April 28, 2014

Cable Car Capital LLC Q1 2014 Letter

Dear Friends,

It is a great pleasure to write the first of what I hope will be many quarterly letters to you. I plan to follow in a long tradition of investment managers by using this regular opportunity to share business updates, commentary on recent performance, and bits and pieces of my ever-evolving investment philosophy. I will also continue to discuss individual investments and market observations more frequently on Cable Car's website at www.cablecarcapital.com/blog. The tone and content of these letters may vary as I find my voice, but my main hope is to spark a dialogue. Please reach out with comments, questions, and criticism – or just to discuss investment ideas – at any time.

I have been managing personal assets according to a concentrated, hedged value investing strategy since shortly after leaving Porter Orlin/Amici Capital last summer, and Cable Car's investment adviser registration became effective on November 8, 2013. The firm has been steadily adding new client accounts since that date, with most of the initial capital contributed in February and March. I believe it is essential to align my interests with those of my clients. My wife Annie and I maintain the majority of our discretionary investable assets in Cable Car's strategy.

Cable Car currently manages $4.1 million. It feels invigorating to be up and running and on the hunt for attractive investment opportunities!

Performance

The composite, time-weighted return of Cable Car's fully discretionary accounts was +2.4% for the quarter ended March 31. During this period, worldwide equity markets as measured by the MSCI All Country World Index (ACWI) were volatile and returned +1.1% including dividends net of withholdings. Since inception, the Cable Car Composite has returned +6.3% vs. a total return of +5.0% for the ACWI.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov*	Dec	Year
2013											+4.2	-0.3	**+3.8**
2014	-3.3	+3.9	+1.9										**+2.4**
Since inception (*November 8, 2013)													**+6.3**

ACWI is a trademark of MSCI, Inc. Client portfolios are not managed with reference to any particular benchmark, and performance is not comparable to and likely to diverge significantly from the performance of any given index. The above performance statistics are preliminary and unaudited. Returns are presented net of all expenses and fees, including accrued but unpaid performance fees. Cable Car is in the process of selecting a third-party verifier with the goal of claiming compliance with the Global Investment Performance Standards later this year. Approximately 7% of the composite's assets are non-fee-paying.

The Cable Car Composite includes all accounts Cable Car manages on a fully discretionary basis. It excludes a passive portfolio of cash and shares in a broadly diversified holding company managed on behalf of a corporate pension plan. Cable Car manages the pension plan in its entirety, but invests only a portion of the plan's assets in its composite strategy, as ERISA recommends greater diversification. Otherwise, all client accounts are managed according to a common approach. However, it is important to note that the performance of individual client accounts can vary significantly from the performance of the composite. The timing of cash flows, the size and type of account, the fee arrangement, and the availability of investment opportunities for each account may lead to divergence from composite returns. This first quarter's results in particular are less representative due to the timing of initial account funding. In future quarters, when most accounts will have been funded for the entire period, I will reference positions that contributed most to and detracted most from performance.

As an aside, I mention the pension plan in part to highlight Cable Car's flexible approach and ability to accommodate a wide variety of account types. Bringing on a pension client required a few adventures such as obtaining a fiduciary bond and learning the ins and outs of UBTI (unrelated business taxable income), but it was a worthwhile education in an interesting regulatory niche. I look forward to working with new clients to determine the account type that makes the most sense for each set of circumstances.

Portfolio

One of the advantages of a separately managed account structure is that clients have complete transparency into positions and transactions. I encourage clients to reach out with questions or concerns that could help me further evaluate an investment thesis. Cable Car's investment advisory agreement contains customary non-disclosure language, as position details can be sensitive. Although Cable Car is still quite small, it may not always be in clients' best interests to publicize positions broadly. Like most long/short managers, I will be selective in disclosing positions, particularly shorts and positions in less liquid or lower capitalization issues. Short position disclosure will be evaluated on a case-by-case basis.

As of quarter-end, the 5 largest long positions were IntercontinentalExchange Group (ICE), Walgreen Company (WAG), Insignia Systems (ISIG), NetDragon Websoft (777 HK), and Infinity Cross Border Acquisition Corp Warrants (INXBW). Most of these are long-term investments that I will likely have opportunities to discuss in future letters or on the blog. While Cable Car is new, WAG is a good example of a long-term investment. I have followed the company closely since 2010 and met with all levels of management; my prior employers Dodge & Cox and Amici Capital have disclosed ownership stakes at various times. WAG is a classic compounder, and I believe market participants have yet to fully appreciate the transformative impact on the pharmaceutical supply chain of its combination with Alliance Boots and partnership with AmerisourceBergen.

Rather than discuss the rationale for each individual investment, I think it may be more expedient and appropriate for a first letter to outline some expectations for the portfolio. My approach, which I describe as concentrated, hedged value investing, is detailed in Cable Car's brochure and on the website. Accordingly, my goal here is not to write a manifesto on my investment philosophy, but I do want to highlight some features of the strategy and thoughts that are top of mind. In keeping with the theme of using these three bullet points to summarize my approach, there are important performance considerations for each of concentration, hedging, and value investing:

Concentrated – one important consequence of a relatively concentrated portfolio is that it does not have the aim of minimizing variance. Although long/short portfolios in general may have lower volatility than a comparable long-only index, clients should not expect Cable Car's returns to necessarily be of lower absolute value than those of a long-only index in any given period, as the impact of mark-to-market changes in a single large position can exceed movements in the broader market. My goal is to generate absolute returns over the long-run, not to avoid ever having a down month.

Qualitatively, I think about the volatility of the portfolio as being generally lower than overall equity markets in the very short term (e.g. on any given day without significant position news), while it should be higher over time as data and events cause positions to move toward their fair value. If my stock selections prove successful, I do not want to diversify away too much of the positive variance. That being said, protecting capital is equally important. I seek situations with favorably skewed risk/reward dynamics and have established position limits so that mistakes are survivable. I fully expect that even after careful analysis, I will make mistakes. I pledge to be transparent with clients and learn from every investment, successful or not.

HEDGED – Cable Car's short exposure is designed both to benefit from individually mispriced securities and so that clients will have incremental capital available to invest in quality businesses when market prices decrease indiscriminately. The portfolio maintains a net long bias, which means that aside from the impact of concentration just described, the portfolio should be expected to rise less than the overall market in periods of generally rising equity values and decline less during periods of declining equity values.

VALUE – while I make an effort to hedge identifiable risk factors, certain thematic shifts are likely to have a predictable impact on the portfolio. Though I am allergic to the overbroad generalizations popularized by market commentators and don't like to describe the portfolio this way, Cable Car may tend to be long 'value' (defined as low multiple stocks) and short 'growth' (defined as high multiple stocks). For example, some of the portfolio's return in Q1 is attributable to a few higher-multiple short positions declining in price during a broad decrease in the price of 'growth' stocks. Given my general skepticism of hype and preference for long investments that are in some way out of favor, Cable Car may underperform during periods of strong positive momentum.

Despite the 'value' label, stocks with lower multiples are not necessarily undervalued, just as stocks with higher growth profiles are not necessarily overvalued with higher multiples. I will save a detailed discussion of justified multiples for another letter, but to the extent my investments fall into other investors' mechanistically determined categories, asset rotation and other flows can meaningfully affect short-term performance. This is of little consequence to the patient investor, but patience is not always a virtue. While an unjustified decline in price for a long position may present a buying opportunity, an equally investor psychology-driven, fundamentally unjustified increase in the price of a short may require at least partial capitulation to protect capital from unmanageable losses.

I believe shifts in investor sentiment toward entire sectors or asset classes are impossible to predict. As a limited defense against these whims of the market, I have adopted a deliberate agnosticism in my value investing approach. There are many valid techniques for discovering assets below intrinsic value, and some managers focus on just one. This can result in an unacceptably long wait for other investors to come around to one's point of view. Instead, I think it important to have a variety of approaches in the portfolio at any given time: Graham & Dodd "cigar butts" trading below net tangible asset value, misunderstood businesses at low multiples that could mean revert, high-quality compounders purchased at reasonable prices, and special situations arising out of corporate actions, just to name a few. At any given time and in any given market environment, it is hard to say which approach will work, but the odds are better that at least one of them will, providing an opportunity to redeploy capital elsewhere.

The avoidance of dogma is a difficult gospel to preach. While I hope it will not scare away potential capital allocators, Cable Car cannot be easily classified into a style bucket. However, I think it very important to maintain a diversity of ideas in the portfolio.

Outlook

With an eye toward market history, it is somewhat nerve-wracking to have launched an investment firm with the S&P 500 near all-time highs, frothy valuations in some sectors, a bond market with fewer covenants and riskier issuance, and price movements that often seem to be driven by factors other than fundamentals. Yet my agnosticism extends to the direction of the market as a whole. This will not be the umpteenth letter you read that attempts to divine whether the current US ten-year normalized trailing P/E ratio fairly reflects the globalization of corporate profits and the current monetary policy environment. I do not know. I do know that valuations have been significantly higher in the past, and they have also been significantly lower. There are still bargains to be had, but they seem fewer and further between than they were a year or two ago. It feels like a good time to invest both long and short, a good time to try to make money whichever way the market might go.

Cable Car has maintained relatively low net (below 50%) and gross (at times, below 100%) exposure so far this year. That is partly out of caution in the current market environment, partly a reflection of not wanting to sacrifice the quality of due diligence to the demands of getting a new firm up and running, but mostly it is a deliberate attempt to maintain optionality and the ability to be opportunistic. I have recently invested in several shorter-term special situations, some of which have been described on the blog, and I plan to continue to capitalize on similar opportunities, especially for my smaller clients.

My goal over a complete market cycle is for Cable Car's returns after fees to exceed the long-run nominal cost of equity. I look forward to reporting my progress in the years to come.

Acknowledgements

Cable Car would not be possible without the understanding and patience of my incredible wife, Annie. Though I appreciate her role as a thought partner and now primary breadwinner, which she relishes, Annie has also been good humored about the standing desk colonizing a corner of our dining room. Special thanks are also due to each of my initial clients for believing in me and helping me to develop a track record.

I am deeply grateful to my family, mentors, friends, and clients for their support in this venture. If you are reading this first letter, there is a very high probability that you have in some way, shape, or form contributed to my development as an investor. I have learned a lot from my former colleagues, peers, and friends in the industry, and I am indebted to all of you for your guidance and friendship. I note with sadness the passing of Alex Porter, founder of Amici Capital, on April 18. He set an extraordinary example I can only hope to emulate.

I welcome your feedback. Thank you for reading.

Jacob Ma-Weaver

Jacob Ma-Weaver, CFA