IDIOSYNCRATIC RISK

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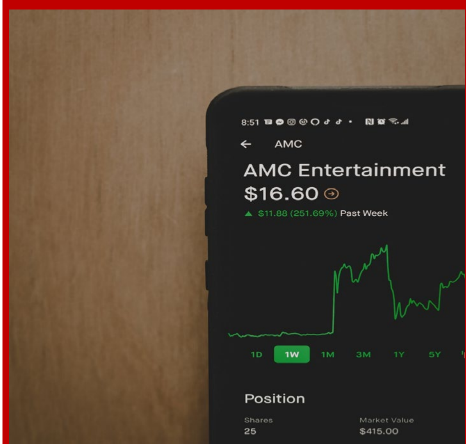

Nothing to see here.

WHAT A LONG STRANGE TRIP IT'S BEEN

Today's issue being the twelfth installment of *Idiosyncratic Risk*, it seemed an appropriate occasion to attempt to sum up the events of the past year into a sort of concise, "Year in Review." One sentence in, and the task feels like a doomed, Sisyphean labor. On April 1st, 2020, when the initial issue of this newsletter was published, "Tiger King" was celebrating its eighth day as the number 1 rated show on the streaming service, Netflix. That Tiger King would last for seventeen more days at number one and become one of the most enduring phenomena of 2020 says more about the pace of the modern news cycle than it does about Joe Exotic's staying power within the zeitgeist.

For this author, personally, there was something slightly inauspicious about announcing the launch of Antrim Investment Research on April Fools' Day. From a practical point of view, it seemed that there was something inopportune about advertising a service focused on bottom-up, fundamental, qualitative analysis, security selection, and due diligence during a pandemic and market meltdown. From a marketing perspective, it was unwise to compete for institutional investors' mindshare on the same day Dave Portnoy announced the creation of his "anything-but-investment-advice" livestream, "Davey Day Trader Global."

For those of us who do try to take the markets seriously, the coronavirus pandemic was a tremendously disorienting shock to the system. Value investors, like this author, have felt for years that the market's nosebleed valuation augured for lower future returns than investors had become accustomed to. Fed watchers and interest rate observers who had noted in May 2019 when the yield on 3-month Treasuries surpassed the rate on the 10-year issues might have felt vindicated, or awestruck, as the pandemic seemed to provide a catalyst for the recession the yield curve inversion had portended.

The depth and magnitude of that recession was awe inspiring, and the speed with which the world was plunged into it was virtually unparalleled in economic history. And yet, there was something vaguely reassuring about the idea of a pandemic-induced recession. After all, the world was gripped by pandemic in 1918, just before the end of WWI and the beginning of the “roaring 20s.” The “p-word” had a renaissance in 1958, a year when the S&P appreciated by over 38%. Investors seemed to take note. Historically speaking, the end of days has never arrived, no pandemic in recorded history has ever lasted, “forever,” and in the immortal words of Nat Friedman, CEO of GitHub, “pessimists sound smart, optimists make money.”

It was against that backdrop that the first issue of *Idiosyncratic Risk* saw fit to make what this author believed to be, at the time, a controversial call: documented in these pages was this author’s claim that Despegar.com (NYSE:DESP), the leading online travel agency in South America, was well capitalized and positioned, not only to survive, but to thrive throughout the crisis and emerge on its other side in excellent position to reward its shareholders. In that same issue, though, was a claim I believed would prove far less controversial. Namely: that no specialty insurer, not even the high-flying, high performing specialty P&C insurer Kinsale Capital Group (Nasdaq:KNSL), should trade at 5.7x book. The vicissitudes of market volatility being what they are, it is perhaps fitting that the former claim appears obvious and uncontroversial, in hindsight, while the latter appears disastrously naïve and out of touch.

It is with no small degree of self-reproach that I recount to you, dear reader, that the first individual short idea discussed in this newsletter, by the author of a service focused on the identification of profitable short ideas, has proven, thus far, to be disastrous. But there will always be markets (like the one we have born witness to over the last year) where overvalued securities continue to appreciate and deteriorating, decelerating fundamentals do not seem to matter. And there will always be markets where the returns on individual security selection pale in comparison to the impact of macroeconomic considerations and quantitative factors. And because I can be equally as obstinate as reproachful, I would remind my subscribers that a stock trading at near 7x price to book is not prima facie evidence that a valuation of 6x book is reasonable.

In many ways, Kinsale Capital Group is a microcosm of a much more pervasive issue in today’s equity markets, the impact of passive equity ownership on security valuations and equity performance. After KNSL was added to the S&P Small Cap 600 Index in November of 2019, passive vehicles managed by Vanguard, BlackRock, and State Street were required to purchase well over 7% of the float of KNSL (in addition to the ~20% those managers already owned), in a security that simply does not offer investors the requisite liquidity to complete a purchase of that magnitude without an outsized, distortionary impact on its price. That Kinsale’s ascent continued for as long as it remained in the S&P Small Cap 600 speaks to asset allocator’s appetite for risk in the wake of the coronavirus pandemic and market sell-off of March/April 2020. That it peaked, literally to the minute, on the day it was announced KNSL would be added to the S&P Mid Cap Index, and replaced in the Small Cap 600 is an eerie harbinger of future market volatility. (The Mid-cap index is comprised of larger companies, but the ETFs which track it are less popular with investors than their small-cap counterparts)

Of course, it would be impossible to address the impact of passively managed investment vehicles on equity returns and prices in a newsletter dated, March 1st, without discussing the events of the final week in February. From its peak on February 16th, 2021, the Nasdaq fell 7% by the end of the month, led by numerous equities that make up large position sizes in Cathie Wood’s “ARK Innovation Fund,” (“ARKK”), after reports that ARK and affiliated Japanese mutual funds managed in tandem with Cathie Wood’s flagship strategies owned outsized stakes in several small, illiquid issues that could not reasonably be sold in short order presaged record redemptions from her firm’s ETF vehicles. That ARK has taken

irresponsibly large positions in a number of equities given the daily liquidity that they promise to investors is an opinion shared by the author of this letter. When we've shared our thoughts on the issue with other investors, the persistent refrain is some variation of, "it's tough to criticize a strategy that's been proving people wrong for so long, isn't it." Respectfully, the argument is not that ARK has chosen bad companies or failed to identify "innovation," and generate returns. The argument is that the fund is structurally incapable of meeting redemptions should they ever occur. That the entire market has crashed in the first fortnight that ARK experienced net redemptions only strengthens our moral certitude on the issue.

That passive investing strategies are not terribly discerning in terms of security selection is not a tremendously profound or insightful statement. It seems, however, that the notion their proliferation may have had unintended consequences on the integrity of the markets the funds are built to track, is. In our July issue we outlined our concerns related to two extremely successful equity issues (Nasdaq:TSLA, NYSE:GSX), which appear to have valuations supported by accounting and consumer fraud. In our September issue, we discussed the proliferation of private companies coming public through reverse mergers with "Special Acquisition Corporations," ("SPACs"), and we continue to note that the seemingly bottomless pool or capital sloshing around passively managed vehicles seems to be an irresistible siren call to fraudulent promoters, who require only a publicly listed ticker in order to be conferred popular legitimacy and near endless wealth.

Once again, we are reminded of Nat Friedman's immortal advice, "pessimists sound smart, optimists make money." (I know I've repeated the aphorism in this letter, but I have to think about it every day, so I trust you can survive it twice) And yet, price appreciation is not a good proxy for prudent and well-reasoned debate. Enron continued to appreciate for years after allegations of improper business practices and accounting improprieties came to light. Wirecard was a money laundering organization with ties to illegal offshore gambling, pornography websites, and Russian oligarchs for long before it was required to admit to fraudulent and irregular accounting practices.

In January, this newsletter discussed its authors skepticism that Bitcoin would ever have the liquidity and market capitalization to provide a meaningful alternative to the world's reserve currencies. On January 26th, as bitcoin sat at $32,597.30, near 20% off from its January 8 high of $40,675.80, our words seemed prescient. On February 8th, when Tesla announced that it had used $1.5B dollars that it couldn't find to pay its employees' bonus incentives to acquire bitcoin, we were again made able to reprise one of our most popular, recurring roles – the classic fool. Incidentally, ARK Invest, through its investment in the Greyscale Bitcoin Trust, is a major holder of bitcoin and Tesla and a big contributor to the rally in the price of both over the past year. That Tesla, ARK, and Bitcoin should share a correlation coefficient of 1 is indicative of a market bubble, less so of the narrative that new technologies and disruptive innovators provide a hedge against inflation or market collapse.

In February, *Idiosyncratic Risk* discussed the impact ETFs have had on cost to borrow heavily shorted securities, and the indirect role that pervasive passive management has had in creating the pre-conditions for the GME short squeeze and market crisis. Shortly after that letter was published, incredulous Redditors were confronted with the news that most of the GME shorts had covered – an eventuality that, believe it or not, many thought structurally impossible. Rather than admit that their investment thesis was predicated on misinformation and misconceptions, most posters on the popular social media site have doubled down. Now the median individual investor is more convinced than ever: the market is rigged against them, and they cannot be convinced otherwise. Somehow, the belief that a short squeeze in GME might still push shares to $1,000 (or, to the moon, perhaps) persists. Only last week, GME shares rallied again. On Thursday, February 25th, GME shares rallied to an intraday high of near $200 before closing at $108.73, one day after suspiciously large purchases

of deep out-of-the money call options almost certain to expire worthless on Friday February 26th forced market makers to purchase large amounts of GME shares in order to delta hedge the open exposure on their books.

At a bull-market peak or market bubble top, with regulators largely absent or inept and misinformation proliferating online at unprecedented rates, the only predictable feature of the markets is uncertainty. In such an environment, a letter like *Idiosyncratic Risk* could never hope to predict with any accuracy what the events of the coming days or weeks would bring. In normal times, this endeavor would be impossible. Rather, *Idiosyncratic Risk* seeks to be something of a guiding light. A consistent reminder that facts and fundamentals matter, eventually, and a moral voice proclaiming that the markets can be saved from inefficiency before the insanity drives participants out of the casino.

In our last year in business, we've had a lot of conversations with short sellers – both clients and prospective clients. We are consistently reminded that in this environment, it is the short sellers who actually retain some optimism. They retain the belief that, perhaps, the securities markets can still be saved from themselves. That market efficiency can return, that fundamental active management can continue to be a fruitful endeavor, and that fraud and malfeasance can be uncovered and punished before its consequences become catastrophic to the entire system. It is more cynical, in our view, to proclaim that none of these factors matter any longer, or to ask, "why bother?" when confronted with a compelling short thesis related to an overvalued security with deteriorating fundamentals.

Now that the short sellers are more optimistic about the integrity of capital markets than the bulls, perhaps it is time that the optimists start to get paid. If for no other reason – they're due.

PAST PERFORMANCE IS NOT A RELIABLE PREDICTOR OF FUTURE RESULTS

Recommendation	Date	Performance Since Recommendation
Short ACEL	October 1st, 2020	+3.5%
S&P 500	October 1st, 2020	+13.3%
Long LMND	August 3rd, 2020	+116.2%
S&P 500	August 3rd, 2020	+16.5%
Short TSLA	July 1st, 2020	+212.8%
Short GSX	July 1st, 2020	+71.4%
Long AKRXQ	July 1st, 2020	-100.0%
S&P 500	July 1st, 2020	+22.9%
Long MIK	June 1st, 2020	+288.6%
Short QSR	June 1st, 2020	+12.7%
Long MINM (formerly: ZMTP)	June 1st, 2020	+49.3%
S&P 500	June 1st, 2020	+25.2%
Long NLY	May 1st, 2020	+43.5%
Long AGNC	May 1st, 2020	+38.7%
Short SWKS	May 1st, 2020	+73.1%
S&P 500	May 1st, 2020	+30.9%
Long DESP	April 1st, 2020	+109.9%
Short KNSL	April 1st, 2020	+68.8%
S&P 500	April 1st, 2020	+47.5%

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If you are coming across this, the twelfth issue of ***Idiosyncratic Risk***, for the first time, welcome. I would always like to make new friends. If you find my views interesting or helpful, and if you'd be so kind, feel free to forward this newsletter along in your network to those who might also make use of its content.

I sincerely appreciate the friendship, support, mentorship, and camraderie I've experienced during my career in Investment Management and I would like to thank my friends and readers for supporting me, whether by forwarding this email and my contact information along in your network, or merely reading these pages and considering what I have to say.

Feel free to reach out with questions, criticisms, suggestions, and investment ideas if you've got any good ones.