Q3 2020 Masonry All Cap Select Commentary **October 2020**

"Major market tops are a process, not a single event. Markets peak on exhaustion; everyone must be in. Meanwhile, in the background, the weakest leave the party first."

Peter Atwater from his blog post, "The Coming Age of Screwtiny"

To Our Client Partners:

The aim of our quarterly updates is to provide insight into the current portfolio and how we are positioned going forward. Please reach out with any questions or comments you may have.

Overview of the Portfolio

As of September 30, 2020 we were approximately 94% in equities and 6% was in a combination of cash and fixed income. The largest exposures at the end of the quarter were the common stocks of ViacomCBS, DISH Network and Anheuser-Busch InBev. The weighting of our top ten holdings as a percent of the total portfolio was just over 52%.

Portfolio Highlights

We continue to find incredibly attractive bargains in the market. A very large group of stocks has been ignored as speculative investors chase growth stories which tell tall tales of large total addressable markets (TAMs) and amazing future profits – albeit 10 years out in the future. Meanwhile, there are slower growing companies currently generating large amounts of earnings and cash flows but stock market participants are discounting their stocks to lower and lower prices. There is only so much money to go around and when a company like Nikola (ticker: NKLA) achieves a market cap larger than Ford despite never having manufactured a vehicle or recorded a sale it takes away investment dollars that might otherwise be allocated to businesses that actually generate profits. Yes, it is frustrating, especially with a stock like Nikola where there is ample evidence it is a potential fraud, but the current opportunity set of extraordinarily attractive stocks would not be available without going through this temporary insanity.

In addition to continuing to own quality businesses at attractive valuations, we have greatly expanded our ownership of stocks we consider to be special situations. Many of these companies have benefited as the US and world economies continue to recover but this reality is not yet reflected in their respective share prices. During the COVID-19 lockdowns they worked hard to lower their expense base and take inefficiencies out of their businesses. Strangely, this operational improvement is also not evident in their share prices as many remain at lows not far off where they traded in March at the onset of the pandemic. Over the past few months we have purchased stocks of businesses in the insurance, shipping and beverage industries. The common thread is that they all trade at a fraction of their normalized value.

What is important to note is the minimal risk we believe were are taking in making many of these investments while we wait for the substantial upside to be realized. The downside case is supported by assets or cash flow and the upside we calculate to be multiples of their current prices. By way of example, when a stock trades at 0.2x book value (as one of our holdings does) the journey back to book value results in a share price gain of 400%. Similarly, if a stock trades at 3x earnings (which a handful of our holdings do), the journey back to a historically average stock multiple of 15x earnings also results in share price appreciation of 400%. The portfolio is full of these asymmetrical risk /reward propositions. The ground we have lost as measured against the S&P 500 YTD and since inception could be made up in very short order if we are right in the medium-to-longer-term on even a small part of the portfolio.

Select Portfolio Details

One of the most encouraging things the management of a company can do to portray confidence in their business is to commit capital to buying back shares or retiring debt. In Q3 we had two companies that made extraordinary announcements in this regard. The first was **AMC Networks (ticker: AMCX).** AMCX announced a Dutch Tender to buy back $250 million of their common stock which represented approximately 25% of their total outstanding shares. The company earned just over $8.75 per share in 2019 valuing the company at around a 2.75x price-to-earnings (PE) ratio and that was before the buyback. This share repurchase will significantly increase our ownership in the company's future earnings.

Another holding issuing news was **Scorpio Tankers (ticker: STNG)** which announced in early September that they were buying back up to $250 million of outstanding securities including common stock, convertible notes due 2022 and senior unsecured notes due 2025. For a company with a market cap of just over $650 million this is a significant development and one that has all but been ignored by the investing public. For a more comprehensive review of our broad shipping thesis, please see The Long-Term Tanker Trade.

What these collective actions tell us is that the people who know the company the best are seeing extraordinary value at present.

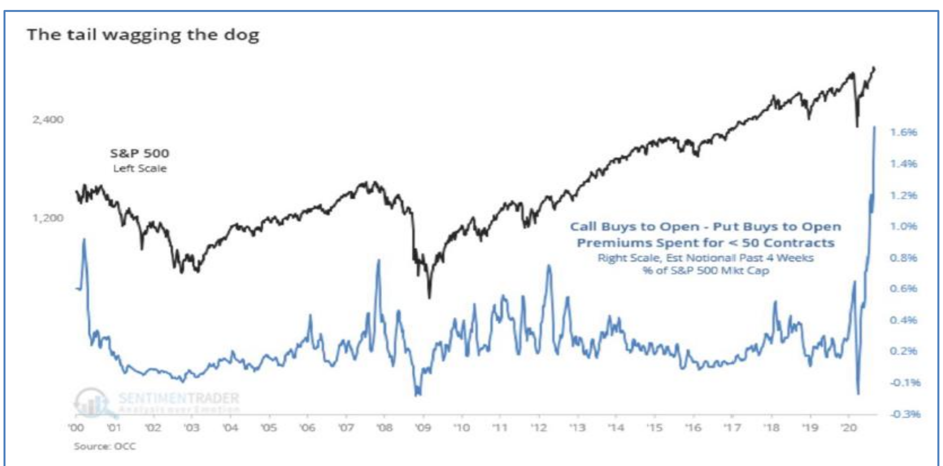
Corteva (ticker: CTVA) is a core position added earlier this year. The company was spun off from DowDuPont in 2019 and is in the agricultural products business providing seeds and crop protection products as well as software and digital services. Spinoffs generally warrant our close attention. Many times they are sold post-spin for uneconomic reasons as the shareholder of the parent may not want to hold the shares of the spinoff. The financials can also be hard to decipher on a pro forma basis as the future financials are a bit like putting together a puzzle. In CTVA we saw a company that was trading at distressed levels as a result of the initial COVID-19 panic. The company has identified almost $2 billion of cost savings as an independent company which is almost 100% of their 2017 EBITDA. We believe the company still has room to grow to bring both their margins and subsequently their earnings in line with their peers. In fact, if CTVA could achieve industry-like margins the stock could trade around $50 per share versus the price at quarter-end of around $29.

Our ability to be nimble and opportunistic should benefit us greatly in the months and years ahead. We have come across so many favorable investment ideas that we are now having a difficult time fitting them in the portfolio. This has happened only twice before in Mark's career – in 2000 and in 2009. The post period returns from each were very favorable.

Market Thoughts and Observations

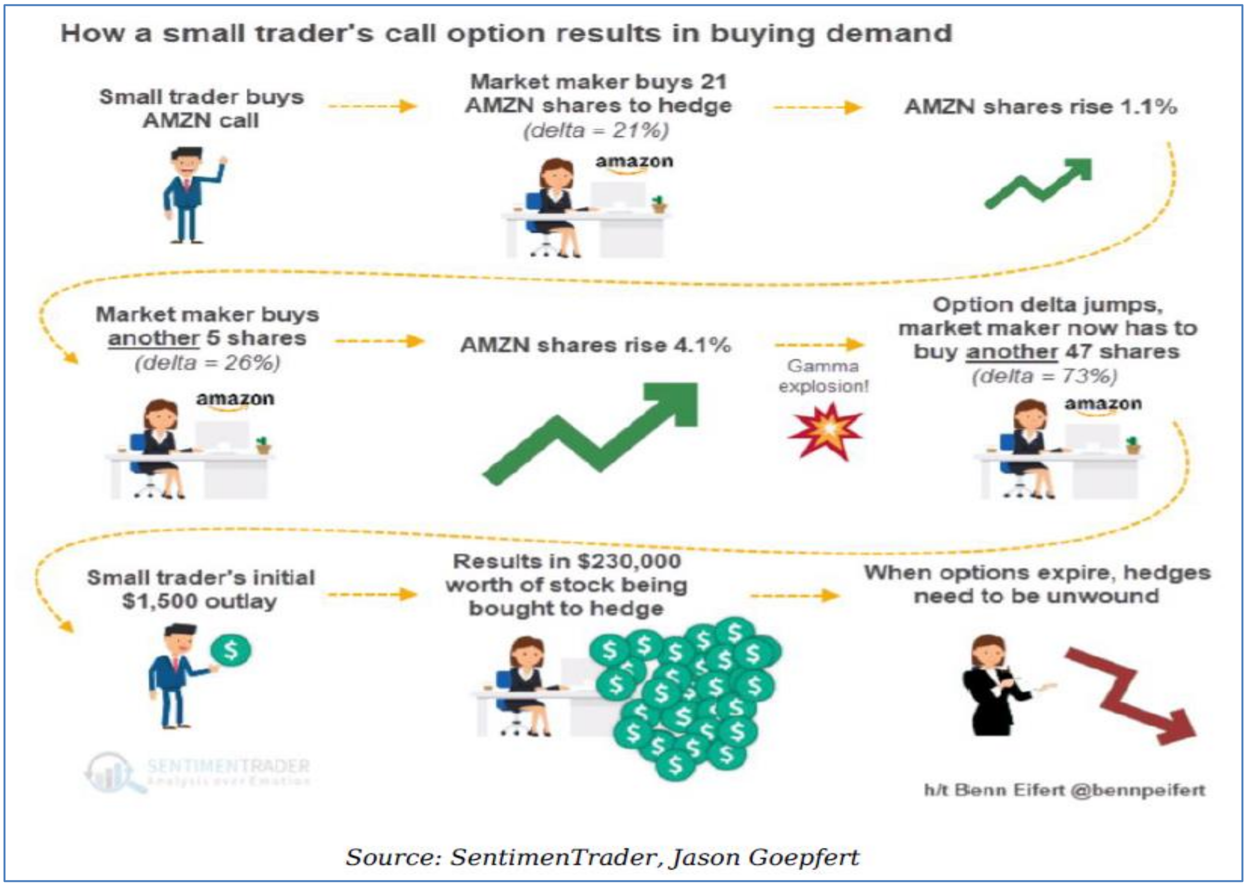
In past bubbles small traders speculated in stocks to drive prices up but this go round they have upped the ante. The current mania is largely being fueled by day traders and institutional buyers purchasing <u>short-term</u> call options. **Chart 1** shows the extreme level of call options (a leveraged way to profit when a stock goes up) purchased relative to put options (which profit when a stock goes down), while **Chart 2** lays out the effect this leverage has on the price of the underlying stocks. It seems increasingly evident that the most recent outsized share gains from the stock market leaders were the result of speculative options trading rather than a substantial improvement in the underlying company fundamentals. Leveraged short-term bets have made this bubble one of the biggest in recorded history.

Chart 1



Source: SentimenTrader, Jason Goepfert

Chart 2



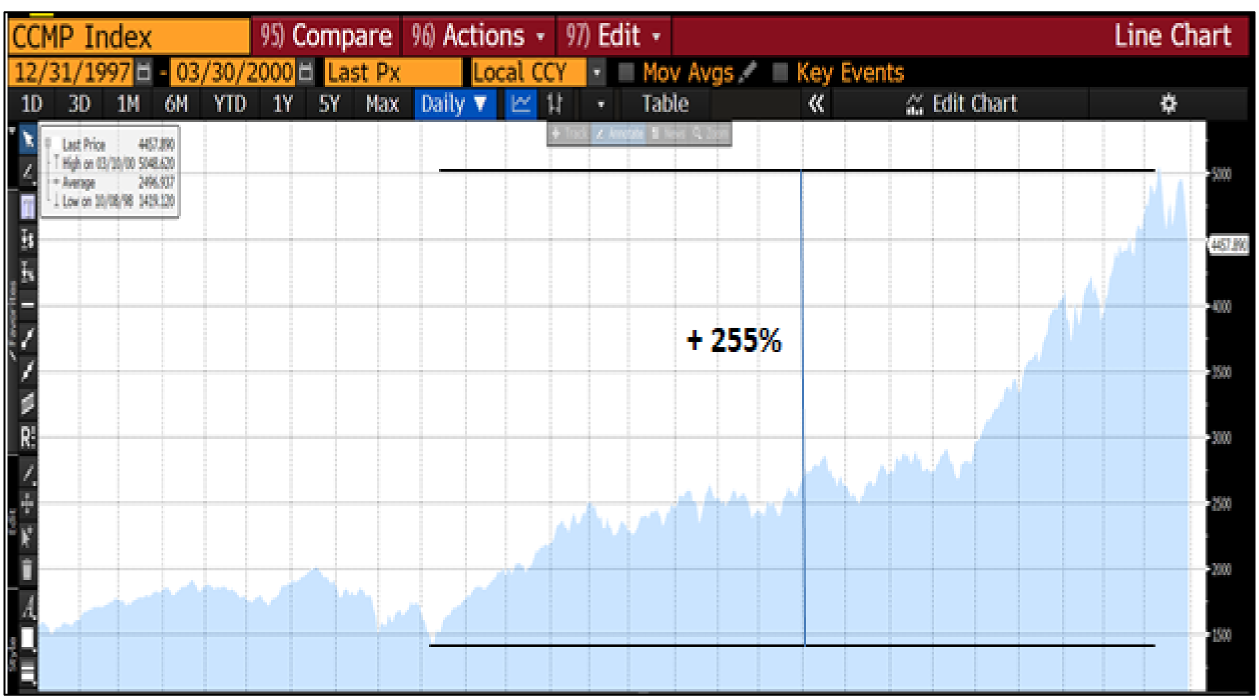
We have heard and read ad nauseam that the NASDAQ 100 of today isn't a bubble like it was in the Dotcom era and that logic is then used to deny that a bubble exists anywhere in the stock market. We find this line of reasoning to be short-sighted and without serious thought or analysis. No bubble looks exactly like the last one. In our view, to find a proper comparison to the Dotcom Bubble one has to do more diligence. With so many bubbles being blown there are many contenders but we believe the best comparison can be found in the Goldman Sachs 8x EV/Sales software basket (ticker: GSCBSF8X Index in Bloomberg). To become an index member the stock has to trade at greater than 8x sales which is an incredibly rich multiple for a stock as we detailed in our Q2 2020 update. The euphoria (our opinion) and returns (fact) of this index match that of what was experienced in the NASDAQ 100 in the late 90's and into 2000. Each is characterized by rapid price increases concluding with exponential rises toward the end. The following two charts were both sourced using Bloomberg data.

Chart 3 shows the expensive software stocks as represented by the Goldman Sachs 8x EV / Sales Index (ticker: GSCBSF8X Index in Bloomberg) from the low in December of 2018, after a brief economic growth scare, through September 30, 2020. **The index was up 253% in 21 months.**

In **Chart 4** we show the NASDAQ 100 Composite (ticker: CCMP in Bloomberg) from a low in October 1998, after the Russian Financial Crisis, through the peak in March of 2000. **The index was up 255% in 17 months.** We highlighted a similar analog just before the COVID-Crash in our mid-January blog post, see [Return comparisons between NASDAQ 100 (QQQ) in 1999-2000 and Goldman Sachs Software Index 2019-2020](#).

Chart 3

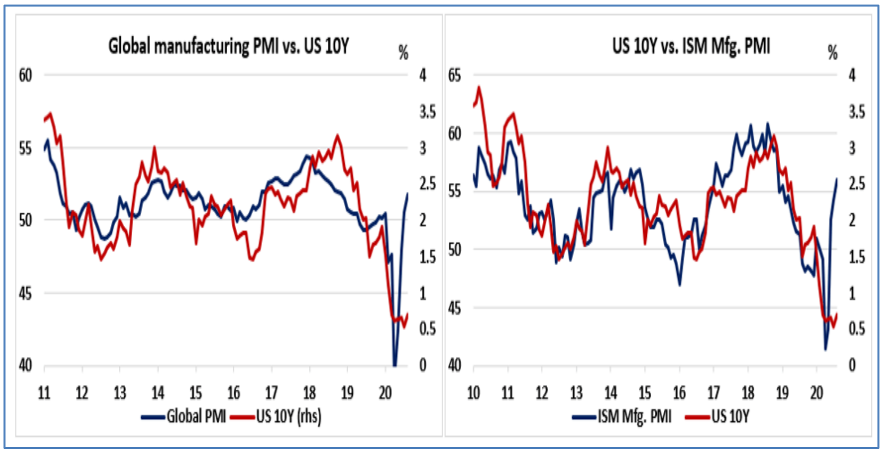
Chart 4



US Interest Rates, Long Duration and Short Duration Equities

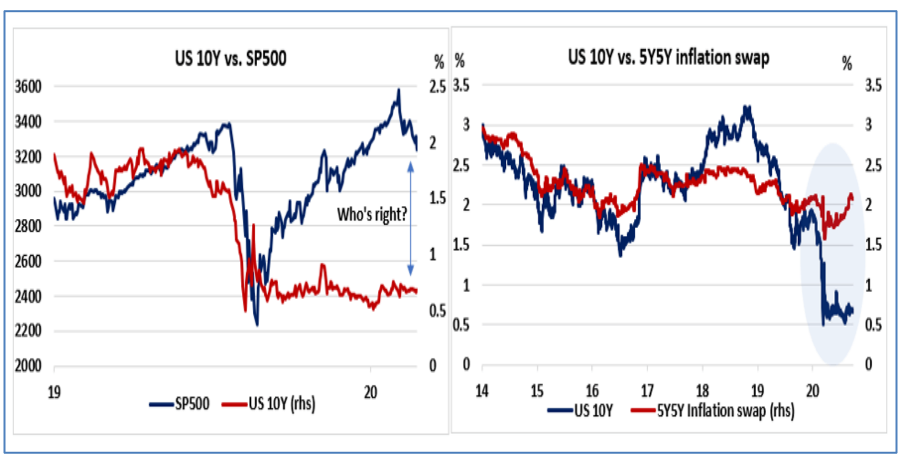
One of the more unusual aspects of the current recovery is the tight trading range of the 10YR US Treasury (UST) as well as its persistently low level. What have been historically tight correlations between the 10YR UST and various other factors have inexplicably broken down since the COVID lockdown and subsequent recovery.

Chart 5



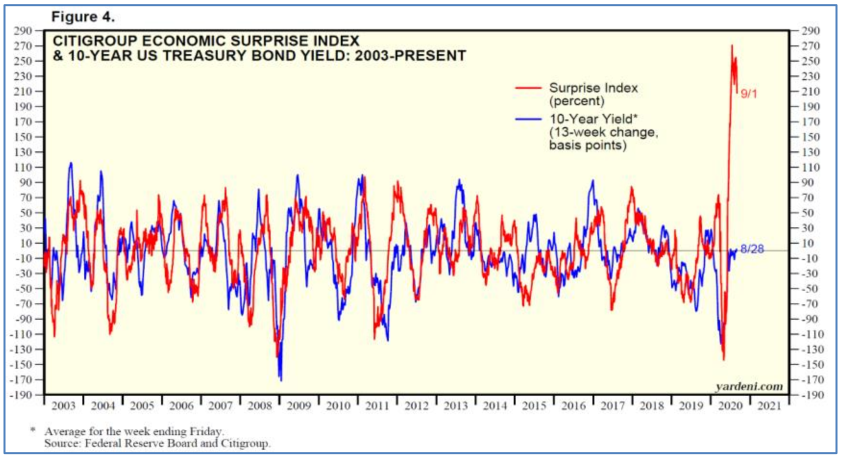
In the past, Global and US Manufacturing have had a tight correlation with the 10YR UST – until this year. If the relationship held the 10YR UST would be at a much higher level.

Chart 6



The 5Y5Y Inflation swap has been a very good proxy for the level of the 10YR UST and their levels should converge over time.

Chart 7

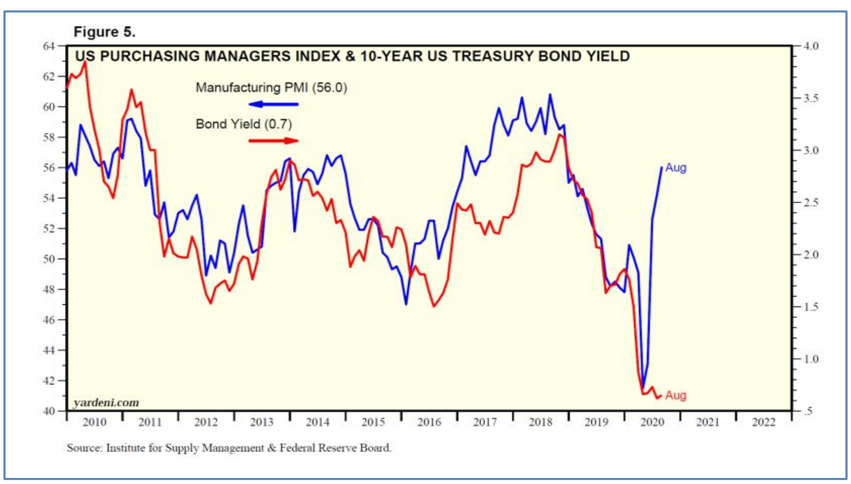


The Citigroup Economic Surprise Index has rocketed upward but this move has not been followed by the 10YR UST as it has in the past. The correlation looks like it has been broken for now.

Chart 8

The Copper price divided by the price of Gold vs the 10YR UST has been a good indicator of rates based on the direction of economic growth. The normalized relationship suggests higher rates.

Chart 9



The US Purchasing Managers Index is a proxy for economic growth. Higher or lower growth equates to higher or lower rates – or at least until now.

So why is the level of the 10 YR UST important? Over the last year we have noticed an extremely tight correlation between certain groups of stocks to the level of the 10YR UST including many of our top holdings. We would categorize these stocks as being part of what the investment community is now calling the ‘Reflation’ trade. These are companies whose stock prices have traditionally risen during periods of economy recoveries. Of course, this makes sense as their earnings prospects brighten considerably as an economy rebounds. This time around, however, their share prices have not moved up to the extent we would expect though their operational results have improved and in many cases are better than we anticipated. We believe much of this can be explained by their correlation with the 10YR UST and its current abnormal / artificial level.

For those positively correlated (like our holdings below) to the 10YR UST, when the yield moves up the stocks move up (**Chart 10**).

Chart 10

MACS Top 10 Holdings

Correlate with $TNX over 1 Year Go

Average Correlation: 0.49

SYMBOL	NAME	CORRELATION (1 YEAR)
DISCK	DISCK - Discovery, Inc.	0.94
BUD	BUD - Anheuser-Busch InBev ADR	0.90
STNG	STNG - Scorpio Tankers Inc.	0.90
COP	COP - ConocoPhillips	0.89
VIAC	VIAC - ViacomCBS Inc	0.81
DISH	DISH - DISH Network Corp.	0.53
EURN	EURN - Euronav NV	0.39
GAIA	GAIA - Gaia, Inc.	-0.34
RRC	RRC - Range Resources Corp.	-0.55

Source: StockCharts. Data as of 10/14/2020

Conversely, should we get a move up in yields, there are a group of stocks negatively correlated with this move (their stock prices will go down if rates go up) and it includes the FAANGM stocks and the stock market darlings (many are software/cloud stocks) of today which are depicted in **Charts 11 and 12**.

Chart 11

FAANMG Stocks

Correlate with $TNX over 1 Year Go

Average Correlation: -0.56

	SYMBOL	NAME	CORRELATION (1 YEAR)	
	GOOGL	GOOGL - Alphabet Inc.	-0.21	
	FB	FB - Facebook, Inc.	-0.37	
	AAPL	AAPL - Apple, Inc.	-0.53	
	MSFT	MSFT - Microsoft Corp.	-0.69	
	AMZN	AMZN - Amazon.com, Inc.	-0.74	
	NFLX	NFLX - Netflix, Inc.	-0.82	

Source: StockCharts. Data as of 10/14/2020

Chart 12

Market Darlings

Correlate with $TNX over 1 Year Go

Average Correlation: -0.60

	SYMBOL	NAME	CORRELATION (1 YEAR)	
	ROKU	ROKU - Roku, Inc.	-0.00	
	CVNA	CVNA - Carvana Co.	-0.44	
	BYND	BYND - Beyond Meat Inc.	-0.50	
	W	W - Wayfair Inc.	-0.59	
	CRWD	CRWD - CrowdStrike Holdings, Inc.	-0.66	
	MDB	MDB - MongoDB, Inc.	-0.66	
	NOW	NOW - ServiceNow, Inc.	-0.67	
	ZM	ZM - Zoom Video Communications, Inc.	-0.68	
	VEEV	VEEV - Veeva Systems Inc.	-0.71	
	ZS	ZS - Zscaler, Inc.	-0.71	
	WORK	WORK - Slack Technologies Inc.	-0.74	
	TEAM	TEAM - Atlassian Corp.	-0.78	

Source: StockCharts. Data as of 10/14/2020

Chart 13 shows the equity only performance of the Masonry All Cap Select (MACS) portfolio for the time period of May 14, 2020 through June 8, 2020 which correlates to a move in the 10 YR UST yield from 0.62% to 0.89%. The performance was brief but it was substantial and larger than any short-term move in our portfolio that we can recall.

Chart 13

10 year US Treasury climbed from around 62bps to just under 90bps from May 14, 2020 to June 8, 2020. The performance below corresponds to this time period.

Category	Return
Masonry All Cap Select (equity only)	31.62%
S&P 500	8.89%
Nasdaq 100 Composite	11.07%

Performance of Masonry All Cap Select Composite equity returns for the above time period is unaudited and does not include the returns of non-equity holdings during this period. This presentation is for illustrative purposes only. Past performance is no guarantee of future results.

We repeat our belief that for the Disruptor trade to remain in force the combination of low interest rates, low inflation and low and slow economic growth needs to continue. What seems evident to us is that even if one of the factors is held artificially low, such as interest rates, this will cause the other two (inflation and economic growth) to accelerate meaningfully. A change in any of the present conditions could provide a tailwind for our holdings. It seems increasingly plausible that we are in the midst of a regime change and a meaningful and lasting rotation out of the winners of the last few years and into the laggards – many of which are securities we own in meaningful concentrations—a topic we covered in our September blog post: Short Duration Value: Reflation Hedge & Call-Option on Recovery.

"100 Reasons Why"

We have written extensively in past quarterly updates about the relationship of Value to Growth as well as other historical financial relationships that have been pushed to extremes never before seen. So we decided to take it another step. We have attached a PDF of a presentation titled, '100 Reasons Why' which examines this epic period in time through pictures, graphs and text. The link to the presentation is here: 100 Reasons Why. Among the topics discussed are the cyclicality of Commodities, Value and Growth stocks and their relationship through market cycles; the effect on various markets of the massive amounts of Monetary and Fiscal stimulus unleashed on the U.S. and worldwide as a response to the COVID-19 economic lockdowns; the rampant speculation in today's stock market; and the impact of interest rates and inflation on stock prices. ***To spoil the ending, the set up for our value-based, catalyst driven strategy has never been better***. We hope you enjoy it and we would welcome the opportunity to engage you regarding its contents.

Peter Atwater's September 22, 2020 blog entitled "The Coming Age of Screwtiny"

As we have said before, sometimes others can articulate thoughts or sentiment better than you can yourself. It is at that time when you are simply better off conceding and sharing their wisdom rather than trying to turn it into your own. In that vein, we are pleased to reproduce Peter Atwater's blog entitled, "The Coming Age of Screwtiny" as an appendix to this letter.

Firm Update

We continue to pursue like-minded client partners to join us as investors. Please feel free to contact members of our team with any comments, questions or potential investment ideas.

Best Regards,

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Appendix

The Coming Age of Srewtiny

Last fall, with the downfall of Adam Neumann and WeWork, I suggested that the "Age of Illusion" was coming to an end. After almost a decade of blitzscaling, moving fast and breaking things, and ever-increasing acts of deception, the whole thing felt like it was finally collapsing under its own weight. There were nine too many heads on what was once just a two-headed lady.

I was early. WeWork was yet another ignored warning sign. Investors simply bought the dip and moved on.

Looking around today, it feels like we are once again at an important juncture. Since WeWork, we've seen the spectacular collapse of Luckin Coffee and Wirecard, and, as I write, EV truck start-up Nikola is wobbling.

Major market tops are a process, not a single event. Markets peak on exhaustion; everyone must be in. Meanwhile, in the background, the weakest leave the party first.

I don't pretend to know when the market will top – or if it already has for that matter – but what is already clear is what is ahead: "The Age of Screwtiny."

By "screwtiny" I don't mean the plain-vanilla kind of investigation and inspection that naturally arises as confidence falls. That is a given. What is coming will be different. Think scrutiny but with an angry attitude intent on finding those responsible and then nailing them to the wall.

You see, what is ahead will be the third major betrayal in twenty years. After the dot.com debacle and the housing crisis, the crowd won't take kindly to yet another bubble burst.

And today's bubble is different. This time it isn't tech stocks or real estate; its illusion. Deception has transcended the financial markets. It's cultural and it is everywhere. From "influencers" on social media to blitzscaled business start-ups, the past decade has been a Gold Rush in fakery.

The problem with it all is that other than on a magician's stage, illusion is predatory. It is deception with intent to gain advantage and to defraud. It is a zero-sum game in which the sideshow barkers and con men win at the expense of the crowd. And win they have. The wealth amassed by those at the center of the act has been unprecedented.

For now, with the crowd still making money, the illusion is enticing. The ten-headed lady is incredible, and the Sirens' Song of today's P.T. Barnum's is promising an eleven-headed woman tomorrow.

Step right up!

The problem with it all, as Theranos, WeWork and Wirecard have already shown, is that when the slightest light shines on extreme illusion, the hollowness is obvious. Like a Hollywood set, there is no there there. At best, that beautiful ten-headed lady is a one-headed hag surrounded by mirrors.

It may not be this week or this month, but when the Age of Illusion is revealed for what it has been, the anger will be intense. Yet again, the crowd trusted and was betrayed.

How the anger ultimately manifests is anyone's guess, but those responsible won't get off with the wrist slaps that they did after the financial crisis. The societal vilification will be profound. Today's "influencers" will become "imposters" and those business, financial and political figures responsible will become scandal-ridden pariahs. Jeffrey Skilling and Harvey Weinstein will look like Boy Scouts by comparison. As I said above, in the "Age of Screwtiny", the goal will be to nail those responsible to the wall.

I would pay very close attention to how things unfold with Nikola. It could easily become the tipping point. If it does, things could move very quickly ahead. The danger with deception is that the more of it that is exposed the more of it the crowd will expect to be exposed.

Betrayed crowds don't wait for details. Ten-headed ladies either have all their heads or none.

Peter Atwater is an adjunct professor in the Economics Department at William & Mary. He studies confidence-driven decision-making - how changes in our level of confidence naturally impact consumer preferences, decisions and actions.

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