November 28, 2016

Cable Car Capital LLC Q3 2016 Letter

Dear Friends,

Cable Car passed the three-year mark on Election Day. The Cable Car Composite returned an even +20.0% annualized return net of expenses and fees in the three-year period beginning November 8, 2013. After three years, a hypothetical $100,000 invested with Cable Car at inception was worth approximately $173,000 before taxes, while an equivalent investment tracking the MSCI All Country World Index (ACWI) would have been worth about $110,300. Satisfying milestone duly observed, you want it darker?

Kakistocracy

Along with the plurality of American voters, I am still grappling with the electoral outcome. Last quarter's letter was almost apologetic in offering a few political observations; this time, what else really matters? Describing Cable Car's accomplishments feels insignificant amidst a potentially catastrophic sea change in American governance. Yet the world hardly needs another anguished assessment of the unpredictable implications of elevating a venal egotist and his cadre of bigots to the presidency. Any response seems inadequate, and weeks later I am still bordering on speechlessness.

To counter the dumbfounding effect of the new political order in which we find ourselves, you will notice this letter makes liberal use of my favorite writer's crutch, self-reference. More on that later. If I cannot express a thought, perhaps I can at least describe the unsuccessful attempt. Not all readers will agree with my perspective, but as I have emphasized in the past, Cable Car's investment process is inextricably linked to my own state of mind. Like it or not, I feel the need to share my thoughts. Consider this letter a personal essay I needed to write. You are welcome to join my oddly public effort to come to grips with intense cognitive dissonance.

Those of us in the reality-based community have certain baseline assumptions about discourse. We take it as a given that words have meaning. Language has the power to persuade, data and facts underpin analysis, and reasoned decisions outperform the emotional. Claims can be validated and accepted or rejected. These assumptions extend to markets, sometimes to an excessive degree. Market participants often demonstrate a distressing credulity when words issue from authority. Not everything a corporate management team says is true! The task of fundamental analysis can sometimes be reduced to fact-checking a company's statements about itself.

However, decision-making on the basis of facts requires an underlying presumption that there exists some objective truth, which can be analyzed, and which will ultimately be reflected in valuation. As any short seller can tell you, this is not always the case. Reason does not always apply to asset prices, and nor do words. An activist can disseminate objective proof of material corporate wrongdoing without affecting the market price, just as a news organization can document a candidate's untruths without affecting the ballot box.

My father's father was a newspaperman. To me, fundamental investing, like journalism, is a pursuit of truth. Investigative journalists and activist short sellers defend society against those who would fraudulently distort the truth for personal gain.

Markets offer a perfect window on the world, and the day-to-day work of investing demands continuous engagement with the news. It has always been necessary to account for potential sources of bias in the media, but content is becoming more difficult to filter. In addition to run-of-the-mill rumor-mongering and stock promotion, we now encounter fake tender offer filings by individuals seeking to manipulate markets. Algorithms have been tricked into trading on outdated headlines resurfaced by content aggregators. Completely fabricated news stories are endemic on social media. The work of truth tellers is never done.

It is no coincidence that the weakening of the fourth estate accompanies a period of significant technological change. The democratization of content generation through the Internet has enabled even the most humble correspondent (ahem) to reach an audience, but it has also created Balkanized echo chambers where objective reality becomes secondary to group affiliation. Technological innovations of the past couple decades will have societal implications that are not yet fully understood.

In past periods of dramatic technological change, arts and letters have reflected economic and political upheaval. Bear with me; I find myself dusting off my collegiate studies of modernism to try to understand our current predicament. The Industrial Revolution and reordering of societies in the late nineteenth and early twentieth centuries prompted deliberate breaks with artistic tradition. The beginning of modernism is sometimes defined as the period in which artistic and literary movements began to engage in self-reference, situating their particular style of expression in opposition to what came before. The recognition of the epoch we inhabit is the hallmark of modernism.

As self-awareness gradually became apparent within literature, from the use of lyrical first-person in German poetry to the advent of stream of consciousness narration, it came at a cost of distancing the reader from the text. The reader is prevented from engaging solely with the narrative and is forced to interact with the author and consider the text as a work unto itself. Bertholt Brecht famously termed his efforts to break the fourth wall in theatre – as recently demonstrated by the cast of *Hamilton* – a "distancing" effect. Narrative distance opened a space for explicit social commentary and stylistic rejection of perceived social decadence.

I'm giving very short shrift to entire schools of academic thought in an attempt to briefly situate the current state of public discourse within its historical context. Taking narrative distance to its logical extreme eventually meant discarding the requirement of readability and allowing for the total alienation of the reader. Artists questioned the confines of reality, particularly amid the incomprehensible devastation of world wars. Dadaists proclaimed the death of language itself. Expressionism gave way to surrealism and abstraction, and eventually to the post-modern rejection of modernism itself.

In my view, the wholesale distancing of language from meaning was dangerous, but it was symptomatic of political change. Modernist writers, especially in Germany, were acutely aware of the risks of a post-truth society. Repeating a lie sufficiently often does violence to language, weaponizing the primary tool of truth tellers against them. Is it any wonder today that falsehoods proliferate most easily in media that mandate brevity? Cultural theorists will no doubt have a field day, if they have not already, with the 160-character SMS, the 140-character tweet, and their apotheosis in the ephemerality of a snapchat.

Perhaps my own difficulties with self-expression are traceable to the investor's constant task of discerning fact from fiction. It is with an eye to history that I am deeply troubled by the financial market reaction to the election, despite minimal direct impact on Cable Car's portfolio. Markets are presently engaged in a dizzying display of doublethink. Mainstream opinion has coalesced around a peculiarly selective reading of campaign statements, anticipating the implementation of a traditional conservative program of tax reduction and deregulation. Markets have risen in the cynical belief that supposedly "pro-business" policies will be enacted, while statements advancing a more inflammatory agenda of trade protectionism, religious and racial discrimination, and open corruption are presumed to have been lies told for political expedience.

Leaving aside the question of whether conservative policies would in fact stimulate economic activity rather than further enriching the most fortunate among us, the market reaction is rational to a certain extent. No statement from a candidate known for dissembling and outright falsehoods can be taken at face value; it is perhaps reasonable to assume that only those proposals favored by the Congressional majority are likely to come to fruition.

Yet words are not so easily dismissed. At least, I continue to presume they still have meaning. The United States has therefore entered a profound period of political uncertainty. I question the basis for any assessment of which of the many campaign falsehoods should be disregarded, and which misrepresentations may have taken on a life of their own by emboldening fringe elements of society.

Masha Gessen, writing in the *New York Review of Books*, says that the first rule of surviving an autocracy is to believe the autocrat. Markets, by contrast, have suspended disbelief. Will the new administration become an autocracy? Faith in some of the very institutions attacked during the campaign – a free press, an independent judiciary, and a pluralistic society – demands the belief that it cannot. These institutions are fragile; their power stems from our collective support. Cognitive dissonance arises from the simultaneous conviction that the words of a political leader carry weight, as do the institutional norms challenged by those words. The patriotic believer in American institutions is left with no choice but to hope many statements are untrue. My profession inspires cynicism and constant questioning of power, but I cannot quite bring myself to express optimism that a presumed voice of authority is lying.

In other words, many observers seem to expect a conventional administration with conventional policy disagreements. While that is of course one conceivable outcome, I struggle to see it as the most likely one. Campaign rhetoric, which one could choose to disbelieve, promises something different altogether. The only reasoned response is to hope for the best, while expecting the worst.

If my reaction seems alarmist, perhaps I can distance a few more readers by dwelling for a moment on my own identity politics. There has been much handwringing about how the embrace of diversity may alienate a supposed silent majority; let me then be among the outspoken minority to declare this unequivocally wrong. I believe America's greatest strength is its diversity of perspectives, but that diversity is actually supported by the relentless intolerance of points of view that would marginalize or persecute. Freedom does not include the right to deny freedom to others.

I am a straight, white male, hardly the first against the wall. That social privilege creates a moral obligation to speak out against discrimination toward groups of people who have historically had and continue to have unequal opportunities and representation within our society. Even in this unrelated context, in an environment where truth seems to be in question, it seems necessary to restate what I thought we all believed to be obvious, accepted principles. Women and men are equal. Religious intolerance is wrong. Immigrants contribute to society. Differences in sexuality, gender, and ethnicity are no basis for discrimination. It would not hurt for our leaders to more actively emphasize these fundamental truths.

I am also Jewish and husband to a naturalized citizen. Members of my extended family are gay. Others are Muslim. Forgive me if I do not share your enthusiasm at the prospect of tax cuts.

One thing I will not miss from the campaign is the omnipresent and misleading quantification of probability. Prediction markets and poll aggregators provide up-to-the-minute analyses of likelihood, given models with imperfect assumptions and data. Though useful tools, they are often quoted with irritating precision. Statistical likelihood, an estimate, should not be confused with probability. The odds that the prediction of a particular model represents the actual outcome, given the data, are not the same as the unobservable probability that that outcome will occur. For example, polling data does not provide any indication of the probability of new information (whether or not true!) changing voter preferences before an election. Prediction markets incorporate speculators' subjective beliefs about known and unknown factors, but suffer from the same behavioral biases as other financial markets.

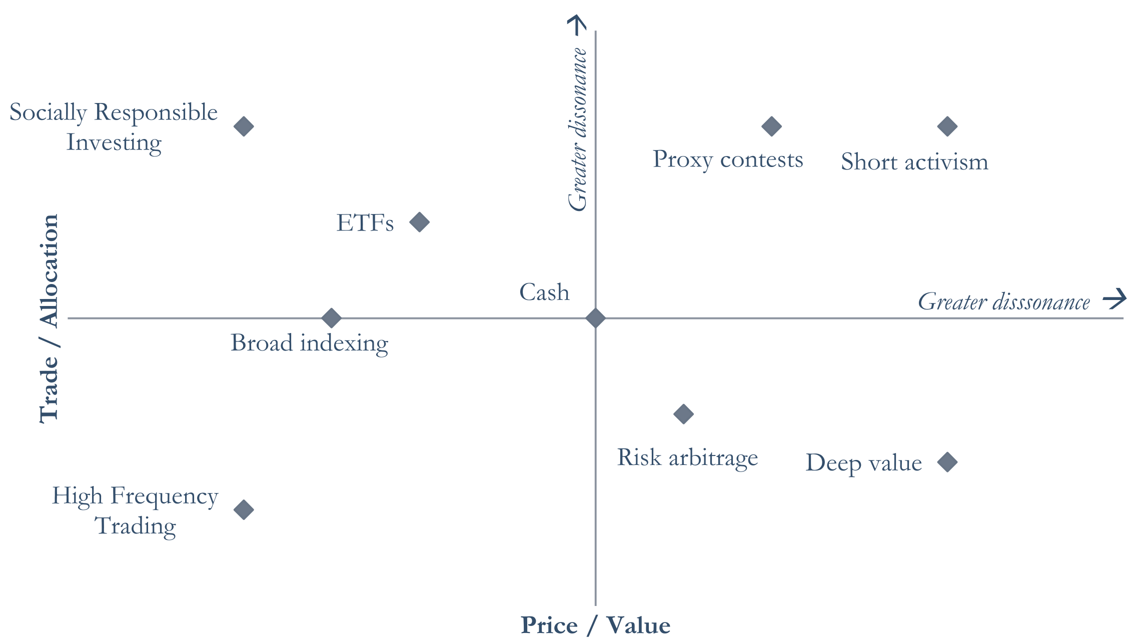
My own pursuit of truth frequently assesses these subjective probabilities. Investors often make the mistake of weighting expectations too precisely in the absence of repeat trials of idiosyncratic events, but it is still possible to state with some conviction that an outcome has become more likely than before, or that one outcome is more likely than another. Clearly, the United States now has greater political risk exposure. Some approaches to valuation would demand a return premium for that. Certain catastrophic outcomes are arguably more likely than they were before, but existential risk factors do not generally enter into my financial analysis. For instance, for reasons of personality alone, nuclear conflict is now substantially more likely (and even if the subjective odds went from one-in-a-million to one-in-ten-thousand, that would be reason enough to abhor the electoral outcome). It is not possible to hedge such a terrible scenario. For the same reason, I am unlikely to ever speculate in shiny metals. If the financial system faced existential threats, it strikes me as quaint to believe in the orderly settlement of futures contracts or safekeeping of physical assets.

Despite the political upheaval, it remains necessary to make decisions under uncertainty, and conclusions can be supported by the available data. I continue to think it foolish to guess the most likely direction of markets as a whole, but there are negative scenarios that I now think more probable than before. There seem to be additional potential transmission mechanisms for a recession beyond changes in interest rate policy and the mere length of the business cycle. Increased political uncertainty could encourage businesses to defer planned investment. Introduction of protectionist trade policies could reduce economic activity. Perceived weakening of securities law enforcement could lead to misallocation of capital to frauds with funds that might otherwise have contributed to the real economy.

If you have indulged me in personal philosophy this far, I will try to offer up something investing-related and perhaps conceptually useful out of these ruminations. Considering big questions of truth reminds me of the constant tension at the heart of investing. There is a conflict in every capital allocation decision; no matter the investment approach, the investor takes the position that the investment activity (or portfolio of investments, in expectation) will be superior to the alternative of leaving capital uninvested. Investment is based on the anticipation that value received, however measured, will exceed the price paid. Yet an investor may or may not perceive the market price to be a faulty indicator of value. Some investors accept market prices as the arbiter of potential return. Others create frameworks to distinguish between price and value, in the belief the two can temporarily diverge. Similarly, an investor may or may not conduct investment activity with any consideration of its larger social purpose of allocating capital to productive enterprise. The decision to allocate to a preferred enterprise resolves a conflict between the existing status quo and a preferred state of the world. Conversely, an investor may trade securities with no regard for how capital should be dispersed in the real economy. Different investment strategies accept varying degrees of dissonance between the world as it is and how it should be, between price and value and between trade and allocation.

I would propose that all investment philosophies can be situated along these two axes of dissonance, the price/value dissonance and the trade/allocation dissonance. On the right side of the axes below are strategies, broadly termed "value investing," that accept dissonance between price and value. On the top half of the chart are strategies that accept dissonance between the current and ideal allocation of capital and actively seek to resolve those differences. I've plotted a few examples arbitrarily, but the extent to which any particular investment within a strategy may fall into a particular quadrant varies. Fundamental strategies may place greater or lesser emphasis on the productive allocation of capital depending on the time horizon of a particular trade. Practitioners of socially responsible investing, who apply a moral lens to each investment decision, may or may not also seek to purchase securities that are undervalued.

Selfishly, I privilege strategies that differentiate between price and value and focus on allocating capital to its highest and best use, but a functioning marketplace can benefit from participants on all parts of each continuum. Quadrant I represents my idealized view of investing and the bulk of my work, though Cable Car also makes trades that do not fall within its boundaries. There are shorter-term trading opportunities where, for example, fundamental value is less important than the price of an imminent capital raise. In other situations, suboptimal corporate actions can nevertheless provide returns; I take a small measure of satisfaction when opportunities arise to redeploy capital from situations on the lower half of the chart into those on the top.



When I look back over the past three years, it is gratifying to have contributed to the savings of my clients. Yet I have no illusions that in the grand scheme of things, my relatively insignificant allocation decisions make any real impact on the economy. With luck, though, that may not always be true. Accuse me of 'Millennial' thinking if you must, but I aspire to make the world a better place, and I want my daily activity to have purpose. In investing, that means meaningful capital allocation, regulatory engagement, and perhaps even this writing. In exigent times, we should all seek to achieve something worthwhile in our work.

If my words have any meaning, know that they are the closest representation I can muster of the truths I perceive. I will consider myself very fortunate if they speak to anyone else.

Performance

The Cable Car Composite returned +9.0% net of expenses and fees in the third quarter. Worldwide equity markets, as measured by the ACWI, returned +5.3%.

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)	+1.2	(0.7)	+8.5				**+14.6**	+6.6
Annualized since inception (November 8, 2013)													**+21.0**	+4.1

Attribution

As of September 30, the five largest long positions were Insignia Systems (ISIG), Retrophin (RTRX), NetDragon Websoft (777 HK), Pangaea Logistics (PANL), and Dell Technologies Class V (DVMT), which notionally tracks the performance of VMware (VMW). 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	+459	Short CDZI*	-95
Long ISIG	+190	Short TWLO*	-62
Long 777 HK	+175	Short SHIP*	-38
Short Company D	+78	Short Company F	-33
Short Company G	+54	Short WRLD	-27

*Denotes closed positions as of the date of this letter. 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 67% long and 30% short. Previous letters have already discussed most of the top contributors and detractors in the period. I will save more detailed analysis for a future letter. There are worse fates than being doomed to profitably buy and sell the same handful of stocks repeatedly.

A few brief comments: RTRX rose during the quarter due to unexpectedly strong clinical data from sparsentan, a potential treatment for proteinuria in certain nephropathies. Company D remains technically insolvent and under SEC investigation. Seanergy (SHIP) is an overvalued shipping concern that has repeatedly demonstrated some of the clearest examples of deliberate market manipulation I have ever encountered. It has unfortunately become prohibitively expensive to borrow. Company F is a Canadian lithium stock promotion scheme that suckered in a few mutual funds and now trades at more than ten times the transaction value of its mineral rights. Company G is the regional bank mentioned in last quarter's letter.

The only trade Cable Car made in direct response to the election results was to cover the entire position in Cadiz (CDZI), discussed at length in a recent blog post. While I believe Cable Car paid more to purchase CDZI than the equity will ultimately be worth even if the proposed water project is constructed, the decision to cover was an example of decision-making under uncertainty described earlier. The most likely attitudes of incoming Department of the Interior appointees and the increased importance of other policy priorities to the opposition substantially increase the likelihood of the project being built. Even in the absence of legislative change, political expectations will support the company's ability to continue to raise capital. I expect to short it again someday.

By contrast, Cable Car did not adjust its short position in World Acceptance Corp (WRLD). I believe early market predictions of the Consumer Financial Protection Bureau's demise are greatly exaggerated, and a challenge to Director Cordray's authority may be delayed pending a legal process. Even if threatened by the incoming Congress, the bureau still has plenty of time to complete ongoing enforcement activities, which are the work of rank-and-file attorneys as opposed to political appointees. Although doubt has been cast on future rulemaking; if anything, I expect increased political pressure on the agency to accelerate the timeline for the CFPB to bring cases or reach settlement agreements with companies it has already served with notices of potential legal action.

Thank you as always for reading. I hope to be able to return to more prosaic topics in the next letter.

Jacob Ma-Weaver, CFA

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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.