September 12, 2016

Cable Car Capital LLC Q2 2016 Letter

Dear Friends,

Cable Car had satisfactory overall performance during the second quarter, but it was often easy to forget while observing current events. Conventional wisdom holds that good investor letters should probably not discuss a manager's day-to-day feelings or dwell on the implications of Brexit months after markets shrugged it off. I do not think I have quite yet earned a soapbox to expound on my personal opinions about political leaders and technology luminaries. Nevertheless, these are the topics on my mind, so please feel free to skip ahead if you'd prefer more directly investment-related discussion.

Performance

The Cable Car Composite returned 4.9% net of expenses and fees in the second quarter. Worldwide equity markets, as measured by the MSCI All Country World Index (ACWI), returned 1.0%.

CCC	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**Year**	ACWI
2013											+4.2	(0.3)	**+3.8**	+3.9
2014	(3.3)	+3.9	+1.9	+1.6	+3.3	(0.5)	(1.6)	(0.5)	(6.2)	+4.7	(1.6)	+5.8	**+7.2**	+4.2
2015	(3.8)	(0.9)	+17.5	+4.6	+24.9	(6.1)	(2.9)	+4.5	(1.7)	+3.5	+1.9	(4.2)	**+38.4**	(2.4)
2016	(5.5)	+5.1	+0.9	+1.6	+5.1	(1.7)							**+5.1**	+1.2
Annualized since inception (November 8, 2013)													**+20.0**	+2.6

Brexit

Markets may have recovered, but I am still in mourning for Europe.

The financial community, if we are honest with ourselves, is composed of privileged economic elites who benefit from the continual progress of globalization, international cooperation, and removal of barriers to mobility and trade. We are culturally and financially predisposed to support the European project. In the United States, the children and grandchildren of immigrants ought to be natural allies of diversity and integration everywhere.

That the immediate market reaction to the United Kingdom's vote to leave the European Union was one of horror is therefore unsurprising. I share in grief not for the unknowable economic consequences, but for the bleak referendum on cooperation with the continent. Europe faces many difficulties; skepticism of the political and monetary structure of the union is no doubt justified, but it takes only a rudimentary understanding of history to understand the motivation for tackling challenges jointly. Brexit does not necessarily imply the end of European integration, and indeed I hope it spurs European leaders to collaborate ever more closely. Yet, from an outside perspective it was unambiguously a step in the wrong direction.

My opinions on controversial topics are not necessarily relevant to Cable Car's investment process, but historical perspective is essential to investing with a long time horizon. I remain agnostic about the nearterm direction of the stock market, but upon reflection, the rapid recovery following a negative world-historical event was perhaps equally unsurprising. In an environment of generally high valuations and low yields, widespread price declines may seem like opportunities to invest at rates of return that are attractive on a relative basis. After seven years of broadly rising markets, this "buy the dip" mentality appears to be a conditioned response to any significant decline. Mindful of the historical cyclicality of markets, I am increasingly anticipating a change in prevailing sentiment.

The immediate impact of the post-referendum GBP depreciation on the portfolio was positive. Cable Car hedged by converting the GBP cash from its net short UK equity position into USD prior to the event, in effect introducing modest net short exposure to the pound. This offset notional long exposure from the continuing Plus500 short position, since Plus500 takes money from clients primarily in USD.

Bucking the global trend of depressing political developments, Belgium became the first European country to outright ban OTC binary option and CFD trading in August.

Know thyself

Brexit was the second major dislocation in 2016 that briefly appeared to herald a Schumpeterian cleansing of bull market detritus. Despite performing reasonably well in the aftermath, your correspondent experienced periods of intense frustration at the apparent irrationality of some of the excesses that accompanied both broad market rebounds, alternating with delight at new short opportunities. (My mood is partly a function of whether the most nonsensical price movements precede or follow the decision to initiate a short position).

I have written before about the critical distinction between the impossibility of avoiding the emotional response to investment outcomes and the separation of natural emotions from investment decisions. I believe self-awareness is one of the most important qualities of a good portfolio manager. It is necessary to identify your emotional state in order to distance your decisions from it. As a result, I make a deliberate effort to be hyperaware of my own psychology. In California-speak, I am very in touch with my feelings and not ashamed to talk about it.

I have recently come to a realization: most of the time, I want the market to decline. Don't get me wrong; Cable Car remains net long, I am a congenital optimist, and I take no pleasure in others' losses. While it would be nice to see fewer successful stock promotion schemes and more attractive equity valuations, I have come to recognize the preference for declining markets as an inherent psychological aspect of managing a long/short portfolio. Cable Car maintains a concentrated book of long positions that are generally long-term in nature, while the short book turns over more frequently and is more diversified.

On a day-to-day basis, I find myself caring more about 'batting average' than returns. In a portfolio with a greater number of short than long positions, more individual investment decisions are likely to appear wrong in a rising market. In a declining market, a greater number of positions are moving in the 'right' direction. When the market declines, a long/short manager can therefore receive stronger external validation, as more decisions seem correct in the moment, than in a rising market where the portfolio may actually be performing better on an absolute basis. The feeling is compounded by the tendency of long/short portfolios to outperform long-only benchmarks during downturns.

Ultimately, position sizing matters and the baseball metaphor is usually extended to point out that being correct on larger positions – 'slugging percentage' – is more important than just being correct. A high hit rate can nonetheless be more psychologically satisfying than generating returns from fewer big calls. To be clear, this desire is only a bias. It may seem like a trivial insight, but since short sellers are often accused of pessimism and a desire to watch the world burn, I submit it as one theory for why many of us will generate the bulk of our returns from long positions over time, while still rooting for market declines.

Incidentally, these thoughts arose despite good results from both the long and short books in the second quarter. Gross return on capital employed in the period was 3.7% on long positions and 9.8% on short positions for the representative account.

The other frustrating aspect of short selling of late is that by seeking out wrongdoing in the marketplace, you really do find quite a lot of it. Some of what I have witnessed in the market this year, especially when combined with political developments, has left me with a persistent feeling of revulsion. Short sellers may start to sound unhinged when pointing out wrongdoing by public figures, but sometimes people really are behaving unethically. Short selling may attract conspiracy theorists, but sometimes stocks really are manipulated. Developing technical expertise in identifying pump-and-dump schemes, for example, can mean witnessing criminal activity on a near-daily basis. That these behaviors are so rarely punished can at times be rather a lot to take. I continue to find regulatory whistleblower programs to be a welcome outlet for some of these feelings.

Of course, markets and Brexit are not the only causes for depression this year. I would not be the first to point out that the level of political discourse in America is concerning. One of the two major party candidates has masterfully managed the news cycle by making as many offensive, controversial, or downright untrue statements as possible. This continually generates headlines in what appears to me to be a fairly transparent attempt to stay in the public eye and distract attention from his eminently more qualified competitor at all costs. Outrage fatigue sets in at repeated lies and misrepresentations, and it becomes difficult to keep track of new misstatements. If this were still the behavior of a public company executive, there would be long-winded and no doubt unhinged-seeming short reports attacking his self-serving and possibly fraudulent business dealings on a fairly regular basis. For a politician, the most appropriate response may be to just not provide the attention he so obviously craves. Better that he not be named.

How to lose friends and alienate people

Speaking of people with a tenuous relationship to the truth, perhaps a different public company executive came to mind as you read the previous paragraph. Lately, when we see friends, my wife takes great delight in teasing me by finding even the slightest pretense to suggest that someone ask my opinion of Elon Musk. I believe the legend of Mr. Musk's visionary genius is greatly exaggerated; I see him as a common promoter who has been unusually successful in raising money by appealing to popular imagination and adopting a willingness to distort the truth. Let's see if I retain any friends in the Bay Area.

Cable Car recently increased its long-standing TSLA short position from immaterial 'bragging rights' size to a more meaningful position. Let me preface discussion by noting that shorting TSLA is unlikely to be profitable as long as the company retains unfettered ability to raise capital. For this reason, I have long viewed the short position as little more than a 'beta' hedge of sorts against a change in the overall market environment. That is still the case. However, I increasingly believe TSLA to be a stock promotion scheme rife with conflicts of interest that is showing signs of having run its course. The recent bond redemption and loss of a lease financing partner suggest that its ability to raise capital may not be infinite. If the SCTY bailout is ultimately consummated, TSLA could risk financial distress in even a minor economic downturn.

I am not going to lay out the full fundamental case against Tesla's valuation, which has been well-established elsewhere. You cannot conclusively disprove a hypothetical. TSLA is one of those widely covered situations where I believe one can add value primarily by interpreting the available data and making portfolio management decisions rather than performing unique analytical work. Indeed, I have deliberately outsourced some of my fundamental work in this case. Online, I follow a small army of analysts who track every development at the company for free. Thanks to a number of smart obsessives, one can easily keep a close pulse on everything from the many unannounced executive departures to new vehicle sales in Scandinavia. Mr. Musk's pledges are extensively documented, both the verbal ones he has failed to keep and the incremental half billion dollars of his TSLA and SCTY holdings he has taken personal loans against since the beginning of the year.

There is a stark difference at law between promotional language in the context of selling a product or service and promotional language in the service of raising capital. As with a certain political candidate, it becomes quite difficult following outrageous statement after outrageous statement to pick a particularly egregious omission or arguably material misrepresentation that justifies a skeptical stance. However inured the market may be to unrealistic forward-looking commentary, close examination of TSLA inevitably reveals something that should cause a reasonable investor to lose trust in the company. TSLA is a popular short, and I imagine each manager had a moment in which it became clear that there were too many red flags to ignore. Maybe it was a particularly pie-in-the-sky production timeline, or maybe it was a non-GAAP accounting gimmick too obvious to dismiss. Perhaps it was too stage-managed a press event, too self-serving a related party transaction, or too self-aggrandizing a falsehood about Brady bonds told to a biographer. Maybe the hagiography in general was simply off-putting enough to peek behind the curtain.

If I had to pick just one recent and under-discussed tipping point, it was the company's defensiveness and misplaced critique of short sellers following the death of a driver while using its assisted-driving software, 'Autopilot.' Never mind that the misnomer may encourage risky behavior; I do not believe the tragic death of a single individual is material to TSLA. However, I do believe publishing a deliberately, if subtly, misleading blog post is. My academic background is in statistics, so I was particularly galled by the company's response, which stated, "This is the first known fatality in just over 130 million miles where Autopilot was activated. Among all vehicles in the US, there is a fatality every 94 million miles. Worldwide, there is a fatality approximately every 60 million miles."

Since so much of Mr. Musk's promotional behavior is excused by fans citing purported genius, he surely must be aware of the apples-to-oranges nature of comparing Autopilot statistics to the safety record of all vehicles, which gives the false impression that driving a Tesla with Autopilot is safer than driving without Autopilot. The correct statistical claim after one fatality in only 130 million miles is that there is not yet enough data to conclude whether driving with Autopilot is less safe than driving a comparable vehicle.

Vehicle age and car class are significant factors in the likelihood of driver fatalities. With an average new car cost of about $33,500 and age of over 11 years as of 2015, the US vehicle fleet as a whole, let alone the rest of the world, is not at all comparable in terms of safety to a brand-new luxury car. The relevant comparison is to driver fatalities for new cars. According to the most recent data available from IIHS, "the overall driver death rate for all 2011 and equivalent models during 2009-12 was 28 deaths per million registered vehicle years. Nine models had driver death rates of zero." Based on the average annual mileage for passenger cars, that is approximately one driver fatality every 400 million miles. Some luxury cars were even safer. The Audi A4 was driven over 1.3 billion miles without a fatality during the period.

Attribution

As of June 30, the four largest long positions were Insignia Systems (ISIG), Retrophin (RTRX), NetDragon Websoft (777 HK), and Pangaea Logistics (PANL). The fifth largest long was a cash shell that Cable Car may accumulate further before disclosure. The largest performance impact by issuer for the representative account was as follows, expressed in basis points (bps) on beginning-of-period assets:

Contributors		**Detractors**	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long RTRX	+521	Long ISIG	(536)
Short EPSC*	+159	Short WRLD	(75)
Short BTU*	+138	Short PLUS LN	(63)
Long 777 HK	+119	Short CDZI	(63)
Long KXM CA*	+37	Short TWLO*	(23)

*Denotes closed positions. Please see important disclosures on the last page of this letter. Attribution includes position-level negative rebate costs for short positions.

Net exposure for the representative account at quarter end was 65% long and 28% short.

Cable Car added to its position in Insignia Systems (ISIG) and visited the company in Minneapolis in June, following a price decline caused at least in part by the actions of a highly fractious board. Cable Car will continue its policy of not commenting publicly on the investment thesis as long as the boardroom drama continues.

Epic Stores (EPSC) was the most profitable short position in the quarter. With the company in liquidation and shares now trading below a penny, it was ultimately closed only because carrying costs exceeded the value of deferring realization of the gain in taxable accounts. EPSC was initially interesting primarily due to paid promotional activity, but upon further research it quickly became clear that the purported thrift store business existed primarily as a way to enrich the principals through a rather appalling scheme to misappropriate charitable donations. Thanks are due to a good friend who first brought the company to my attention and the assiduous efforts of the Interactive Brokers stock loan desk to maintain a difficult-to-locate borrow. Notably, at its peak EPSC had over $100 million in market capitalization, and there were enough shares available to accommodate a similarly sized position for funds up to about $50 million in assets under management.

A few positions in recent weeks have reemphasized the importance of a differentiated ability to locate stock loan inventory as a contributor to returns. In the current environment, there have been numerous opportunities to short objectively worthless 'pieces of paper' at manipulated valuations suggestive of a real underlying business. The difficulty lies in securing a stable, affordable borrow, not in concluding that the security will eventually prove worthless. Two recent examples with liquidity and surprisingly large capitalization include a reverse merger shell consisting of two guys, no revenue, and a vague plan to buy a drone, and a penny stock airport restaurant-cum-app developer with a UPS store mailbox for an office.

During the second quarter, there were several natural resources bankruptcy candidates that presented attractive risk/reward based on careful analysis of the anticipated timing of chapter 11 filings. Year-to-date, Cable Car has held short positions in four such companies that have declared bankruptcy. At least one more appears nearly inevitable by late October.

Short sales were not all successful in the quarter. Shorting Twilio (TWLO) was an unforced error that is expected to make the third quarter's negative attribution table as well. TWLO is a good business, but its customer base includes many venture-backed start-ups, and it seemed an appropriate market hedge. It is a hot IPO that traded so far above the offering price and any reasonable valuation that I mistakenly concluded it would quickly self-correct. In the aftermath of Brexit, it was the closest thing I made to a directional market call, and I got it wrong. Like many high-growth, low-float IPOs, it may become a more attractive short-sale candidate after more shares are distributed to the public following the expiry of the initial lock-up period.

I was also mistaken on the timing of Cadiz (CDZI), a long-running, promoted, and in my view completely harebrained scheme to pump water from a desert aquifer underneath a national monument to communities in Southern California. The project has been blocked at multiple levels of government due to environmental concerns, but after nearly two decades of lobbying, the proponents have achieved a few partial legal victories. That has prompted investor optimism that the project will come to fruition despite continuing roadblocks. Most recently, CDZI managed to insert a rider into an appropriations bill that would reverse an agency decision against the project, but the language is staunchly opposed by Senator Diane Feinstein and is highly unlikely to become law. Congressional schedules make it probable that the bill will not even be considered during the current session, and CDZI faces another liquidity crunch in 2017. When CDZI ran out of cash early this year, I misjudged the willingness of its financial backers to continue pursuing the project without wiping out equity holders. They may not be so charitable next time. CDZI currently trades 30% above the effective price of a dilutive convertible offering over the summer, and Cable Car remains short.

Special thanks to Dhruv Rajput, Cable Car's first intern. Dhruv was a big help to me for a few months before joining Citi in New York this summer.

As Cable Car approaches three years since inception, it remains a one-man shop, though I have become more willing to hire on an ad-hoc basis for individual projects. Sometimes that means I miss self-imposed letter-writing deadlines in order to prioritize research. I apologize for the later-than-usual quarterly update. I will give myself a pass as long as there are positions in the portfolio that have yet to file their financials despite teams of accountants, like a regional bank Cable Car recently began shorting.

I want Cable Car to be around for many years, and consequently have not been willing to spend ahead of revenue. Unlike many of the capital-consuming businesses I criticize, I have the luxury of being able to grow at a deliberate pace. For that, I am very grateful to my investors.

For institutions who would like to learn more about Cable Car, I will be attending Context Summits West later this month and Cap-Intro West in January.

Thank you for reading.

Jacob Ma-Weaver, CFA

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Cable Car implements its strategy in part through short sales and makes limited use of derivatives and leverage. Gross exposure is generally limited to 200% and portfolios maintain a net long bias. Additional disclosures regarding the risks associated with the firm's investment approach are contained in the firm's brochure on Form ADV. The firm's list of composite descriptions and additional information regarding valuation policies, performance calculation, and performance presentation is available upon request.

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 account's base currency, the fee arrangement, and the availability of investment opportunities for each account may lead to significant divergence from composite returns. In 2014, net returns of accounts funded for the full year ranged from 6-10%. In 2015, net returns of funded accounts ranged from 22-55%.

While the composite is benchmarked against the ACWI in order to compare performance to broad market equity returns, client portfolios are not managed to any particular benchmark, and performance is likely to vary from the performance of any given index.