

Idea Brunch with David Orr of Militia Capital

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Welcome to Sunday's Idea Brunch, your interview series with great off-the-beaten-path investors. We are very excited to interview David Orr!

David is the chief investment officer of Militia Capital, a long/short equity fund that he launched in February 2021. According to his most recent investor letter, Militia Capital was up 49% in 2021 and up another 42% in the first half of 2022. Before launching, David was investing in his personal account and returned 171% in 2020 and 91% in 2019. David spent a decade living in Thailand as a professional internet poker player but has recently moved back to the USA.

(If you missed it, our last Idea Brunch was with Dalius Tauraitis of Special Situation Investments and our next one comes out Sunday, November 5.)

David, thanks for doing Sunday's Idea Brunch! Can you please tell readers a little more about your background and why you decided to launch Militia Capital?

My passion has always been playing games, particularly strategy ones. Growing up I played as many as I could and had a natural talent for games of imperfect information.

Poker was having a boom in 2003 when I was in high school. I'd never played before which got me invited to every game. However, I learned fast and after a couple of months there were fewer invitations so I began playing internet poker to fuel my new obsession.

I stopped playing in my second year of university to focus on my studies — majoring in accounting and economics. I went through an internship at a public accounting firm

but due to the financial crisis didn't get a job; the job market was pretty thin in 2009. To avoid moving back in with my parents I played poker again.

A friend was moving to Thailand to teach English and invited me to come since I was working remotely. I ended up staying long-term because internet poker was banned in the USA in 2011. By 2017 I'd played 10 million hands of no-limit Texas hold 'em and it had become a chore even though I was winning at the highest level.

I began reading about markets. They quickly seemed like the most complex and interesting strategy game I'd ever seen. This became my new passion. I also had a lucky connection to my mentor - a professional short seller - who a close friend knew from Caltech.

I had early mistakes but persisted. By the second half of 2018, I was showing an edge. A few friends and fellow professional poker players were following my work and by 2019 they wanted to invest with me, which we did through my personal account. In 2020 folks from Twitter started reaching out to invest and it made sense to launch a fund.

You have an interesting portfolio with dozens of positions including a Latin American steel company, a German airport, and U.S. homebuilders on the long side and a lot of niche bankruptcy plays among others on the short side. How do you come up with off-the-beaten-path ideas in an industry with so much groupthink?

I go through lists of stocks ticker by ticker. I skim the company description and then look at the financials. I consider all factors like earnings multiple, growth, business quality, etc to guess the present value of future cash flows. Most companies seem reasonably priced and I move on in less than a minute but a few percent of stocks stand out which I look at more closely. After finding an interesting company the thesis should be obvious within a couple of hours or I pass. Prices of companies constantly change and cycling into the lowest hanging fruit is my goal, rather than trying to be a genius. I don't want to outsmart the crowd; I want to find the stuff that they overlooked.

I actively avoid groupthink. A few examples:

- I never read the sell-side research that gets linked to me.

- I identify and avoid investing cliques like \$TSLAQ or the traders who focus on shipping.
- Comments are a contra. I often pass even if something seems cheap if too many people on social media agree. The best possible response is no response.

I've also identified independent thinkers who sometimes share great ideas. I'm not so concerned if they have many bad ideas, even. I just like that they're outside of the various echo chambers that are so prevalent today. I don't want to be able to predict what type of company they will invest in, or how they will think about it. Those are the best guys to listen to.

What are some common traits you look for in your investments? What gets you excited about a potential long or short and what can turn you off?

I look for investments where the expected return is 12%/year but I'm okay with lower returns if it's correlated to a short.

The basic equation is simple. Earnings yield plus earnings growth should be 12% or higher. For high-quality companies 12% is fine. High quality means they have a high return on invested capital, or better yet they require no money to grow. For lower-quality companies, I look for 15%+ earnings yield + growth.

From there, I guess if there will be new or accelerating headwinds/tailwinds. This is the qualitative side that computers can't do but is very important. I'm imprecise - modeling margin or growth is a waste of time. Instead, I arbitrarily add or subtract from my expected return estimate depending on how big the factor seems.

Besides catalysts, which everyone knows about but there are never enough of, my favorite shorts are value traps. They're usually uncrowded, don't have extreme squeezes and trend decently to zero. Unlike catalyst shorts, I can often be short for years. I see them as melting ice cubes with only so many quarters until they run out of money.

These are easy for me to find. Most commonly, I find debt death spirals that are almost sure to go bankrupt. In other cases I can see clearly why revenue/margins will keep

trending down - most often it's an inferior business model or product. As their clock ticks down to zero, I can add to the short.

That said, since 2021 I've been focusing more on growth shorts due to extreme valuations combined with fed tightening. I plan to shift back to value traps once this ends.

Your fund seems designed to be hyper-aggressive. Last quarter you were 255% long and 140% short and your fund has a 0.5% management fee and a 25% performance fee for performance above the S&P 500. Can you tell us a little more about your position sizing and risk management on the long and short side?

I run a very diversified portfolio that currently has around 200 positions. Most of my longs are sized around 3%. I have a few larger concentrated bets as well, around 10%. My biggest individual short position is 2% but most shorts are more in the .5% range. I try to make sure that my positions aren't too correlated so that I have true diversification. A third of my short exposure comes from the S&P 500, Russell 2000, and NASDAQ.

High volatility doesn't mix with high gross leverage because after 10-15% drawdowns you're forced to deleverage the portfolio which ends up being a permanent loss of capital even if you're fundamentally right in the end. Having too much concentration increases volatility too much, which is why I run so diversified.

Running with as much gross leverage as I do has real tail-end risk. However, this maximizes my investor's return on equity. Another benefit is that Militia Capital is less correlated to the general market. And with so many more options than a typical portfolio, it's easy to keep realized capital gains low for many years. As long as my investors don't risk too much with me, I'm offering them a truly differentiated fund that they can rebalance out of as they win.

What are two or three interesting ideas on your radar now?

My three biggest longs today are:

- US Home builder, M/I Homes (NYSE: MHO — \$1.06 billion)

- US Natural gas pipelines and terminals, **Energy Transfer** (NYSE: ET — \$35.4 billion)
- Mexican airports, **Grupo Aeroportuario del Centro Norte** (NASDAQ: OMAB — \$2.38 billion)

M/I Homes trades for 2.5x trailing earnings and 50% of liquidation value and they have a low debt to equity. The market thinks higher mortgage rates are a severe headwind. I agree this is a concern but I strongly disagree about the magnitude. It also seems temporary since rates will probably come down someday. There's even a chance that the market is completely wrong - *real* rates are so negative right now that maybe this isn't a headwind at all. So far earnings have been holding up for US home builders and last week Lennar gave us the latest clue with a strong Q4 guidance. This is by far my highest conviction idea since I began investing.

M/I Homes is located in the hottest US housing markets — especially Florida and Texas. I live in Tampa, one of their markets and here it seems like there is genuine demand. I've heard similar views from Militia investors living in Texas and down in Miami. One of MHO's current projects is 10 minutes from me and it's one of the best options. I wanted to buy a unit but bought more shares of MHO instead because the price gap is just too big. Since then, all of the units in that project sold. Raleigh is another one of MHO's markets and there's a [video](#) of a huge crowd showing up to an open house — do they seem like speculators, or people looking for a home to live in?

The most common argument against US housing is that there will be a repeat of 2008. However, *The Big Short* outlines the primary cause of that crisis: There were *zero* lending standards. Literally anyone, or even their pet, could get a mortgage. Given the leverage, this allowed people to gamble and create fast paper profits, which is extremely addictive. This was even rational - the sucker was the bank, which had most of the downside risk. The opposite is true today, where banks won't give loans to anyone without solid proof of income and a good credit score. I was declined a mortgage in 2016 from my longtime bank due to a non-traditional job despite offering a 40% down payment. The government over-regulated mortgage lending standards. I follow mortgage insurers and their standards are rigid, too. And finally, home builders will be overly cautious given that still-recent pain.

Another big argument is that rising interest rates are bad for home prices. I'll point out that builders like Lennar did well during periods of rising rates in the '90s. As rates go up I expect people to shop for smaller homes and/or in worse locations, but ultimately pay whatever they can afford while supply is constrained. I see homes almost as a consumer staple - I joked to some friends, "When your lady wants a house, you get a house." Only higher-priced homes will reach supply/demand equilibrium in the short term. Home builders can just build cheaper homes, which is still a high-margin business.

A final criticism of home builders generally is that they're low-quality businesses. This is a good example of a consensus narrative that's wrong. For example, an equal weight portfolio of D.R. Horton, Lennar, PulteGroup, Toll Brothers, and NVR (five of best home builders) has compounded at 18.5% for the last 25 years.

Energy Transfer trades for around 6x earnings assuming that depreciation overstates the real expense a bit. The business seems almost as predictable as a utility. They have a new tailwind from the Ukraine war since Europe will buy more natural gas from the USA long term. They do have a large debt load, which I consider a downside, but many of the maturities are far out with a fixed interest expense. Meanwhile, Energy Transfer can increase its prices with inflation, which could make Energy Transfer an inflation winner.

Grupo Aeroportuario del Centro Norte trades for 14x earnings and grows earnings >10%/year ignoring covid. Airports are particularly predictable long-term monopolies, although there could be some regulation risks. Business quality is very high since each additional customer costs them almost nothing so extra revenue drops straight to operating income. They probably have a new long-term tailwind from the trend of companies divesting from China and "near-shoring" production.

What would you like Militia Capital to look like 10 years from now?

I want to back a few other highly skilled investors with differentiated strategies and have Militia Capital be a small, multi-strategy fund that can hopefully win most quarters.

Over time I will reduce my gross leverage gradually, probably starting in 2024. This is mostly because running the fund like I am today takes over my entire life and I should have a better balance.

David, thank you for the great interview! What is the best way for readers to follow or connect with you?

My email is orr.davey@gmail.com and I'm [@orrdavid](https://twitter.com/orrdavid) on Twitter.

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