



January 2019

	MRCM Long Short Small Cap	IWM (Russell 2000)	Barclay's Hedge Fund Index
Annualized Since Inception	20.6%	12.3%	5.7%
Q4 2019	11.0%	9.9%	3.5%
2019 Full Year	19.5%	25.4%	10.7%
2018	17.1%	(11.1%)	(5.2%)
2017	37.7%	14.6%	10.3%
2016 (Jul-Dec)	1.6%	18.7%	5.4%

	MRCM Long Only Large Cap	SPY (S&P 500)
Annualized Since Inception	8.4%	11.1%
Q4 2019	6.4%	9.3%
2019 Full Year	25.0%	31.2%
2018	(5.6%)	(4.6%)
Dec 18 - Dec 31	0.1%	(0.5%)

Note: All returns are net of management and performance fees.

As I approach the fourth year of tracking my portfolios, I have been thinking about some of the past investments that have made a large contribution to returns. It's critical to understand what made these positions successful (or not) so that I can learn from the past. During this process I have debated the value of information and whether or not it can be a competitive advantage.

In researching a stock my job involves a fairly repetitive process of gathering and then digesting data. Any decision comes from a synthesis of these findings. As an example, I often start this process with a company's SEC filings. Gathering data comes from written disclosures and historic financials, while digesting involves noting important factoids and constructing a financial forecast. Through this process I learn where my knowledge is lacking and return to gather and digest additional information to gain a better picture. Once I have enough data points, I must balance whether it is an attractive investment given my estimate of future cashflows, the conviction I have around those cashflows, and the potential risks of something going awry. So the question begs, where do I believe my competitive advantage lies within this framework?

Similar to most other things in life, the answer is that it depends.

With regards to small cap stocks I believe there is a significant value gap from simply processing information. To frame the discussion here are a few numbers. Of the publicly listed companies that are incorporated in the United States there are 1,767 that have a market capitalization greater than \$1bn and another 1,653 with a market capitalization between \$50mm-\$1bn. From a dollar value perspective the largest companies account for \$33.0 trillion dollars while the smallest ones account for just \$0.6 trillion.¹ Thus, while these two buckets account for roughly the same number of companies, the vast majority of money is concentrated in the former.

This fact is important because the asset management industry is all about fixed costs and scale. Fixed costs include office space and research products, but mainly constitute an investor's time. If it takes the same amount of hours to analyze a \$10bn company as it does to analyze a \$100mm company, it makes logical sense for investors to focus on the larger company where they can deploy more capital. This is

¹ Sentieo. As of January 2nd 2020.

why many institutional fund strategies are set up to scale well into the billions. The same is true for sell-side research and other third party service providers. Research analysts at investment banks will only report on the larger companies where trading volume is more significant.

Many of the companies I analyze for the small cap fund are in the bucket that is generally overlooked. Other professional investors are uninterested given capacity limitations or unaware given a dearth of research coverage. Furthermore, these companies screen poorly as they do not have earnings estimates provided by the banks, therefore making it just a little harder to get up to speed. In these instances the process of gathering and processing data creates value. That is not to say that there are no other smart, hardworking, and motivated small cap investors doing the same thing; but rather that the number of competitors versus the opportunity set is attractive. The conclusion here is that there are not enough capital doing the hard work to understand things such as a company's competitive positioning, earnings potential, management incentives, or catalysts for value realization.

Since most institutional investors are focused on large cap stocks, logic would hold that it is more difficult to gain an informational advantage in this sector. Most all of these companies are analyzed by the large investment banks that release periodic research reports, provide earnings estimates, and facilitate meetings with management or company tours. Hedge funds and mutual funds follow these stocks closely and it would be safe to assume that everyone has analyzed their financials and competitive positioning. Obviously sometimes people get it wrong and that would present an opportunity; but it would be naïve to assume that I consistently have more knowledge than others who cover large-cap stocks. This is particularly true given my limited research budget, especially in comparison to the largest mutual/hedge funds that have every research product at their disposal. So assuming all information is known and digested by my competitors, where does my advantage lie?

On the television show *The Good Place* there is a protagonist named Chidi who is a professor of moral philosophy. Chidi possesses a wealth of information on how to judge human actions, but struggles with the weight of each argument and is paralyzed by his indecision. Clearly information is not enough – the ability to properly synthesize data points and then act in a manner consistent with one's beliefs is paramount. With regards to the ability to synthesize data, it is impossible to quantitatively determine whether I am at an advantage or not. I believe I have a strong ability to properly weigh information, draw connections between events, and make inferences based on the knowledge at hand. But this is impossible to measure and I therefore cannot definitively say whether or not my belief is correct.

On the behavioral side of things, however, I can be a bit more concrete. Incentives can lead to behavioral biases making portfolio managers suffer from benchmarking and short-termism, as fund flows are determined by performance relative to a given index. Given our alignment as investors, I do not suffer from such tendencies, or at least they are minimized. As such I am able to make investments without the fear that a stock will underperform over a 12 month period. For instance, a natural inclination during a period of uncertainty would be to sit it out and wait for more clarity – when, in fact, that may be precisely the time to buy or sell. I saw this on two notable occasions in the past year alone: when Insurance Auto Auctions (“IAA”) lost some GEICO business and when ServiceNow (“NOW”) experienced executive turnover. Both periods led to a precipitous decline in the stock price that was well beyond the impact to long-term earnings potential; and both situations proved to be attractive buying opportunities (please see my Q2 and Q3 letter for more background on IAA). Simply put I choose to compete on a different playing field, largely differentiated by time horizon. While this may make our performance diverge from the index over the short-term, I believe it is the right approach for long-term wealth generation.

Before getting into a portfolio review, I would like to thank everyone for trusting me as a steward of your capital. This is a position I do not take lightly and am fully dedicated to maximizing our returns, but will never lose sight of the importance of risk mitigation. I wish you a happy and healthy 2020!

Large Cap (Long Only) Review

The large cap portfolio was up 25% in 2019. This is an attractive return on an absolute basis and I am happy with it given our portfolio construction. Nonetheless, it did lag the S&P 500, and being that this is a year-end letter I will touch briefly on relative performance. First off, we were “hurt” by holding over 10% of the portfolio in cash which obviously had a de minimis return. Similarly, our investment in Four Corners (“FCPT”) was basically flat from our initial purchases. This one is a bit of a head-scratcher as REIT’s broadly performed in-line with the market and FCPT grew its dividend in-line or better than its closest peers. It seems that investors bid up more risky players and left FCPT in the dust. These two positions were clearly a drag in a rising “risk-on” market.

Our large stake in NOW was a strong contributor in the year as the stock rose almost 60%. Since our initial investment a few years ago, NOW has established itself as a core software platform for many of the world’s largest companies and sustained this revenue growth in 2019 by further penetrating these relationships. Because their IT product touches so many corporate departments, the company is deeply embedded in their customer’s work stream and is well positioned to expand its service suite to drive organic revenue expansion. What was once viewed as solely as a single niche company, NOW has successfully expanded into new verticals such as customer service and human resources. With a long runway for future growth and the proven ability to leverage fixed costs, NOW remains an attractive investment and core holding.

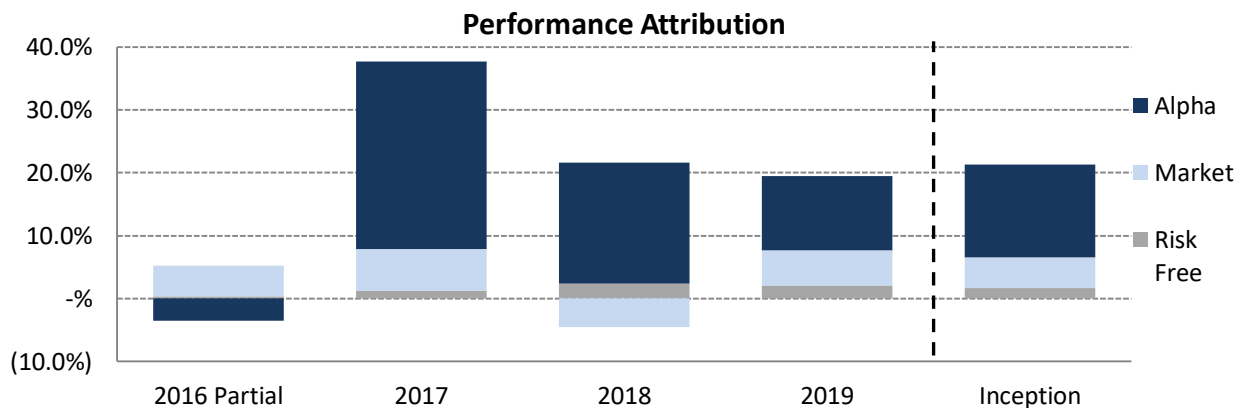
We lost money on our investment in Interactive Brokers (“IBKR”) as lower interest rates, the industry shift to zero commissions, and somewhat slowing account growth weighed on the stock. I sold our position at a loss, though I continue to see tremendous value in their platform and believe that they are well positioned for the future given their low-cost structure. I exited because I decided there were more attractive opportunities elsewhere, though I will continue to monitor the company going forward.

During the most recent quarter I added to our position in Take-Two (“TTWO”). I built our initial stake in Q1 of this year when I rotated our video game exposure out of EA off of strength in Apex Legends. You may recall that in 2018 I also owned and sold Ubisoft, which means that I have now invested in three of the four major video game publishers. There is clearly a reason for this, and it is not solely because I enjoy playing video games (joking aside, I believe this does help me stay abreast of the latest developments). I view the long-term secular trends for the game publishers as particularly attractive given improving adoption, monetization, and operating leverage. While TTWO is the most cyclical and expensive from a near-term multiple perspective, they own trophy assets and are incredibly well managed. Since its release in 2013 Grand Theft Auto V has sold in more than 115mm units and revenue from the title is expected to grow this year (over 6 years since initial release). TTWO has done a great job building out the rest of its portfolio with 10 other franchises that have each had at least one 5mm unit release, with titles such as Red Dead Redemption, Borderlands, and NBA 2K. The release of new hardware consoles this year should benefit the entire industry; and, while TTWO has not stated their intentions on the next installment of Grand Theft Auto, there are industry rumors that it may come this year. While timing on GTA VI is uncertain, I expect it to be very positive for the company when it finally occurs.

Small Cap (Long Short) Review

The small cap portfolio was up 19% net of fees during 2019 while averaging a beta adjusted net exposure of 24%. Our largest contributor during the year was Mastech Digital (“MHH”). I wrote up MHH extensively in the Q2 letter where I laid out my investment case, bolstered by better cash conversion and operating improvements in their data and analytics business. This thesis proved correct following their Q3 report leading to roughly a doubling of the stock price. Our biggest detractor during the year was Zixi (“ZIXI”), an email security company that recently completed a transformational acquisition of AppRiver, a Microsoft cloud service provider. While integration has gone smoothly and the fundamentals have been strong, I erred in buying the stock too high.

Since inception the portfolio has annualized at a 20.6% return with beta adjusted net exposure of 34%. We have obviously been in a rising market during this period so I would like to breakout the source of these returns.



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Over the past 3.5 years, 1.7% of our annual return has come from the risk-free rate (if I had just put the money in treasuries), 4.9% from the market risk premium (if I had maintained our market exposure in the benchmark index), and 14.7% from alpha (the outperformance of our stocks above the market). The important takeaway is that portfolio construction has insulated us from the market movements, with returns largely coming from specific stock selection. But all of this is obviously in the past and what matters is the future.

I started building a stake in Office Depot (“ODP”) in Q3 of this year and increased our position last quarter. My initial thesis was that ODP was trading too cheaply and this fact would become apparent following near-term resolution of several events. Most notably, over \$700mm of non-recourse debt, which often mistakenly gets counted in their enterprise value calculation, would be fully offset by receivables in Q1 of this year and actually result in a cash influx of \$80mm. This resolution would improve how the company screens and make investors recognize the company’s extreme valuation.

² Beta used in calculations uses the Russell 2000 as the benchmark. Beta used for annual calculations is based on average of monthly historic beta adjusted net exposure. Beta used for inception calculation is based on reported beta.

Subsequently, concurrent with their Q3 report ODP announced that they are reviewing a holding company reorganization. If enacted this would facilitate the separation of their retail business from their B2B and CompuCom divisions. A sum of the parts would be beneficial to the stock as their B2B operations should trade at a higher multiple than the retail segment, but the real kicker comes from a potential retail merger with Staples. Back in 2016 the FTC blocked a merger between ODP and Staples based on the grounds that the companies would have too large of a market share in B2B – by separating these divisions, ODP could pave the way for the retail companies to finally join up. This optionality still seems underpriced. In the meantime, the company is taking steps to stabilize its struggling CompuCom division and generating a ton of cash with a >20% FCF yield. There is also the potential for improved capital allocation as ODP will be net cash positive but still bearing interest of \$70mm on its outstanding debt. Without these interest payments ODP's FCF yield would be closer to 25%.

Sincerely,

A handwritten signature in black ink, appearing to read "Aaron Sallen". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Aaron Sallen

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