

June 28, 2020

Figures are rounded to save time.

1. Results from March 30th - June 26th 2020

SP500 +19%. Max Drawdown 7%.

Fund +63%. Max Drawdown 14.5%.

On Friday, April 3rd we were market neutral because I thought New York City hospitals would be overloaded the following week. However, over the weekend there were only 1/5th of the patients I expected. Moreover, new ICU cases in Sweden were supposed to go exponential with no lockdown but that [wasn't happening](#). On Monday the market started going up and I slipped into mental gymnastics for two hours. I justified our neutral position with all sorts of excuses, that somehow this news was not important. These thoughts made me feel weak¹, like I was being dishonest with myself. That's my tell that my thought process is going off the rails. I recognized what was going on and snapped out of it in time. In fact, this was very good news. It meant the virus probably wasn't nearly as bad as I thought. I switched from neutral to 130% net long² that day. From there, I continuously tracked down cheap businesses to replace holdings as they neared fair value. We stayed 130% long doing this until June, when the extreme bargains dried up. Because the market was moving so much, we had positions in 150 different companies this quarter.

I'm finding lots of great shorts now so we're currently 140% long and 70% short.

Long:

We're up 75% on the long side, more than doubling the market adjusted for leverage.

There wasn't a substantial loser this quarter. A few minor losses came from companies we owned briefly and exited because I found something better.

The biggest winner was M/I Homes (MHO). It started as a 13% position which I trimmed as it went up. We won 10% and it's now a 7% position. I mentioned this company in the Q1 letter. Buying this was indeed like buying homes for 45 cents on the dollar. Turns out that new home sales hardly slowed and, if anything, the pandemic might increase new home sales as people move from inner cities to suburbs and more rural areas - this was not part of my thesis and I was lucky.

Our next biggest winner was Grupo Aeroportuario del Centro Norte (OMAB). We won 4%. It's currently a 9% position. I explained the thesis in the 2019 annual letter. OMAB sold off a similar percentage to other travel stocks even with 1. Less debt and 2. Lower traffic needed to get back to break even. Airlines

¹ A good piece of advice from Jordan Peterson is, "Stop doing the things that make you feel weak."

² 160% long and 30% short.

might break even with ~70% of normal traffic, whereas OMAB might with ~25%. Airlines will lose lots of money before that happens³ but airports won't feel that much pain. At the start of the quarter, American Airlines (AAL) was down 50% while OMAB was down 55%. I love this long/short trade.

Short:

We're down 8% on the short side, in line with the market adjusted for leverage.

The biggest loser was Wayfair (W). They're an online home goods and furniture store. We lost 8% even though I lowered position size to reduce risk on the way up. Our faces got ripped off since the stock went up nearly 10 times from its March low price. What happened? They will have a couple "good" quarters because physical furniture stores were forced to close, online ad prices temporarily dropped and people bought more furniture than normal while stuck at home and moving. Good is in quotes because despite all that, Wayfair will probably still lose money in this period, a testament to how bad the business is. While it's painfully obvious to me that this is a temporary boost, I might have anticipated that this group of investors wouldn't care. Still, nobody could have anticipated it'd jump *this* much, so that part is bad luck.

I found Wayfair when I first started picking stocks. I waited until July last year to go short when I noticed the story finally falling apart. Losses increase linearly with sales. The absolute dollar value of losses became enormous and the company couldn't demonstrate any improvement. Why is this? Think of some qualitative differences with Amazon (AMZN). 1. People log into Amazon routinely to buy all sorts of goods: toilet paper, soap, food, books, electronics, etc while they buy furniture rarely. Amazon's customers are more valuable. 2. Wayfair can't have membership similar to Prime since people don't order often enough. 3. Bezos explains in an [old video](#) that he started by picking products deliberately; ones that sell better online. Is furniture a key oversight? Or perhaps he realized it's not efficient to sell furniture online; shipping costs come to mind. 4. Say that Wayfair somehow becomes efficient. Why can't Amazon just copy it and have a scale advantage - and lure existing customers with Prime? I've got a plan on how to play this short from here but want to keep that private. Right now W is a 2% position.

The biggest winner was Hertz (HTZ), the car rental company. We won 6%. I had been short Hertz for over a year which made it satisfying to watch go bankrupt. I thought the company was plainly worthless the whole time; a speed bump was all it'd take and a pandemic is a hell of a speed bump. They had \$20 billion debt which exceeded their fleet value. It'd be like running a car rental business where you have negative equity in every car. Seems hard to believe that works. They also had negative cash flow even during the economic boom. Ride sharing is becoming a popular alternative. We got to short Hertz three times: The long term short, bigger through the bankruptcy and after the post-bankruptcy short squeeze.

³ American Air is in an awful spot. I still think Delta and Southwest could be smart long bets here, but still inferior to airports.

HTZ - Hertz Global Holdings, Inc.

1.69 0.08 (+4.97%) 4:00 PM 06/25/20

NYSE | Post-Market: \$1.62 -0.07 (-4.14%) 7:44 PM

Summary Ratings Financials Earnings Dividends Value Growth Profitability Momentum Peers

All | Analysis | News | Transcripts | Press Releases | More Headlines



A few other long term shorts went bankrupt this quarter as well. Pyxus (PYX), part of the marijuana bubble⁴. Diamond Offshore (DO), from the demise of offshore drillers. I mentioned these two ideas in my first annual report. Stage Stores (SSI) is a failed retailer that I've followed since I started - unfortunately we didn't have a position as the share price was too low and took up too much margin.

2. Notable Long and Short Positions

Our largest long is OMAB described above.

Our next biggest long is the office chair company Herman Miller (MLHR). These are loved by poker players, the financials are strong, and they're finally marketing to gamers. They got a new 5% loan so it doesn't seem like there's short term liquidity issues. The bet is incredibly straightforward and is an 8% position.

Our biggest short position is Chesapeake Energy Corporation (CHK) at 4%. They're one of many energy companies on the verge of bankruptcy - this one might go bankrupt tomorrow.

3. Oil Madness

Oil price dropped when China's economy shut down in January. It dropped more in March as the virus spread. Then the Saudis flooded the market causing a sharp drop. In mid-April there was a brief mania where folks thought the world would run out of oil storage. Things got really interesting down here:

⁴ Thanks to @walt373 for finding this company.

Crude Oil WTI 39.45 +0.61 (+1.57%)



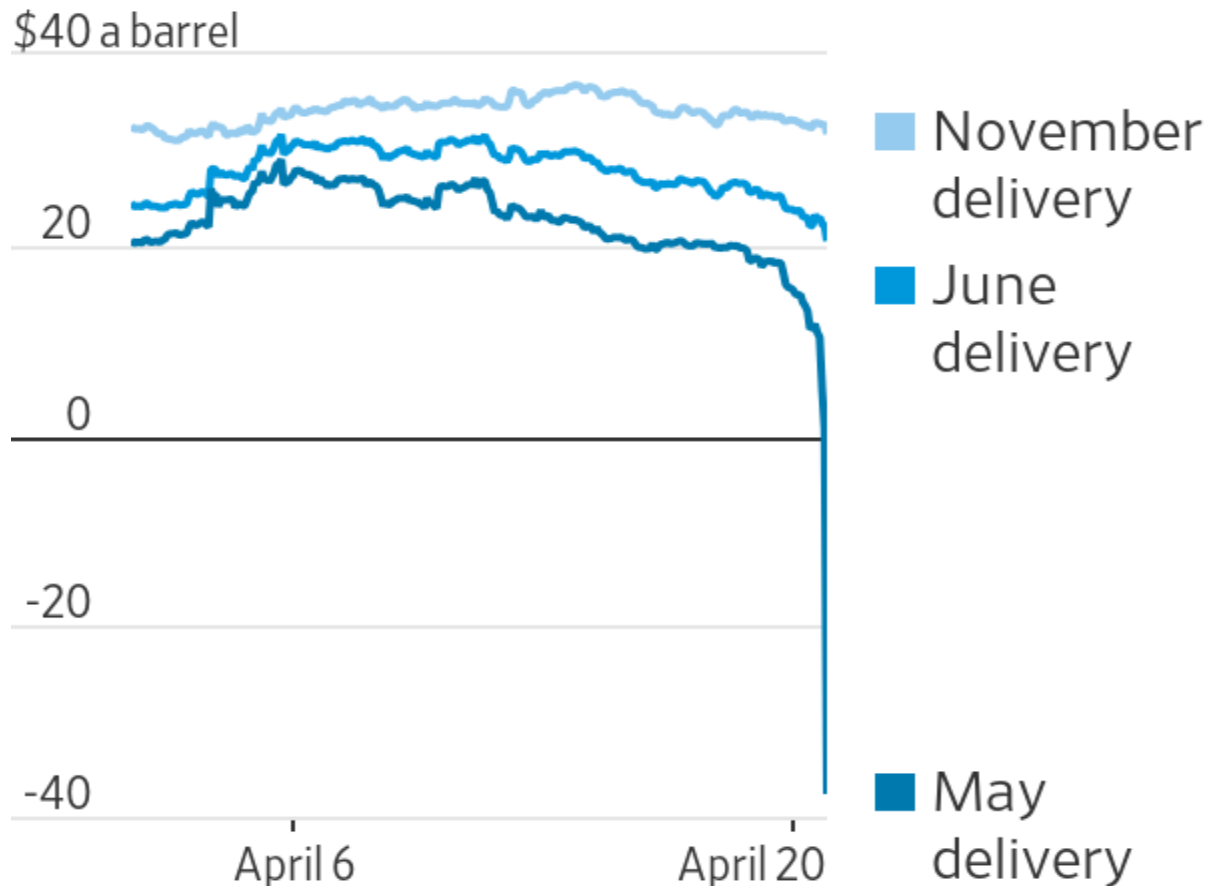
In April, physical oil was trading hands at \$8/barrel while the May futures contract⁵ was selling for \$20/barrel. Once an oil well starts producing it can't be turned off without major cost so owners don't want to shut down. Meanwhile, Cushing was on track to reach full storage in a couple weeks. Because of this, folks thought oil could hit \$0 or even negative. This wasn't clear to me. Near zero seemed possible but there were too many moving parts to bet on it. Some combination of these factors might make that bet lose:

- The EIA claimed that there were months of available storage outside of Cushing. It doesn't cost *that* much to use it.
- People would get creative to store oil and refined products when they're cheap enough.
- Pandemic news came out better than consensus, so demand might return quickly.
- OPEC successfully negotiated a cut *before* May futures settled, so supply was already lower.
- Shale oil wells, 60% of US production, have output that [drops fast](#). Supply naturally drops quickly since nobody starts new wells sub \$40 oil.
- Older, less economical wells would shut in early, also lowering supply.

⁵ WTI oil futures work by setting the price of oil at a specific location (Cushing) and date (monthly).

I didn't see the edge and just watched. However, something unbelievable happened near the May contract settlement: oil hit \$-38/barrel for a single day. While this happened I thought this bet was more lopsided than I originally expected:

U.S. crude-oil futures, by contract



Source: FactSet

Notice in the above chart that June oil was still trading for \$22 a barrel while May was trading for \$-38 a barrel. This made no sense so I made a snap decision to short June oil for a ~12% short term position. I covered the next day at \$12, for a whopping 5.5% win. Here's the June chart the following day:



A couple days later I learned that a huge Chinese fund was a forced seller of the May contracts the day they went negative. -\$38/barrel was not the true fundamental price; this was a market anomaly. The day after that happened, May climbed back into positive territory. And in fact, the true spot price of oil in May ended up being \$27 and June \$37. So this victory was luck but I'm still okay with the thought process. Either May or June had to be far off which presented a brief asymmetric risk:reward situation: heads I win a lot, tails I lose a little.

Another thing that made *no* sense is that long dated oil sold off through this. I bought a 12% position⁶ in December 2021 oil. A vaccine is supposed to come out in '21 which would presumably normalize demand. But ignoring that, it's improbable that oil demand will actually be suppressed for 2 years - I'll believe it when I see it. A key point in this thesis: if almost no new wells are created while oil is below \$40, supply would steadily fall to reach demand anyway. Then if demand suddenly came back some day, with lower supply, oil prices could skyrocket. Less supply in the short run actually helps oil prices in the long run. I plan on holding oil until \$50+, which is close to shale extraction cost. This is still a 12% position.

4. Detailed Broker Reports

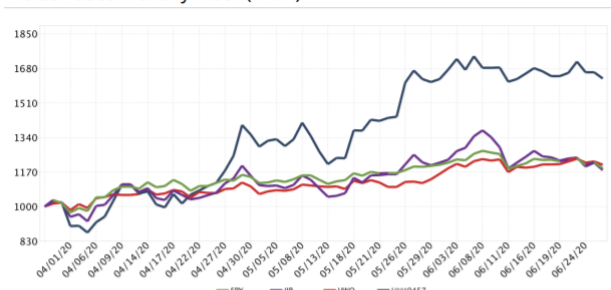
I'm investing close to a million dollars now, the majority of which is close friend's money. So far, I haven't noticed the edge dry up from having a small account except for a few after hours trades and tax optimizing. With a \$10 million account we would have won 3% less this quarter.

⁶ I briefly held a 25% position, but decided that was too big. I'm still mulling over whether lowering the size was a mistake given the asymmetry.

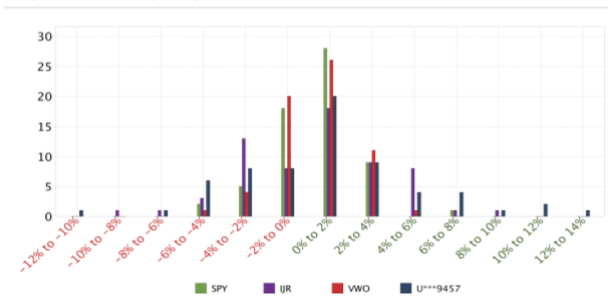
Risk Analysis

	SPY	IJR	VWO	U***9457
Ending VAMI:	1,189.24	1,180.18	1,206.86	1,630.43
Max Drawdown:	6.99%	14.15%	5.15%	14.40%
Peak-To-Valley:	06/08/20 - 06/11/20	06/08/20 - 06/26/20	06/08/20 - 06/11/20	05/08/20 - 05/13/20
Recovery:	Ongoing	Ongoing	8 Days	5 Days
Sharpe Ratio:	2.31	1.51	2.75	3.15
Sortino Ratio:	3.53	2.26	4.24	5.51
Standard Deviation:	1.96%	3.22%	1.75%	4.30%
Downside Deviation:	1.28%	2.15%	1.14%	2.46%
Correlation:	0.68	0.84	0.64	-
β :	1.49	1.12	1.56	-
α :	1.10	1.31	0.97	-
Mean Return:	0.29%	0.31%	0.31%	0.85%
Positive Periods:	40 (61.54%)	39 (60.00%)	40 (61.54%)	41 (63.08%)
Negative Periods:	25 (38.46%)	26 (40.00%)	25 (38.46%)	24 (36.92%)

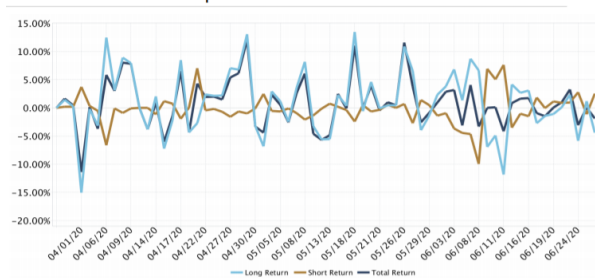
Value Added Monthly Index (VAMI)



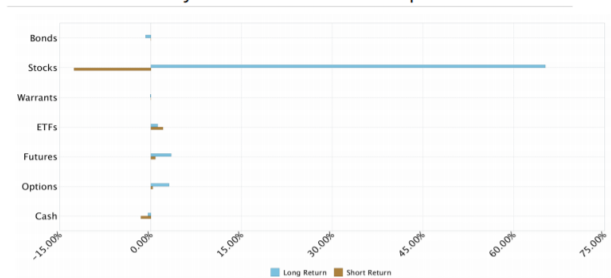
Distribution of Returns



L & S Performance Comparison



L & S Performance By Financial Instrument Comparison



5. Starting a Fund

I'm putting together a fund outline which details my strategy, process, terms, etc. This will be ready in a couple of weeks. Unfortunately, I cannot post this publicly so if you're interested please let me know your email address if you haven't sent it already. Ask any questions you might have, too.
orr.davey@gmail.com

The fund will be very private so these letters will no longer be available to non-investors once we start.