



September 27, 2020

Figures are rounded to save time.

1. Results from June 29th - September 25th 2020

SP500 +10%. Max Drawdown 9.4%

Fund +10%. Max Drawdown 13.7%

During the quarter we were 100% net long and now we're 190% long / 65% short. We're net 125% long because individual companies got reasonably cheap again even if the index seems expensive. At the same time, most governments signal they won't do more lockdowns, which is the substantial economic threat of the virus. On top of that, vaccine news is coming out well plus I think the virus will largely burn itself out in a matter of months.

Here's a grab bag of companies we're long:

- Certain covid recovery plays that were punished too much like theme parks (SIX), airports (OMAB), mortgage insurers (MTG) and retailers (FL)
- Defensive plays like a Mexican poultry farmer (IBA), low earth orbit satellites (LORL), Intel (INTC) and Latin american bottlers (ABEV)

While I agree the virus hits certain industries really hard - airlines, restaurants, hotels, movies, events, oil, etc - it doesn't hit the rest of the economy *that* hard. A subtle point is that if people spend less on these things, they have more to spend on everything else, especially with the government giving away so much money.

Long:

We're up 13% on the long side, losing to the market adjusted for leverage.

The biggest loser was Huntington Ingalls Industries (HII). We lost 1% and this is a 5% position. They make navy boats and so far have remained profitable through covid. People are worried that near term demand for navy boats will drop. I don't know if that's true but I don't think it matters. What matters is medium/long term demand and I think the military industrial complex will continue. HII is 10x earnings while their 7 year [bonds yield 2%](#). Many defense companies are historically cheap; I also considered Raytheon (RTX).

The biggest winner was once again M/I homes (MHO), the home builder I talked about in the previous two letters. We're still long and this is a 9% position. If MHO trades to 10x earnings like other home builders, I will sell out of the money covered calls rather than selling for tax reasons. I cover this strategy in section 3.

The next biggest winner was Ternium (TX), a large steel company in Latin America. We won 2% and this is a 9% position. Steel is a cyclical industry. I value cyclicals by averaging peak versus trough earnings per share. Ternium made \$7/share in a great year and broke even in a bad one, so they'll make \$3.5/year versus today's share price of \$18.7. I think the company is worth at least 50% more. The steel industry isn't *that* competitive if you look at history, which is why long term earnings aren't terrible like mining companies. There are scale advantages in steel. Andrew Carnegie was a famous steel monopolist in the 19th century, an interesting read.

Short:

We're down 3% on the short side, slightly beating the market adjusted for leverage.

Outperformance came from shorting 9 companies through bankruptcy where we won 10%. I mentioned most of these on Twitter¹. Without these bankruptcies - which don't scale in a \$100 million trading account - this quarter would have gone badly. This is a perfect example of the wind being at our back with a small account. This is why I have an edge on more experienced and skilled fund managers. My record will actually get worse over time despite continued learning. This is the key reason investing with new managers is worthwhile.

The biggest loser was Vivint Solar (VSLR). They're a solar finance company. We lost 3% and this is now a 3% position. During the quarter they merged with a larger player, Sunrun (RUN). Investors got *really* excited by this merger for some reason, though I don't see how it matters.

¹ <https://twitter.com/orrdavid/status/1286012031666069505> and <https://twitter.com/orrdavid/status/1271095579964137472>

Sunrun borrows money to install residential solar panels, which are owned by Sunrun. Customers pay nothing up front but have 20 years of payments which are cheaper than utility bills. At the end of the contract, the customer can tell Sunrun to uninstall the panel at Sunrun's expense. Solar financing companies - Sunnova (NOVA) is another - run at large losses under this scheme. Financially it makes no sense, like something out of *Atlas Shrugged*. On top of that, Sunrun uses 35 years for depreciation but realistically after the 20 year contract expires the panel is obsolete. Sunrun's cheapest option at that point is giving the panel away, if the customer even accepts. Because depreciation is 60% of what it should be, losses are even bigger than they appear. Of course that won't show up for another 10 years. Fundamentally, I believe I'm right by a mile.

Shorting this was still a mistake and learning experience. Normally I read comments of bulls to know what they're thinking. Even if a story seems preposterous to me, on the short side you need to know how bulls measure success. It's good if you're looking at the same variable but disagree on the outcome. For comparison, Sunrun bulls don't even mention financial results. They talk in terms of the number of solar panels installed. If that number goes up they consider the company a success. Why? Because the green movement is similar to religion and they think they're saving the world. This religion is gaining popularity. There's also a growing ESG² bubble, which contributed to this run up. This is a perfect example of a company that needs a hard catalyst to short.

I'm sticking with this bet via long dated put options because part of the run up is anticipation of a Democrat victory, meaning more solar subsidies. That's possible but Sunrun is already pricing in a win which means heads I win a lot, tails I don't lose too much. I think the election is close to a coin flip, reflected in the betting market. I plan on exiting the position after the election on either outcome.

The biggest winner was California Resources Corporation (CRC), who went bankrupt. We won 3%. They're largely an oil company in California. Oil is struggling from too much capacity, CRC had too much debt, bonds traded for a fraction of par and California is staunchly anti-oil. I've been following this company for over a year so we previously made money shorting CRC and then we caught this nice bankruptcy drop. Thanks to @walt373 for mentioning CRC a year ago.

2. Notable Long and Short Positions

Besides companies I mentioned previously, our largest long position is Texas Roadhouse (TXRH) at 9%. They are a southern themed restaurant chain that's growing 10% a year without issuing shares. They own a third of their properties and are debt free, so there's no existential risk even with a long restaurant slowdown. Management seems great. The concept is proven and they have plenty of room to grow. I plan on selling long dated covered calls if shares get to \$75 since the company is approaching fair value. Thanks to @JCoviedo6 for mentioning this company back in March.

² ESG stands for Environment, Social and Corporate Governance - "ethical" investing. Michael Moore funded the movie *Planet of the Humans*, which did a good job exposing this for the fraud that it is.

Our largest short is Bed Bath & Beyond (BBBY) at 4%. Their business model is obsolete because there's too much product overlap with what sells well on the internet, which is cheaper and has more variety. The price rebounded from March lows because [home good demand](#) temporarily increased from the pandemic. Despite that, the company had a horrific quarter so it's confusing why investors are so optimistic. There's a narrative that the company is transforming into an ecommerce company, which seems doomed to fail because they have lease liabilities and aren't built for online efficiency like Amazon. I will add to the short after Christmas if shares stay elevated.

3. High VIX, Long Dated Covered Calls and Taxes

Part of my yearly plan is compiling a list of companies for next year's leap³ put options, an illiquid market to exploit with a small account. This year, 2023 put options were becoming available mid-September and I started working on a list in August. However, prices were much higher this year; odds didn't seem stacked like before. This exercise was not worth my time. What did I forget?

VIX is the SP500's implied future volatility, a key variable in setting option prices. Higher means more expensive. VIX averages 18 but has a mode⁴ of 12. VIX hangs around its mode but then an event suddenly causes a large spike and the market takes time to settle. Put another way, the market alternates between periods of order and chaos. Here are the last 15 years:



VIX is a proxy for how expensive options are on individual stocks. All else equal, it's more attractive to sell options when VIX is high and more attractive to buy them when VIX is low. This is why I made a mistake. But this mistake also led to a lightbulb moment: I could focus more on *selling* options when VIX is high, especially if there are multiple reasons to. Higher option prices are often justified during chaos because the future is indeed less clear. But is it for all companies?

³ Leap is jargon for long dated options that come out yearly

⁴ Remember that mean is the average, median is middle-most and mode is the most common number.

Zillow (Z) is a great example. We bought this in April for \$35 a share and my guess for fair value is \$80 a share. When it spiked on earnings up to \$85, I sold June \$100 calls for \$14 each:



There are a few reasons this seems good.

- By waiting 8 months we get long term capital gains on a 140% win. With 20% taxes we win 112%. With 35% taxes, we only win 91%. Tax savings add an uncorrelated IRR⁵ >10% for the entire investment.
- \$14 premium / \$85 share price = 16% return in 10 months if it goes sideways. This play makes sense by itself since the premium is so expensive.
- Zillow is a long term growth story with a binary outcome. Either they disrupt the traditional real estate agent industry, or not. This will take years to play out. Covid is unlikely to impact the final result so options being way more expensive than usual is irrational.

Why did I sell \$100 calls if I think the fair value is \$80? I wanted to leave myself a margin of safety on valuation plus lower strike options weren't much more expensive. Also, stocks bounce around their fair value at random, so there's a solid chance the stock could trade for \$95 in June 2021 even if I'm right.

There are two ways this could go wrong. First, maybe I'm severely underestimating intrinsic value - in which case this is a mistake, though still much better than selling. Second, maybe the market bids Zillow up to \$160 - double fair value - which is just bad luck. I'm okay with losing through bad luck since luck averages out in the long run.

Another couple examples of companies I sold long dated covered calls on are a hospital company (HCA) and a movie theater real estate company (EPR).

Two more benefits of this strategy: 1. You free up some margin and 2. You protect your downside a lot, which is tremendously powerful when using leverage.

⁵ IRR is jargon for the expected annualized rate of return.

4. Detailed Broker Reports

Q: What caused the sharp drop last week?

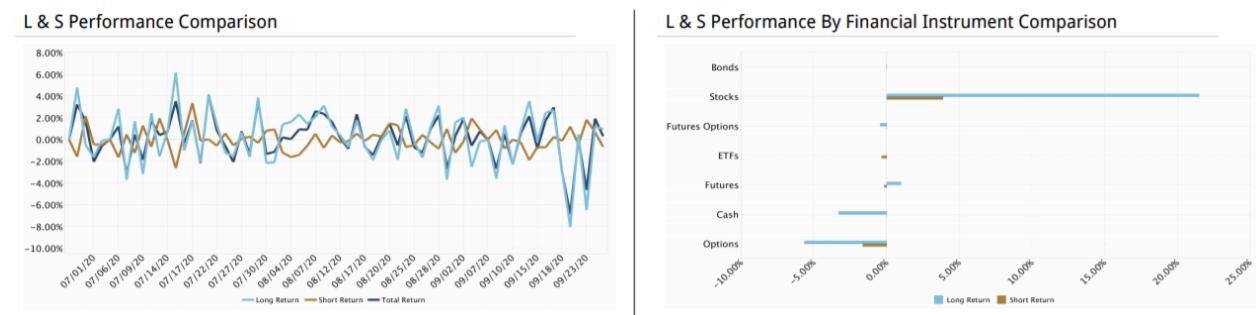
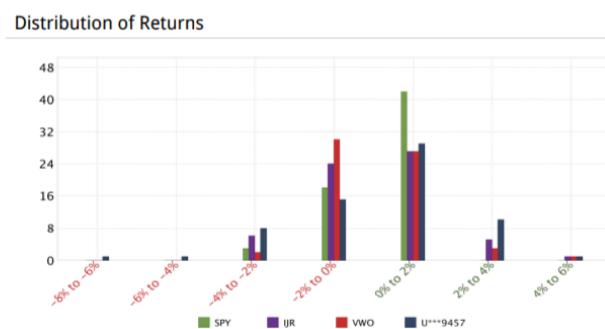
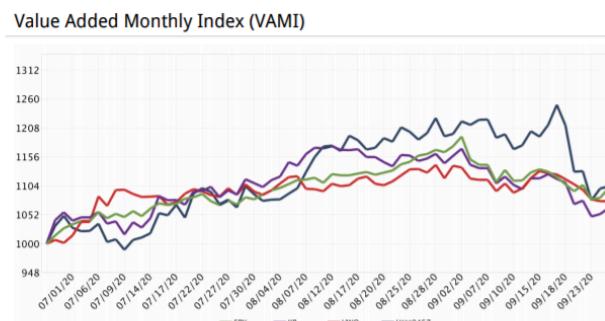
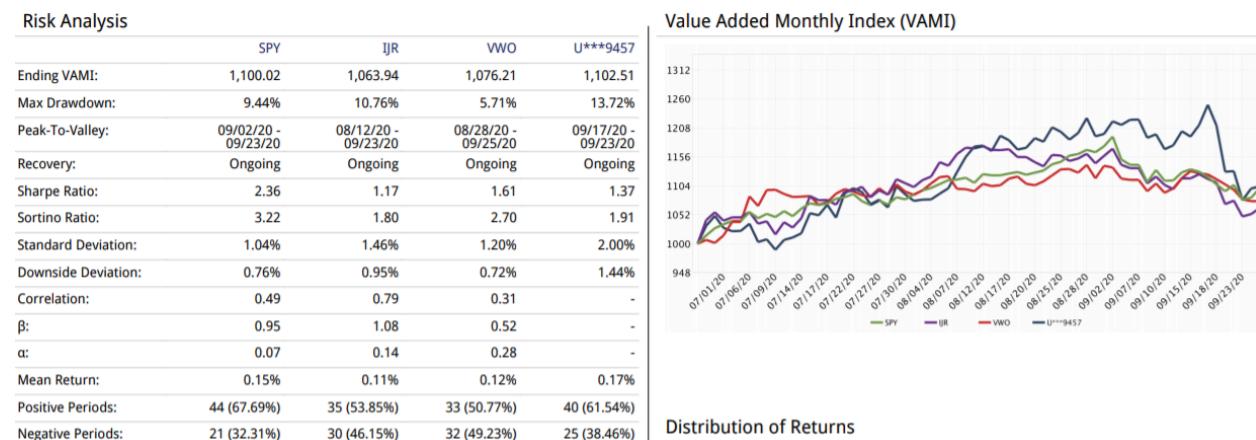
A: I was trying to get fills on long dated put options at a good price in an illiquid market but many didn't fill before the market dropped. Because of this, we had slightly higher net exposure than I planned.

Second, the previous week we raced far ahead of the market while it was dropping which seemed random. It's not surprising we lost some back randomly, too.

I made a mistake. Long dated put options are an extremely effective hedge on a sudden market drop *when VIX is low*. This event taught me that when VIX is elevated, puts act as much weaker immediate protection.

Q: Why is total won in the long/shorts summary so much higher than the quarterly result?

A: I don't know. My guess is that many bankruptcies being delisted caused Interactive Broker's system to glitch out. However, the NAV change indeed matches the Risk Analysis report.



5. Fund Update

There's \$3 million of stated interest including the money I'm already investing. Many said that's just to start, and that they plan on investing more if things continue going well. Several people want to see official fund docs before saying how much they'll invest and others are interested but want to see a bit longer record. I figure the fund will fill suddenly as we near the cap.

Because there's enough interest I'm setting up the fund now. I picked a lawyer. The first draft of the offering documents are complete. I recently picked both an administrator and auditor/tax guy. These people work with each often and have been in business a long time, which makes them seem credible.

I'm conscious of keeping overhead costs low and there's great news. Both the administrator and auditor will charge close to their costs while the fund is small in an effort to win our business long term. All combined, overhead costs will be ~\$20k/year until the fund reaches \$10 million. I don't know the exact timeline for launch since I want to get the details right - I appreciate your patience.

I'm also *really* pleased with the investors I'm attracting. You're mostly professional investors with diverse backgrounds. A couple of you run funds yourselves. This is precisely who I hoped to attract with these letters. I talked with many of you via email or phone and I genuinely enjoyed our conversations. Most commonly, you guys liked my results and approach that I detailed in the fund outline. A few of you commented that you like that I'm focusing entirely on investing rather than marketing, which I will continue indefinitely.

Thanks for putting your faith in me.