February 6, 2015

Cable Car Capital LLC Q4 2014 Letter

Dear Friends,

Happy 2015 and early best wishes for the year of the sheep! If September demonstrated the potential risks of portfolio concentration, then the following three months highlighted the potential rewards. The Cable Car Composite finished 2014 on a high note, returning +9.0% net of fees in the fourth quarter.

Performance

Worldwide equity markets, as measured by the MSCI All Country World Index (ACWI), rose +0.4% during the quarter. For the full year, the ACWI returned +4.2% in dollar terms including net dividends. The Cable Car Composite returned +7.2% net of fees in 2014 and has returned +9.9% annualized since inception, 270 basis points above the ACWI. While I was pleased to exceed this benchmark in Cable Car's first full year, ACWI returns are presented for reference only and are not reflective of my investment approach. I expect results will continue to be volatile and caution that they should be assessed over a long time horizon.

The composite ended the year with approximately 10% fixed income exposure, 70% net equity exposure, and 133% 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	-1.6	+5.8	**+7.2**
Annualized since inception (*November 8, 2013)													**+9.9**

I have been asked by several newly established and aspiring fund managers about the relative merits of managing separate accounts as opposed to a pooled vehicle. While I am a big fan in general of the transparency and flexibility of separate accounts, one characteristic that is important to emphasize in the context of performance reporting is the significant potential for variation in percentage returns among clients. Beginning with next quarter's report, enough accounts should have a sufficiently long performance history according to GIPS requirements for Cable Car to report the variance of account returns.

In the fourth quarter, client returns ranged from +5.1% to +12.7%. Several factors contributed to the wider-than-usual variation from the composite return of +9.0%. In addition to the normal effect of varying tax considerations and fee structures, several positions during the quarter could not be allocated pro rata. Legacy short positions mentioned in last quarter's letter, which could not be implemented for two of the firm's most recent accounts, were marked down the quarter. Certain option positions represented unequal proportions of net asset value for smaller accounts due to the size of a single contract. Additionally, four accounts were adversely affected by the automated allocation of a partial buy-in on a short position in Quarter Merger Corp (QTET) that was intended to hedge the conversion of rights into shares of Pangaea Logistics (PANL). The custodian is reevaluating its allocation process in response to my feedback from the incident. The highest returns were recorded in IRA accounts which cannot hold short positions except through options; these accounts had greater net exposure to the quarter's best performers.

Attribution

As of December 31, the five largest long positions were Insignia Systems (ISIG), NetDragon Websoft (777 HK), Walgreens Boots Alliance (WBA), Intercontinental Exchange (ICE), and Pangaea Logistics (PANL). Together, these five positions comprised 74% of net assets on December 31. During the fourth 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)*
Long WBA	+451	Short EXAS	-252
Long ISIG	+367	Long QTET/PANL	-228
Long RTRX	+327	Long MOMENT 4.69%	-80
Long ICE	+165	Short CVS	-53
Long 777 HK	+119	Short Company B	-50

Please see the last page of this letter for important disclosures.

Volatility

Count me in the camp of investors who believe price volatility is not the same thing as risk. The risk I assess in any investment is the risk of permanent loss of capital, which may or may not be the same thing as the risk of a decline in price. In the context of making long-term investments in public markets, the price at which assets are marked each day may or may not reflect their underlying value. Sometimes a change in price represents a permanent loss; as often as not it represents an opportunity to increase exposure due to the overreactions of other market participants. The first question I ask myself when evaluating a prospective investment is what might be the value of the business in a downside scenario – if my thesis is proven incorrect or external circumstances change unexpectedly, what would be the value of the business? Only afterwards can I ask myself the related but different question: what would be its price?

While one of the challenges of investing is that even this analysis can prove incorrect, I often gravitate toward holdings on the long side such as ISIG or 777 HK that have a notional floor on their market valuations based on the significant asset value on their balance sheets. Of course, with excessive leverage in one's portfolio or an investment that requires further capital, price changes can bring about changes in fundamental value. To generalize, however, I believe that "price" and "value" are independent variables in the short run, which can be expected to converge in the long run.

These thoughts are top of mind as I review the attribution analysis above. The ticker symbols should look familiar. Three of the five largest contributors in the fourth quarter (WBA, RTRX, and 777 HK) were the top three detractors in the prior quarter. In the case of both WBA and RTRX, I took advantage of market volatility to increase my stake in the company, and shortly thereafter was fortunate to have the opportunity to trim my position at significantly higher prices. The Cable Car Composite is down several percent in 2015 as of this writing. However, my level of conviction in the underlying value of several holdings has increased commensurate with the near-term price declines.

Positions

A short position including put options in Exact Sciences (EXAS) was the biggest detractor in the quarter. In October, Exact's stool-based DNA test for colorectal cancer was granted a significantly higher-than-expected reimbursement by the Centers for Medicare & Medicaid Services (CMS), contravening a mountain of cost-benefit research. While I remain short, expecting demand for the test this year to fall shy of what are in my opinion wildly optimistic sellside projections, the reimbursement rate positively affects the company's economics and will likely also be used as a reference point by commercial payers. Regular readers of my blog will recall that I expressed concerns to CMS during the public comment process; I recently followed up with a formal reconsideration request and two inquiries regarding the decision-making process under the Freedom of Information Act. While I am always open to reevaluating my investment thesis and particularly the possibility that my pharmacoeconomic analysis may have been mistaken, I am naturally curious to understand the government's rationale for the payment level that was established. I hope to learn something from the process irrespective of the outcome of the investment.

When it comes to discussing current positions, I am a big believer in the notion of "soft activism" – publishing and discussing my investment ideas with other investors, and occasionally lobbying for specific outcomes as in the case of EXAS. I am generally quite happy to talk my own book once the initial research effort is substantially complete and I do not anticipate changing my positioning in the near term. Particularly for smaller portfolios like my own, raising awareness of investment opportunities among the wider investment community can have a salutary effect on the value of those positions, as long as the analysis is persuasive. I benefit further from feedback and counterarguments from clients and other investors – so as always, please don't hesitate to share your thoughts.

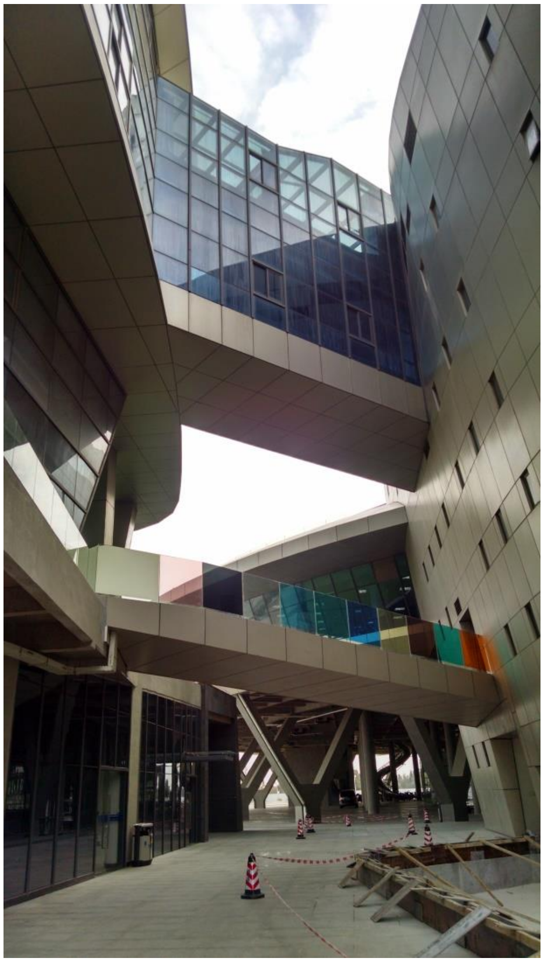
That being said, there are some positions listed in the attribution analysis that I'm not quite ready to discuss in depth publicly as events or my own positioning remain in flux. ISIG is a perfect example, as well as a further illustration of the effect of price volatility on the composite's performance. Cable Car owns 1.5% of the company, and there is a lot I would like to say about it when the time is right. In my opinion, the company's operating business continues to be very attractively priced, even as two activist shareholders engage in a distracting sparring match over an unrelated investment.

CVS is a great business, although I have some skepticism of the integrated PBM-pharmacy model. The short position was intended primarily to hedge market risk relating to the increase in my position in WAG/WBA. Based on my analysis, I also believe the otherwise laudable decision to end tobacco sales in CVS drugstores nationwide (something already prohibited in San Francisco) could lead to a greater-than-forecast loss in pharmacy market share and potential earnings disappointment. I count the position a success despite the decline in value because it facilitated much more aggressive positioning in Walgreens.

China

In January, I spent two weeks in Hong Kong and mainland China visiting family and about a dozen listed Chinese companies. The purpose of the company visits was to expand my knowledge base and perform additional due diligence on NetDragon, which is currently Cable Car's only long position in China. None of the companies I met with generated immediate new investments, but several are interesting candidates for further research and observation. Generally, I think a higher bar for overseas investments with different corporate governance standards is warranted. Trust in the management teams who are the stewards of our capital is an essential ingredient in any long-term investment, and I often find it valuable to meet in person and get to know a business closely over time. From this perspective, I view management meetings as another form of long-term investment, the potential payoff of which is awareness of potential opportunities when market prices adjust.

I will resist the temptation to opine on the state of China's environment and economy; making broad generalizations about China is a fool's errand. Government policy is more heterogeneous and the country is more diverse than many commentators seem to appreciate. While I carefully consider the impact of potential economic outcomes on every investment, I feel similarly agnostic about the likelihood of most macroeconomic developments as I do about overall levels of the stock market. I do not know whether or for how long China's investment-led growth model will remain sustainable, or if policy authorities will be able to smoothly manage the economic transition. However, I believe NetDragon's performance is relatively insulated from changes in infrastructure investment and GDP growth for the country as a whole.



Visiting NetDragon in Fuzhou, the capital of Fujian province, was far and away the highlight of the trip. We spent a full day discussing the company's exciting K-12 online education business and go-to-market strategy, testing a beta version of the educational tablet being developed in a joint venture with Hon Hai, and touring the new headquarters under construction on the coast in Changle. We were the first outside shareholders to visit the new campus, which includes whimsical architecture emblematic of a leading modern technology company – and the scale of NetDragon's ambitions. I promise it did not bias my investment analysis, but we also took a whirl down a three-story outdoor office slide (just visible far in the background of my cellphone photo to the left) that was reportedly also enjoyed by Baidu Chairman Robin Li.

NetDragon is attempting to build the world's first end-to-end online education platform, helping local governments to meet national classroom digitization goals and supporting students, parents, teachers, and school systems before class, during instruction, and with review and testing. It is a difficult and fiercely competitive undertaking, but NetDragon has strong content partnerships, a workable game plan, and an impressive product offering in the works.

Irrespective of the ultimate success of the education business, current trading levels represent one of the biggest disconnects between price and value I have ever seen. Cash on hand plus the recent external valuation of the education subsidiary exceeds the share price, assigning no value for online games or the company's real estate. The gaming franchise remains profitable and recently introduced a hit webgame that I estimate could add 10% to 2015 revenues. I have written extensively about NetDragon elsewhere so will not repeat the entire thesis here, but suffice it to say that Cable Car increased its position in recent weeks.

FXCM

If you've read this far, I'll leave you with a quick thought on my newest short position, Forex Capital Markets (FXCM). FXCM is an online foreign exchange broker that suffered significant losses when the Swiss National Bank (SNB) unexpectedly removed a cap on the value of the Swiss franc, leaving many of its highly leveraged customers with negative equity balances. I was not among the prescient short sellers who identified the risks in FXCM's business model ahead of time, but I am apparently among relatively few investors who have bothered to read the details of the rescue package provided by Leucadia afterwards. In exchange for a $300 million loan, FXCM provided Leucadia with priority claims on a NewCo that now holds substantially all of its assets. Leucadia has the right to force asset sales and receives cash proceeds according to a waterfall schedule that effectively makes FXCM shareholders minority partners in their own business. Leucadia and convertible bondholders receive the first $650 million in proceeds; FXCM shareholders are entitled to only 10% of the next half billion and 40% thereafter. Only a complete rebound in enterprise value to all-time highs before the SNB decision would come close to justifying the current share price of $2.33. By my estimates, the valuation implied by media reports of proposed disposals (and market prices as recently as August) suggests a fair value below $1 per share.

It is hard to imagine that the company's operating business will be entirely unaffected by the negative publicity. The brokerage business requires trust, and despite clear and omnipresent marketing materials promising that margin loans were non-recourse, FXCM is attempting to recover 60% of the client account deficits caused by the SNB move. The decision smacks of desperation and is likely to result in a protracted legal fight, in my opinion. At the very least, it may slow account growth or encourage customer defections. There are already early indications that trading volume on FXCM platform and customer equity have declined sharply in the past few weeks. Meanwhile, I estimate the incremental interest expense on the Leucadia loan will consume more than half of EBITDA.

Welcome to new subscribers from the website – please note that this mailing list is for quarterly letters only. If you want to follow the blog, please use your favorite RSS reader or follow me on Twitter.

To all my clients and readers, thank you for your continued support of Cable Car.

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.

Please note that Cable Car maintains a selective public disclosure policy regarding active short positions that may be competitively sensitive, difficult to borrow, or otherwise unlikely to benefit from broad publicity. Clients retain complete portfolio transparency, and Cable Car will disclose the subject securities to non-clients upon request.

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.