Mark's Musings

Whitmore Capital Management Quarterly Newsletter

Q2, 2013 July 22, 2013

Investing in Light of a Bimodal Future

Generally speaking, I have tended to agree with Charlie Munger when he said, "[w]ide diversification, which necessarily includes investment in mediocre businesses, only guarantees ordinary results." Most of my investing career has been spent concentrating in specific out-of-favor, cheap assets, while avoiding (or even outright shorting) popular, but egregiously overvalued assets.

This has historically served me quite well. The extra returns generated by this strategy, and conversely avoiding the losses, or at least sub-par returns, by refusing to acquire expensive assets, have more than made up for what has been at times rather large short-term pain due to the heightened volatility of a concentrated portfolio.

But there are two necessary preconditions to make concentrated investing attractive: 1) one must be reasonably certain what the medium-long term relevant macroeconomic backdrop will look like; and 2) there must be the existence of cheap assets to buy, expensive assets to short, or some combination of the two. Regarding the second point, since shorting financial instruments is fraught with danger for even the most seasoned investor (as I can tell you from too much experience), let us just focus on finding environments with undervalued assets to be had.

Based upon those two criteria, between 1998 and 2010 I found concentrated investing to be the preferred approach. Before discussing why I believe a more diversified strategy is appropriate presently, let me give you just a two examples to illustrate how I have applied this analytical construct in the real world.

Back in 1998 when I first started investing, the financial world was still reeling from the East Asian crisis. Economies throughout the region had been leveled as currencies collapsed, corporations went insolvent and panic spread. So looking at the two conditions, first it seemed clear to me that Asian economies would revive. While there were significant corporate debt problems in many countries, consumer and national debt levels were extremely modest in the region. Furthermore, favorable demographics in many countries ensured that there would be many eager young people, who were increasingly educated, entering the workforce. The economic catastrophe, while enormous, seemed unlikely to persist much beyond 1999, if that long.

Regarding the second criterion, assets were trading for pennies on the dollar. It was not uncommon to find stocks that had declined in excess of 80%. These were not stocks in companies that had no profits either; finding companies with p/e ratios below 5 was not difficult.

It seemed to me at the time that building a portfolio centered around a basket of stocks from Korea, Thailand, Indonesia, Malaysia, Taiwan, Hong Kong, Singapore and the Philippines would be a way to have the best of both worlds – concentration in cheap assets likely to appreciate dramatically over a period of years while simultane-

"Fasten your seatbelts. It's going to be a bumpy [ride]."

- Margo Channing,

All About Eve

ously diversifying throughout a variety of companies, industries and countries. And while I suffered initial losses that approached 30% in certain stocks, every single investment eventually resulted in excellent multi-year returns.

Several years later, a very different macroeconomic environment existed. By the end of 2001 the Asian economies had recovered quite well, although the US had experienced its tech bubble popping. In response, the Fed had cut their overnight interest rates to below two percent (it would soon go even lower) in a desperate (and ultimately counterproductive) attempt to stimulate the economy. But against the backdrop of a flagging US economy with already burgeoning debt levels, the US dollar was trading at or near record high levels compared to a variety of currencies. Traveling abroad or just across either border, the US dollar purchased a tremendous amount of extra goods than could be obtained domestically, indicating that from a purchase power parity standpoint, it was overvalued significantly. Applying the two criteria, it first seemed likely that the US economy would continue to decline *vis-à-vis* other nations, particularly developing Asian economies, as the US had already been a declining economic power already for some time on a relative basis. Furthermore, believing then as I do now that extending more cheap credit in response to a bursting credit bubble is the *worst* policy response at the Fed's disposal, I felt certain that we were simply postponing more pain to come domestically.

Regarding the existence of cheap assets, one could pick almost any currency that was not the US dollar and it was trading at a historically low level. Moreover, with commodities simultaneously priced at ridiculously cheap levels and inevitably poised for a resurgence, investing not just in gold, silver and platinum, but also in commodity-based currencies seemed like a bargain with huge upside. Therefore, by 2002 my strategy was to invest in a basket of currencies against the US dollar, concentrating on the Australian, Canadian and New Zealand dollars, but also including the euro and others so as to obtain extra diversification. This was a portfolio that I held for years as the dollar experienced a huge secular decline in value.

I bring these instances up not to rehash investing war stories or past successes but to demonstrate what I look for when deciding to invest in a concentrated fashion, and how I have applied the two-part test in the past. Now I will show how different the current environment is.

Regarding the first criterion, this is where I have not seen a worse investing environment in the last 15 years. I detailed a little bit about what I think is the most important "tug of war" ever seen in modern financial history in my last investor email. To recap briefly, on one hand, you have virtually every central bank and government in the world either stepping on monetary and fiscal accelerators respectively, or poised to do so in the event of further global macroeconomic weakness. On the other hand, you have the extremely powerful market forces already in motion due to the collapse of the largest global credit bubble ever seen. And looking at what one could consider the three legs of the global economic stool – China, the Eurozone and the US – there appears to be quite significant risk of slowdowns/recessions in any or all of the three regions (particularly China).

So we have both very deflationary events (an unwinding credit bubble and weak economies) as well as highly inflationary events (mass money printing and stimulus plans) at play simultaneously. And while I would say that odds are two out of three that inflation will ultimately prevail, that is far from qualifying as "reasonably certain" what the macroeconomic environment will look like.

Worse still is the very nature of the uncertainty. Most times, the nature of predicting the future direction of macroeconomic movements is one of degree and not kind. For instance, will it be a low-growth environment or moderate- growth environment? Or when big crises may be looming, ala 2007, the issue is how bad the crash will be (degree), not whether it will occur (kind).

"The market can remain irrational longer than you can remain solvent."
- John Maynard Keynes

As such, most of the time, it is easier to make concentrated investing decisions when the range of economic environments is rather limited. If equities are attractively priced, for example, they should perform satisfactorily in a low-growth environment, and better in a moderate-growth environment. Either way, the investor is likely to profit; it is just a question of how much.

But the future with which we are presented has at the extremes two very different potential realities – inflation and deflation. Almost every asset that would perform well in an inflationary environment will languish if there is deflation and *vice versa*. Hence, what I believe to be most problematic for a prudent investor going forward is the extreme **bimodality** of what the future may have in store. I should note that it is not entirely unlikely that the world economy may steer some third course, avoiding the Charybdis of inflation and Scylla of deflation. I just believe that with the extremely destabilizing influence of mass money-printing against the backdrop of a vast, global credit bubble bursting, the risk of a hard break in either direction increases significantly.
It is also important to note that even if inflation does prevail within the next several years, that does not preclude the significant possibility that we could have a deflationary scare in the intervening time period. So one could still be right and pick a bunch of assets that will perform quite well in an inflationary environment, and still get crushed for a few years if things break the wrong way in the nearer term. As Keynes famously and presciently noted, "The market can remain irrational longer than you can remain solvent." As an investor, I have often thought to myself that I should have that quote tattooed in reverse on my forehead to be reminded every time I look in the mirror!

Concerning the second criterion, beginning about thirty months ago, it became very difficult for me to find cheap assets. After all, it makes very little sense to concentrate your portfolio if there are not opportunities for outsized gains to be readily had. Now I will say that the recent carnage in the metals complex, which I touched upon in my May email to investors and has only gotten worse, does, in my estimation, create an attractive risk-reward opportunity for a long-term investor (I might add that it helps to have an iron stomach). Indeed, while nothing in life, and particularly investing, is certain, I would expect that gold should hold its value reasonably well even if we have a deflationary bout. This is because it is seen as a safe-haven play. But gold should really appreciate in the event inflation or stagflation become significant issues in the global economy again.

Accordingly, given what I think is an extremely unfavorable investing environment going forward, I think a prudent investor is put in the unenviable position of "aspiring to mediocrity" via wide asset class diversification. Investors should always keep in mind that the first goal of investing is not capital appreciation; rather, it is avoiding capital losses. And while the specific effects of money printing are far from certain, it is extremely likely that the extra capital sloshing around in world financial markets will exacerbate volatility going forward. Thus spreading your eggs around what are less than stellar baskets may be the best strategy.

I am not a financial advisor, and my specialty is foreign currencies. Every individual and household obviously has different risk profiles, financial goals and needs. Therefore, nothing that I offer by way of asset allocation analysis should be used as specific recommendations for anyone in particular.

Having said all that, the following asset allocation seems like one that would provide a fair amount of diversification and **relative** protection regardless of the macroeconomic environment: 20-25% precious metals and mining stocks (weighted towards gold, even though I suspect silver has much greater upside, as well as platinum); 15-20% real estate (preferably some exposure to global real estate, perhaps through REITs); 15-20% equities (with no more than one-quarter of that US-based, as I think our equity market has one of the worst risk-reward profiles going forward); 15-20% alternative investment vehicles (hedge funds, art, start-ups, hard-money lending, etc.); 15% cash (the importance of having dry powder in the keg in volatile markets cannot be overemphasized, even if it is extremely painful to lose purchasing power maintaining cash in a zero interest rate environment); and 5-15% bonds.

The aforementioned allocation overweights precious metals and mining stocks, as I believe they represent the closest thing to compelling valuation among major asset classes. It is noteworthy that gold closed out the second quarter with losses of **23%**, the largest such decline in modern financial history!! I believe that the best strategy for investors deploying fresh capital is to purchase assets in a manner so as to keep the above allocation percentages. Accordingly, you would have been purchasing a disproportionately higher amount of precious metals and mining stocks as prices declined, while accumulating fewer appreciating assets such as US stocks.

The portfolio allocation also underweights bonds, as I feel like they represent the worst value of any major asset class, even after the backup in interest rates over the last few months. My summary view of the bond market is that those bonds offering a decent yield carry too much principle and/or duration risk to be attractive risk/reward propositions, while "safe" bonds do not yield enough to even keep up with inflation. Nevertheless, in the event of deflation, creditworthy sovereign bonds will be perhaps one of only two major asset classes to shine, along with cash.

I hope everyone enjoys the rest of the summer. Let me also once again express my gratitude for your participation in the Fund. I hope this has been the first, small step in a fruitful journey together that will span many, many years.

"… spreading your eggs around what are less than stellar baskets may be the best strategy."

---

[*] **Past results are not necessarily indicative of future results. You should carefully consider whether your financial condition permits you to participate in a commodity pool. In so doing, you should be aware that commodity interest trading can quickly lead to large losses as well as gains. Such trading losses can sharply reduce the net asset value of the pool and consequently the value of your interest in the pool. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.**

2Q 2013 Performance Summary: It Has Been A Good Start

"… the future success of the Fund is predicated on taking advantage of volatility."

The first quarter for Whitmore Capital LP as a hedge fund open to investors is now in the books. As you all know, I place very little significance in short-term returns. Nevertheless, I am pleased to report that gross returns for the fund were 7.49%. During the same time period the Credit Suisse Hedge Fund Index was up .13%. If one prorates the performance fee (which is only assessed annually) for the quarter, and include the management fee, net returns to investors would be 5.77%.[1,2]

One of the things that has been most satisfying about the quarter is the relatively low level of volatility in the hedge fund. While other asset markets have been roiled during the second quarter of 2013, particularly bonds and precious metals, the Fund provided monthly gross returns in the 1.4 – 4% range.

Part of this can be attributed to design. As I indicated in my May email to investors, I was, and continue to be, exceedingly guarded in my expectations for the global economy and prospects for asset markets in general. Accordingly, I have attempted to gear the currency portfolio to be more defensive and hedged than would be the case if I were more sanguine regarding the macroeconomic backdrop. For more on financial uncertainty going forward, please see below.

But clearly part of the reason for such low volatility and no monthly losses is pure and simple luck. As I have tried to stress to all investors, this is not a fund for widows and orphans, and it is conceivable that all of the last quarter's gains, and more, could disappear in a bad month. Indeed in March of this year the Fund was down by more than 5%. I will nevertheless continue to navigate what may well become even more treacherous waters as deftly as possible.

A final thought on short-term volatility. One of the most gifted and experienced financial minds I know (and, I am pleased to say, is an investor in the Fund) reminded me that the future success of the Fund is *predicated* on taking advantage of volatility. My strategy is based upon finding currencies that are either priced above or below what I deem to be fair value. Hence, the greater the volatility, the greater the opportunity exists to profit from larger divergences from market pricing and fair value. While that may be cold comfort when reading a future report detailing losses for the Fund, I will stress that personally I have often experienced great gains in my portfolio following months of losses.

For those who are interested in the performance of specific currencies during the last quarter, the Fund has seen solid profits in its positions that have been short the Australian and New Zealand dollars, as well as the Japanese yen. Fortunately for the Fund, the Australian dollar in particular has been hit quite hard in the 2nd quarter of this year, declining more than 7.5% since the end of March. However, the Fund maintained long positions in the Norwegian krone and the South African rand that had significant loss-

---

[1] Past results are not necessarily indicative of future results. You should carefully consider whether your financial condition permits you to participate in a commodity pool. In so doing, you should be aware that commodity interest trading can quickly lead to large losses as well as gains. Such trading losses can sharply reduce the net asset value of the pool and consequently the value of your interest in the pool.

[2] About the Credit Suisse Hedge Fund Index. This index is compiled by Credit Suisse Hedge Index LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database, which tracks approximately 9,000 funds and consists only of funds with a minimum of US$50 million under management, a 12-month track record, and audited financial statements. The index is calculated and rebalanced on a monthly basis, and reflects performance net of all hedge fund component performance fees and expenses. The particular funds that comprise the index may have rates of return that are significantly different and/or more volatile than those of the index. Finally, while individuals may invest in a particular fund included in the index, they may not invest in the index itself.

es, offsetting some of the aforementioned gains.

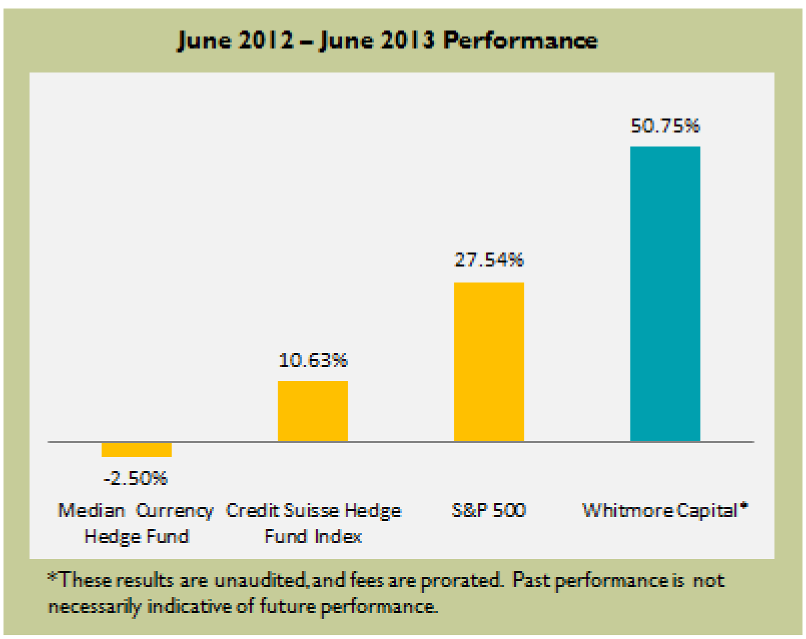
The First Year

While the Fund has only been able to accept investors since March, we launched it back in June of 2012 with our own capital. The idea was to employ the exact strategy that I would be using with other investors' capital. We thus have a full year of returns for the hedge fund.

These returns are both unaudited and use prorating for incentive fees. As such, they will be subject to change, but from June 1, 2012 through May 31, 2013, Whitmore Capital LP returned approximately 50% net of all fees. During the same 12 months, the Credit Suisse Hedge Fund Index was up 10.63%.[3]

I am certainly pleased that Whitmore Capital LP nearly quintupled the return of the hedge fund index in its first twelve months. Nevertheless, this time period was anomalous, producing returns that are unlikely to be repeated, and are certainly not sustainable. The chief reason for the superior returns was the massive decline in the yen. From peak to trough, the yen depreciated close to 25% in the last twelve months. For a major currency, this is a huge movement that may not come along again for many years. And while I believe that it is likely there will be some more downside to come, the potential profits in shorting the yen is **much** more modest now than it was a year

Exhibit 1. Whitmore Capital LP Performance Jun. 2012 — Jun. 2013 Against Select Benchmarks[†]



Sources: Whitmore Capital Management, LLC; Credit Suisse Hedge Fund Index; Standard & Poor's; BarclayHedge Currency Traders Index.

[3] Past results are not necessarily indicative of future results.

[†] Median Currency Hedge Fund data taken from the BarclayHedge Currency Traders Index. This index is an equal weighted composite of managed programs that trade currency futures and/or cash forwards in the inter bank market. The particular funds that comprise the index may have rates of return that are significantly different and/or more volatile than those of the index. Finally, while individuals may invest in a particular fund included in the index, they may not invest in the index itself.

ago when it was the Fund's largest position. Accordingly, I have reduced our positions against the yen.

What was amazing about the decline of the yen was that despite the fact that it should have been an obvious move to currency investors based upon the poor fundamentals of the Japanese economy, the yen's overvaluation on a purchase power parity basis *and* a new government determined to weaken the yen, it would appear that most currency-based investment vehicles missed the boat. It is true that several other much more prominent investors made huge sums of money shorting the yen (George Soros and David Einhorn have reportedly made sums in the nine figures, and possibly more). But as a whole, it would appear that most currency-based investment vehicles have performed rather poorly despite the low-hanging fruit to be picked by shorting the yen. According to Bloomberg, the median currency fund has lost approximately 2.5% over the last year!

In looking back upon last twelve months, perhaps even more satisfying than the absolute rate of return was the risk-adjusted rate of return for the Fund. Despite the fact that Whitmore Capital LP was up almost twice the amount of the S&P 500 in its first year, the Fund's standard deviation (a measure of volatility) was comparable to the large cap index's standard deviation for the last decade.

One popular measure of risk-adjusted returns is something called the Sharpe ratio. It essentially provides a measurement of how much extra return one gets for any given level of risk an investor assumes. A Sharpe ratio below 0 indicates an investor would have been better off simply investing in a "risk-free" asset such as a three-month T-Bill. Any number above 1.00 indicates the investor received extra return for taking on extra risk, or volatility. The Sharpe ratio for the Fund in its first year was in excess of 2. By way of comparison, the Sharpe ratio for the typical hedge fund over the last nineteen years has been around .8 (a rather stinging indictment of the hedge fund industry as a whole I might add).

In sum, I am very pleased that our twelve-month **net** returns have exceeded my expectations. In absolute percentage terms, we outperformed the typical currency fund by more than 50%, hedge funds as a whole by 40% and the S&P 500 by more than 20%. Yet investors should brace themselves for reversion to less spectacular gains at best, and short-term capital losses at worst.

WHITMORE CAPITAL MANAGEMENT

About Whitmore Capital Management, LLC

Whitmore Capital Management, LLC was formed in 2012 to offer investors access to a proprietary foreign exchange investing program (the Fund, Whitmore Capital LP). This program focuses on cash currencies but may also include futures, forwards and currency options. The objective of the Fund is to achieve long-term returns superior to the Credit Suisse Hedge Fund Index.

At the very core of the investing program is a mathematical model developed by Mark Whitmore. This proprietary calculus for determining the "fair value" of exchange rates aims to identify long-term opportunities to profit from temporary currency market mispricing. The outcome of these quantitative analyses are supplemented by qualitative analyses of the circumstances surrounding each currency to determine the configuration of the portfolio itself. Finally, sentiment indicators are reviewed as an additional analytical overlay. Currencies traded for the Partnership's account may include, but are not limited to, pairs of the following currencies: AUD, CAD, CHF, CNH, CZK, DKK, EUR, GBP, HKD, HUF, ILS, JPY, MXN, NOK, NZD, PLN, RUB, SEK, SGD, TRY, USD, ZAR.

Contact: mark@whitmorecapitalmanagement.com

Website: www.whitmorecapitalmanagement.com

WHITMORE
CAPITAL MANAGEMENT