Q3 2020 Investor Letter

Performance & Positioning Summary

For the third quarter of 2020, McLain Capital Fund I, LP returned -6.3%, net, bringing our YTD performance to -17.5%.

For Q3, decent positive attribution from our longs of +5.9% was significantly outweighed by negative attribution from our shorts, -11.9%, despite running a hyper-diversified short book of approximately 90 ~60 basis point sized short positions.

The general underperformance of value through Q3 was again a headwind, but, as in Q2, the much larger detractor was the continued melt-up of speculative securities driven by enormous amounts of flow from retail investors, which is now at levels unseen since the dot-com bubble. Despite our recent stumbles, I remain highly confident in our positioning & risk management and, given the current extremes in markets, I view the current set-up as extraordinarily favorable to our approach going forward.

After rebalancing the portfolio in September, the fund remains defensively positioned with current exposures of 90% long, 63% short, 27% net long. Our long book is composed of 31 securities with no single position exceeding 6% of capital; our short book is positioned across 89 ~70bp sized positions.

Quality businesses with strong balance sheets trading at highly attractive valuations continues to be the profile of our long book, while our shorts generally fall into one of two categories: structurally unprofitable businesses with poor balance sheets that depend on capital markets to fund high rates of cash burn, and story/concept stocks trading at astronomical valuations (generally 20-50x sales).

Market Commentary – Flows over Fundamentals

"What creates opportunities is the fact that most investors and most human beings are constitutionally oriented to buying lottery tickets. When money is going into the dream, it is leaving other areas. It is that tendency that creates the opportunities." Bruce Greenwald

It's no hyperbole to state that 2020 has proven to be the worst year in the past 50 to have run a long/short value strategy.

YTD

	Value	Blend	Growth
Large	-11.6%	5.6%	24.3%
Mid	-12.8%	-2.3%	13.9%
Small	-21.5%	-8.7%	3.9%

Source: JP Morgan (above) & BofA (below)

Investors currently seem to completely disregard many high quality, low-single-digits growth, highly free cash flow-generative businesses as worthless, and view companies with any kind of business perceived as potentially "disruptive" or innovative as priceless. The market's current bifurcation provides a simultaneous abundance of undervalued and significantly overvalued securities, presenting investors that can play both sides of the market with ample opportunity.

To illustrate the former, Molson Coors (TAP) is a high quality business that generates a strong $1.5bln in normalized annual free cash flow and $2.3bln in TTM EBITDA on a mere $4.7bln in net tangible assets and negative NWC needs. With a TEV of $15.4bln and market cap of $7.2bln, TAP is valued at 6.7x EV/EBITDA & provides 21% free cash flow yield – dirt cheap for a high ROIC, acyclical consumer staple business. As a comp to TAP, Brown-Forman, with a similar low-single-digits sort of growth profile as Molson Coors, trades at a rich 30x EBITDA multiple. If Molson Coors was valued at a mere half of the 30x multiple at which the market values Brown-Forman, TAP stock would be trade $120/share, nearly 4x current its current level of $33/share.

The recent IPO of Snowflake (SNOW) provides a great example of the market's current state of euphoria and suspension of sanity. Snowflake's core business is a promising cloud-based data storage and analytics service termed "data warehouse-as-a-service". Having IPO'd last month at vastly oversubscribed level of $120/share, its share price more than doubled the first day of trading and has since settled at ~$240/share. However, with an $85bln fully diluted market capitalization on a mere $400mm in trailing twelve month sales, Snowflake is valued at an astronomical 212x revenue. Assuming Snowflake will, in 10 years, trade at a generous 30x earnings and earn 15% net margins, revenues would have to grow by a factor of 122x for investors to earn just a 10% annual rate of return. Notably, these assumptions would require that Snowflake grow revenues significantly faster than any non-biotech public company has in history - calling that a heroic assumption would be an understatement. We have no current position in Snowflake.

Sentiment for the investment style feels as if it can't get much worse, with notable numbers of publications recently lamenting the "death of value investing" as many had in 1999 & 2000, right before a 7 year stretch of tremendous outperformance.

The market's recent exuberance remains puzzling. Through the past 100-odd years there's no real historical precedent for the current disconnection between markets and the economy. With 30 million Americans still receiving unemployment benefits, we seem to still be quite far away from economic normalization. As recent as the week ending October 2, initial jobless claims totaled 840k, higher than at any point during the 2008-2009 financial crisis. Yet, markets remain eager to look past the current environment and seem to assume a quick resumption of pre-Covid operating performance along with strong growth earnings growth ahead. The range of potential outcomes going forward remains extraordinarily wide and highly uncertain, yet markets appear to be assuming the best-case scenario as a given.

At current levels, the risk/reward for US equities appears quite unappealing. Presently, there appear to be three obvious headwinds for equity returns going forward:

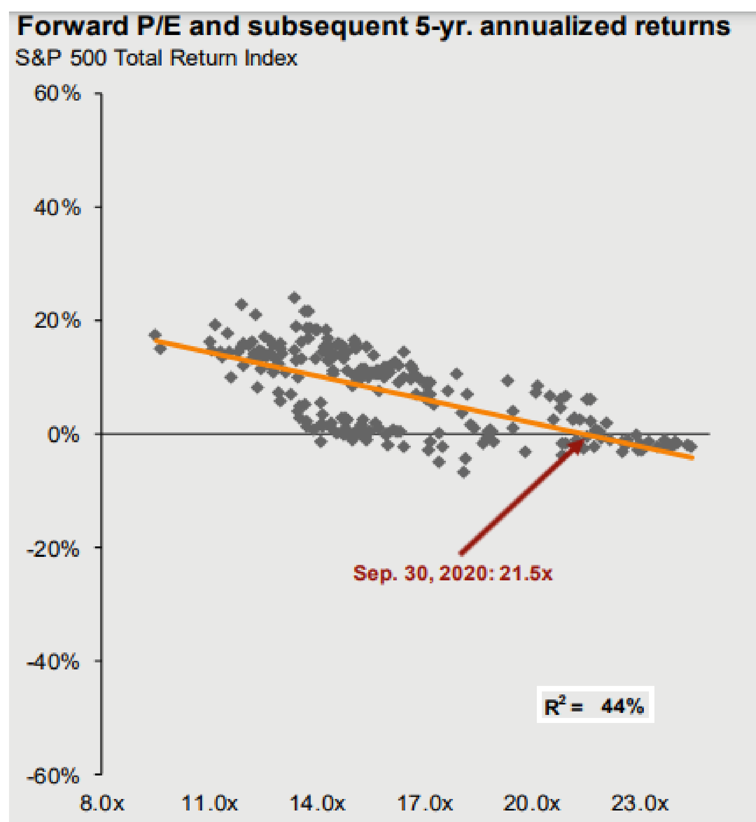
Stretched valuations. Current index-level valuations have only been exceeded during a brief period in 1999-2000; currently, the median US stock has never been more expensive. Even if we use multiples based on 2019 earnings to adjust for COVID-19 impacts, both of these statements still hold true.

Historically elevated profit margins. Based on 2019 earnings, operating margins for US companies stand at all-time-highs and are well above historical norms. Factors such as wage growth, a trend towards deglobalization/onshoring, inflation, and stronger anti-trust enforcement could force corporate profit margins to revert towards their historical mean.

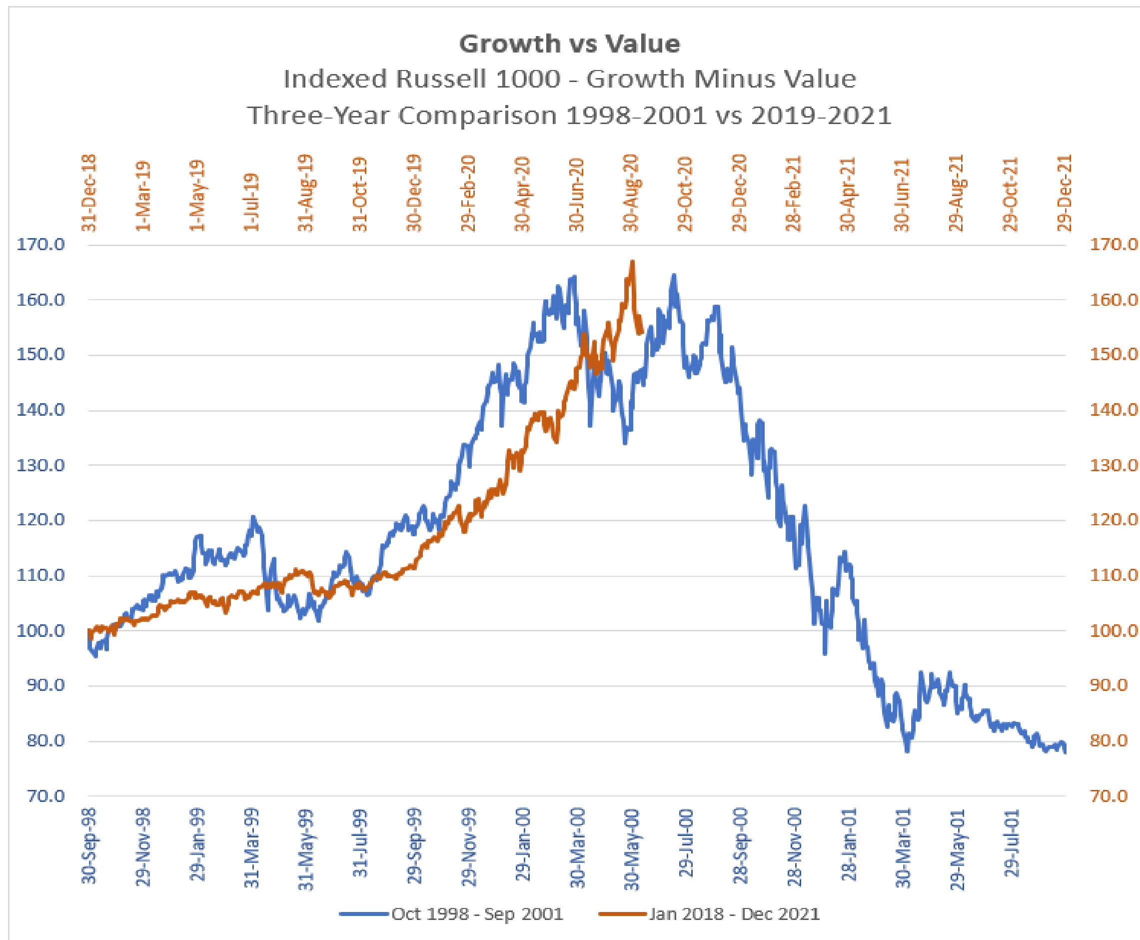
Potential US tax reform. The possibility of a “blue sweep” gives a scenario where higher corporate taxes & closed loopholes would reduce corporate earnings an estimated ~12%. Additionally, proposals that would increase capital gains tax rates to that of ordinary income would likely significantly pressure equity markets.

Investors appear emboldened by the strong trailing 10 year performance of equities which were fortunate to have experienced all these factors in reverse: multiple expansion, margin expansion & tax reform all provided an enormous tailwind for US equities as an asset class.

Let’s assume the following scenario as a reasonable base case to model forward 5-year equity returns at the index level. If we optimistically assume both no margin compression & no tax reform, assume S&P 500 earnings grow at a 4% CAGR from YE 2019 levels (in-line with long-run nominal GDP growth), and assume the market will trade at 17x earnings in 2025, then an investor would receive a return of approximately 4.3% per annum over the next 5 years. This contrasts sharply compared to investor expectations; according to a recent study by Schroders encompassing 23,000 investors, American investors on average expect a 15.4% annual return from their investment portfolio over the next five years.



The market's performance year-to-date obfuscates the extreme divergences occurring beneath the surface. We seem to be witnessing a bear market in many boring, yet quality businesses, and a raging mania in a large number of speculative & unproven businesses – the performance of which seems to be chiefly driven by flows, rather than fundamentals. As investors favor momentum irrespective of price paid, many popular names currently trade at nosebleed levels, while those that are out of favor continue to underperform while trading at bargain basement prices. The presence of cap-weighted index products and quasi-active managers that tightly hug cap-weighted indices have only served to reinforce this phenomenon.



Despite the challenging economic backdrop and employment picture, the enormous amount of speculative trading by retail has remained as the dominant theme in markets through the third quarter. As we outlined in last quarter's letter, the intersection of commission-free trading on gamified trading platforms, social media creating herd-like behavior, & COVID-19 induced stay-at-home boredom has created an unlikely result of 1999/2000 dot-com level excess across large swaths of the market.

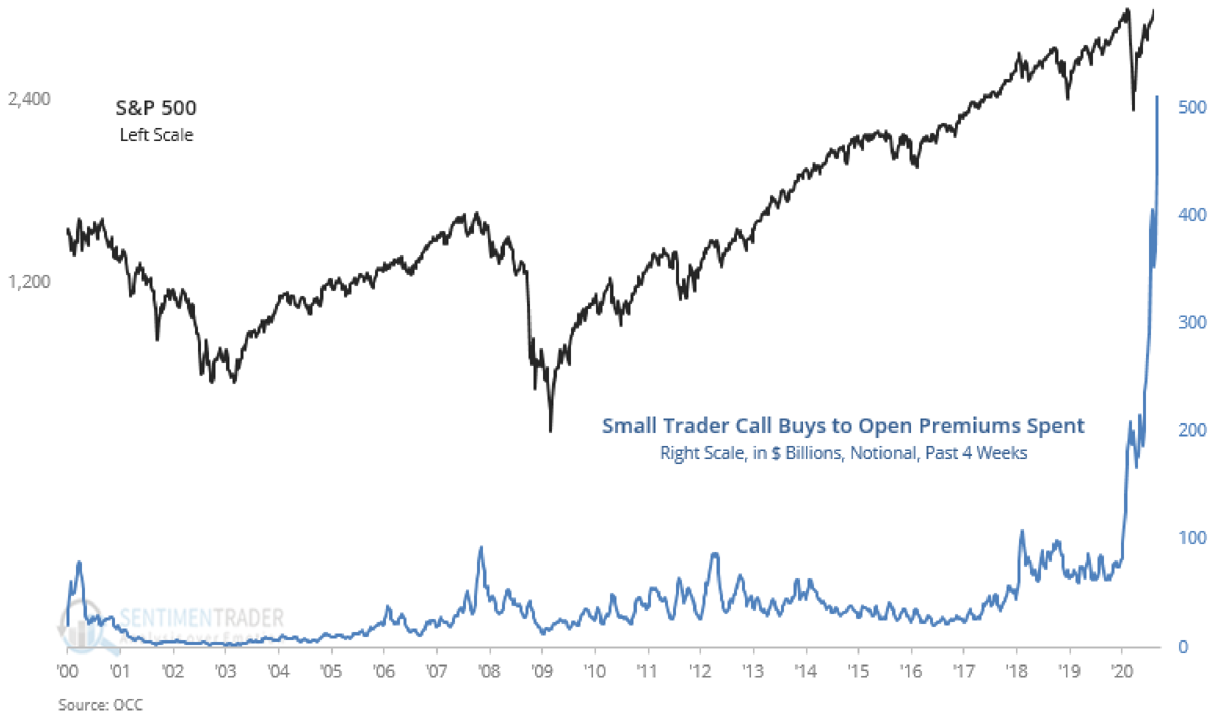
This phenomenon has been a headwind for us in our short book in recent months, but ought to serve as a boon for performance going forward, as high levels of participation by uninformed retail investors creates market inefficiencies where stock prices deviate dramatically outside reasonable ranges of intrinsic value, creating an opportunity rich environment. Retail trading has traditionally represented less than 5% of daily trading volume in a typical year. According to Grant's & Bianco Research, retail traders now account for an astonishing 40% of total volume on the New York Stock Exchange. Notably, these flows have been rather

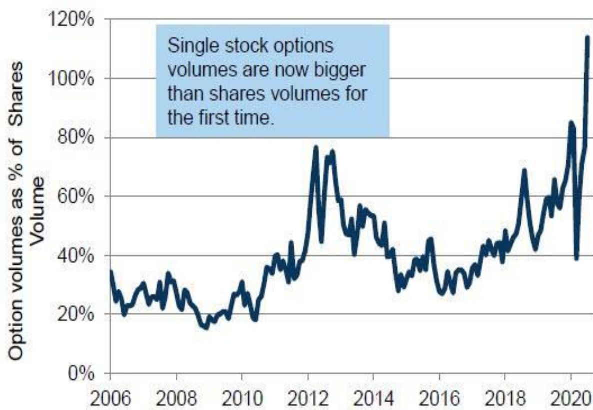
concentrated in a few particular areas: the FANGAM/big tech stocks and speculative story/concept stocks outside of the S&P 500. As we outlined last quarter, these flows have had an inordinate impact on share prices given extraordinarily low levels of single stock liquidity in today's market. A few data points that illustrate the effects of this phenomenon:

- An equal-weighted, annually rebalanced index of small, mid, & large cap NASDAQ/NYSE listed equities (excluding biotech) trading >20x sales would have lost -4% per annum from January 1, 2001 to January 1, 2020. Stunningly, that index of 60 stocks is up approximately +60% year-to-date. For context, the S&P 500 has traditionally traded between 1-2x sales.
- TAN, an Invesco Solar Index ETF, is up a staggering +146% year-to-date, despite being a perennially unprofitable sector.
- A basket of non-profitable tech stocks is up +70% YTD.
- A basket of Liquid IPOs is up +90% YTD.

To quote the accomplished short seller & long-time fund manager John Hempton of Bronte Capital, "This appears to be the most extreme "crap flies" market we have seen in our professional career."

Currently, notional volumes in single stock options stand at ~120% of equity market volume, compared to ~40% in normal years. The retail trading community has recently been spending about $35 billion per week in call option premiums, representing at least $500 billion per week in notional equity exposure by conversative estimates. Importantly, options market-makers are largely on the contra-side of this trade.





The fact that most of the options traded are very short expiration contracts in structure, gives the street a large net short position in “gamma”, which forces market makers to increase their hedge size by buying underlying shares as options deltas increase with rising share prices & vice versa, creating a self-reinforcing feedback loop where buying begets buying and selling begets selling, exacerbating price action in both directions.

Given the short-dated & highly leveraged nature of the instruments favored by investors with only so much capital to expend on call premium, these flows seem unlikely to persist and will likely exhaust themselves under their own weight.

Closing Thoughts

"Our comforting conviction that the world makes sense rests on a secure foundation: our almost unlimited ability to ignore our ignorance." - Daniel Kahneman

If markets are trading at meaningfully lower levels in a year or so, it will be obvious for investors that today's prices and excessive risk-taking were completely untenable, and many of those investments highly regrettable.

Although it's been a challenging year, I'm exceedingly optimistic about our prospects going forward and believe that both our long & short books offer meaningfully asymmetric opportunity.

Thank you for entrusting me with your hard-earned capital. I'm especially grateful for your continued trust and support. Please don't hesitate to reach out with any questions or comments.

Sincerely,

Dave O'Harra

Managing Partner
david.oharra@mclaincap.com