November 7, 2014

Cable Car Capital LLC Q3 2014 Letter

Dear Friends,

Cable Car weathered a volatile third quarter, with performance impacted by mark-to-market declines in several core long positions. Due to the timing of a special situation that was resolved in early October, returns for the four-month period ending October 31 may be more representative of underlying portfolio performance than results as of quarter-end. The pronounced volatility reflects the normal effect of concentration on returns. Although returns in the third quarter were disappointing, I have several milestones to report and remain focused on the long term.

Performance

The Cable Car Composite returned -8.2% net of fees for the quarter ended September 30. Worldwide equity markets, as measured by the MSCI All Country World Index (ACWI), returned -2.3% during the period. No performance fees were accrued in the quarter. For the four months ended October 31, the composite returned -3.9% versus -1.6% for the ACWI. Through October 31, 2014, the Cable Car Composite has returned +3.0% year-to-date as compared to +4.5% for the ACWI. While I see limited value in monthly reporting, I will continue to adhere to the industry convention in the interest of transparency.

The composite ended October with approximately 10% fixed income exposure, 61% net equity exposure, and 125% gross equity exposure on a delta-adjusted basis.

	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	+1.6	+3.3	-0.5	-1.6	-0.5	-6.2	+4.7			**+3.0**
Since inception (*November 8, 2013)													**+7.0**

Attribution

As of September 30, the five largest long positions were Insignia Systems (ISIG), Walgreen Company (WAG), NetDragon Websoft (777 HK), Intercontinental Exchange, Inc. (ICE), and Quartet Merger Corp Rights (QTETR). During the third quarter, the top contributors to and detractors from performance for a representative account were as follows, with contribution to return in basis points (bps) computed on beginning-of-period assets:

Contributors		**Detractors**	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Short MOMENT 11.5%	+138	Long WAG	-296
Short QTET*	+72	Long 777 HK	-180
Long ICE	+68	Long RTRX	-104
Short ONE*	+28	Long QTETR*	-88
Short WRLD	+26	Short ALTI*	-87

*Denotes closed positions. QTET/QTETR converted into shares of Pangaea Logistics (PANL), a current position, in October. Please see the last page of this letter for important disclosures.

Disquisition

This was the first down quarter for the composite. Despite my best efforts, it will most likely not be the only one, so I want to candidly share some thoughts the results brought to mind. I hope to strike the right balance between humility and confidence in asking that you evaluate my performance over the long term.

Considering a long time horizon has me thinking about the oft-repeated notion that there is a difference between *trading* and *investing,* with the former referring to short-term speculation, while the latter is about long-term capital allocation. It is an artificial distinction, but a useful one nonetheless. I have a slightly different interpretation, however. I would unequivocally term what I do through Cable Car *investing*. I am allocating capital in the present in exchange for claims on assets and cash flows in the future. Moreover, it is *value* investing, in that I am trying to identify claims whose market price differs from their intrinsic value. As a matter of basic philosophy, I believe that over time, corporate actions and the realization of potential cash flows cause these claims to converge toward fair value. That convergence creates opportunities to trade, whether through repurchasing claims at a lower price (short positions) or selling them at a higher price (long positions). As this phrasing illustrates, implementing a value investing strategy in public markets necessitates some trading activity. Indeed, by doing my own trading, I sometimes gain insight into supply-demand dynamics that can inform a fundamental thesis.

In other words, trading is not necessarily speculative, just as investing is not necessarily long-term. Most of Cable Car's long positions are intended to be multi-year holdings at inception. Time horizon arbitrage and tax considerations make this a sensible approach. However, while my analysis concentrates on the long-term potential of a company, I would generally be very pleased to have an opportunity to realize fair value from the investment sooner than expected. By the same logic, I will not pass up attractive investment opportunities that I expect to hold for days or months instead of years, with one caveat. In principle, I will not initiate a short term trade that I would not also be comfortable holding as a longer-term investment if necessary. This often means passing up event-driven opportunities at unattractive valuations.

Such an approach can also entail only considering one side of a potential trade. For example, sometimes I observe irrational price increases in stocks with poor or even nonexistent underlying businesses. While I might evaluate taking a short position, I would not even consider owning such a security in hopes of selling to a higher bidder. During the recent Ebola hysteria, several early-stage companies with no connection to the outbreak besides a misleading press release or two were swept up in speculative trading activity. While traders could infer – correctly, as it turned out – that these stocks would rise in price with each new Ebola case, the only fundamentally defensible position was to short or not to participate at all. I held a very conservatively sized short position in one such company before high borrow costs led me to conclude that it would not be a compelling long-term investment. As an aside, I associate high levels of speculative activity like buying 'Ebola stocks' with the late stages of a bull market, but I am not one for trying to guess when the music will stop.

Certain aphorisms are often applied to trading, but they do not describe my experience as an investor. There is a popular image of the ideal trader as an emotionless automaton. I believe this image is inapt. Performance was disappointing during the third quarter, and I felt it. My own capital is invested alongside clients' and I experience loss aversion just like anyone else. While the long-term investor is best counseled not to let perfectly natural emotions cloud her judgment, investors are not immune from normal behavioral reactions to market events. I dare say the best investors embrace these emotions – the pull on your gut when the market is (however temporarily) not validating your research is a valuable signal and a healthy feeling. What matters is how and whether you respond.

Crucially, the essential unemotional response is the ability to recognize one's own behavioral biases, not to avoid experiencing them in the first place. Indeed, knowing the pain of loss should encourage an appropriate level of circumspection in investment selection, with a priority on downside protection. The key thing is having the self-discipline not to let emotional responses lead to unjustified actions. At the end of the day, I pride myself on my ability to experience a full range of emotions while dispassionately deciding if any reaction is warranted.

The price declines in several long positions during the quarter presented an opportunity for reflection. I considered whether I was still comfortable owning a mainland Chinese education and gaming franchise during protests in Hong Kong (yes), and whether the earnings power and growth potential of the world's largest pharmacy enterprise were permanently impaired by contracting missteps and management change (no). I felt disappointment and procrastinated writing this letter a bit, but made few changes to the portfolio.

As the attribution table demonstrates, declines in concentrated long positions can dominate results in the short term. As a long-term investor, I attempt to distinguish the impact of price changes (both positive and negative) due to temporary fluctuations in market sentiment from 'other than temporary' gains or losses that have either been realized or result from significant fundamental changes in the business. Fortunately, most of the third quarter's performance was attributable to mark-to-market losses that I believe are unlikely to be permanent.

777 HK declined 11% during the quarter, even as the company was active in the market buying back stock, and the CEO was quoted in the Chinese press articulating an ambitious 10 billion RMB annual revenue goal within three years for its nascent education business. To put that in perspective, the company currently has sales of only 1.1 billion RMB. I believe the market has yet to ascribe any value to the education opportunity. I attribute the share price weakness to the pro-democracy protests in Hong Kong, where NetDragon is traded, although the protests should have no discernable impact on its operations.

WAG declined 20% during the quarter due to investor disappointment over the company's double whammy announcement of a reduction in its prior operating profit targets and decision not to pursue a tax inversion. Although the new earnings guidance was close to my own base case estimate, I failed to fully anticipate the degree to which other investors had higher expectations. In my opinion, the forecast reduction was mostly unsurprising, with the exception of some avoidable and hopefully one-time generic drug contracting errors. The core earnings power and growth prospects from demographics, private label penetration, international expansion, and continued cost discipline remain unchanged. I added to Cable Car's position as the valuation became even more attractive.

While the ultimate returns of some core holdings may not be observed for years, I also assess myself by the performance of investments with a shorter time horizon. On that score, I was encouraged by the performance of short positions during the period. Short sales generally have a shorter anticipated duration than long positions because high internal rates of return are necessary to justify the higher potential downside risk. Overall, the contribution of short sales net of broker interest was slightly positive in the quarter; effectively, the entire decline in the period was attributable to long positions.

Cable Car also passed a significant milestone on the short side. Two current short positions – Let's Gowex and Momentive Performance Materials 11.5% subordinated notes – are securities that have not yet been cancelled but will likely become the firm's first 100% return short positions. I was in the process of conducting due diligence on the former, unfortunately very small position, when Gotham City's bombshell report exposed fraud at the company. Similarly, I closed a short position in Higher One Holdings (ONE) following the reaction to a market-moving report published during the course of my own research. Although it can be frustrating to be beaten to the punch, it was gratifying to witness another investor influence the share price by expressing a thesis very similar to my own. ONE continues to face significant regulatory headwinds, and I am considering revisiting the analysis following the recent share price recovery.

Also during the quarter, SumZero sponsored the second round of its investment contest, soliciting investors' best short ideas. I was once again named a Runner-Up with my pitch on World Acceptance Corp (WRLD). The full report is available on Cable Car's website.

Taken together, the performance of short positions leads me to believe that I am at least fishing in the right pond with my approach. However, short positions were not all contributors during the period. As mentioned last quarter, I want to be transparent about mistakes, and I learned from one significant error that I hope will be instructive to readers as well. I chose to cover a short position in Altair Nanotechnologies (ALTI) on September 3, an incredibly inopportune time. After the close of trading on September 4, ALTI disclosed the resignation of its auditor the week before; trading was halted before reopening down more than 75% a few weeks later.

ALTI is a nearly defunct battery technology company that became delinquent in its reporting obligations and relocated its remaining assets to China. ALTI experienced significant financial difficulties and management turnover in 2014. I first initiated a short position early in the year when ALTI appeared to be the subject of a pump-and-dump scheme. Shares rose as rumors circulated that ALTI had a connection to Tesla's battery supply chain. It does not. I maintained the position, despite limited liquidity, because the company was scheduled to be delisted by NASDAQ in mid-October, at which time I expected a significant decline in the share price.

Unfortunately, a sudden increase in price and trading volume in early September, coinciding with unrelated news announcements from Tesla, appeared to herald renewed speculative activity in ALTI. Speaking of trying to be dispassionate, I made a risk management-driven decision to cover the position, anticipating that speculators would continue to drive the price up to a better reentry point. In retrospect, my instincts were sound. Shares continued to advance on higher-than-normal volume the following day. However, I could have tolerated some of that volatility. Rather than covering the entire position, I should have covered only a portion, in order to keep position size in check without capitulating on a thesis that remained intact. Although I could not have known that the auditor had already resigned, I was too quick to cut my losses on the basis of price changes. Going forward, I am sizing short positions in less liquid companies such as ALTI even smaller than my previously low limit.

On a more positive note, I want to highlight the Momentive Performance Materials bankruptcy reorganization, which provided a very enjoyable foray into distressed debt investing and another milestone during the quarter – Cable Car's first short bond position. I sometimes find opportunities in bankruptcy proceedings when the potential legal outcomes are known and the risk/reward characteristics of the securities are quantifiable. The subordination dispute that led to the short position mentioned above hinged on the precise interpretation of a three-word phrase in a bond indenture. I indulged my sorely neglected background in comparative literature with an extensive close reading of the relevant legal documents, consulted with a bankruptcy law expert, and ultimately came to the same conclusion as the judge. The one downside was that due to limitations of the bond lending market, the minimum position size was $100,000 in face value. As a result, I was not able to implement the position for my smaller clients.

So far, my long position in the 1.5 Lien notes, which was discussed in detail on the blog, has yet to bear fruit. I believe there remains some hope for increased recovery on appeal, considering the unusual outcome of senior secured lenders recovering replacement notes with a market value significantly below par. Based on comparable securities, at a minimum I expect that once a secondary trading market for the replacement notes develops, they will trade near my cost basis.

Business Updates

During the quarter, Cable Car added its first international account and its first clients with whom I did not have preexisting relationships. I am grateful for your support.

I am very pleased to report that Cable Car now claims compliance with the Global Investment Performance Standards. Please see the disclosures on the following page for more information. Cable Car has hired a third-party verifier, Stonegate International Administration LLC, to examine and verify Cable Car's performance reporting. I believe compliance is an important investment in the eventual institutional marketability of the firm. Now I just have to ensure that there's a good track record to market!

The close of trading today marks the one-year anniversary of Cable Car's launch. I look forward to the years to come.

Jacob Ma-Weaver, CFA

Important advertising disclosures

Please be aware that because this letter is shared with non-clients, it may be considered an advertisement under Rule 206(4) of the Advisers Act. It is therefore subject to GIPS guidelines regarding advertising disclosure and SEC guidelines regarding references to past specific recommendations.

The SEC requires that references to past specific recommendations, including attribution calculations, be based on a reference account and that at least ten holdings be disclosed. Cable Car's largest account serves as the reference account. Detailed computation methodology and a list of all holdings' contribution to the account's performance are available upon request. The holdings identified in this letter do not represent all securities purchased or sold for advisory clients, and past performance is no guarantee of future results.

Cable Car Capital LLC ("Cable Car" or the "firm") is a limited liability company with principal place of business in San Francisco, CA. The Cable Car Composite reflects the performance of the firm's concentrated, hedged value investing strategy. The composite contains all fully discretionary accounts managed by the firm, and it is the firm's only composite. Cable Car claims compliance with the Global Investment Performance Standards (GIPS). To obtain a compliant performance presentation and composite description, contact Jacob Ma-Weaver at jacob@cablecarcapital.com or (415)857-1965. Verification and performance examination reports are also available upon request.

ACWI is a trademark of MSCI, Inc. "The MSCI ACWI Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets." ACWI total returns are presented including dividends net of withholding taxes. Composite returns are presented net of all expenses and fees, including accrued but unpaid performance fees. Returns are expressed in USD.

Cable Car implements its strategy in part through short sales and makes limited use of derivatives, primarily options contracts, 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 feasibility and availability of investment opportunities for each account may lead to significant divergence from composite returns. 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.