. Focus on specific company/industry investments and 2. Talk a little about portfolio strategy. What I'm writing is exactly what I'm working on most of the time. I believe this focus is what will lead to strong, long run outperformance.

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Thanks for investing with me, I'll continue to do my best.

David Orr