# Mark's Musings

Whitmore Capital Management Quarterly Newsletter

**Q1, 2014** **May 20, 2014**

## 1Q 2014 — Now for the Ugly

The first quarter 2014 returns for Whitmore Capital LP, net of all fees, came in at a very poor -7.2%.

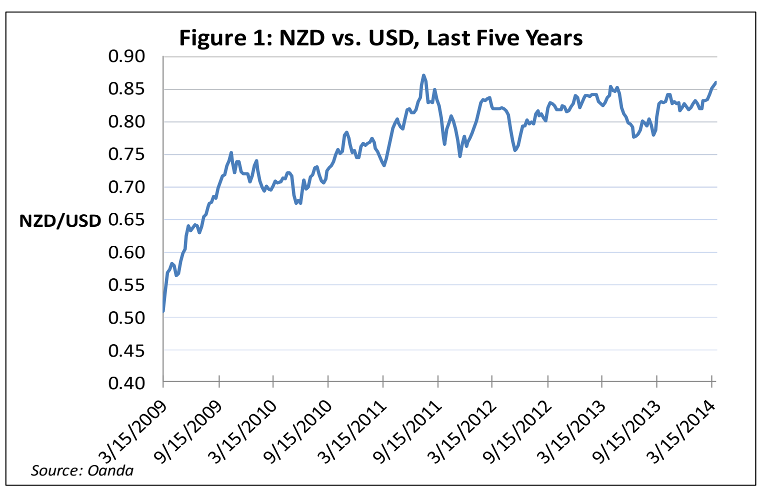
Note: In the period between the end of 1Q 2014 and the publication of this letter, the Fund has received finalized performance figures for April 2014. The investment result for April 2014 is –6.07%.[1]

There are two primary reasons for the fund's disappointing 1Q 2014. First, on a macro level, I continued to position the fund more defensively, believing that the global macroeconomic risks present serious challenges going forward. However, with US equity markets closing the quarter essentially at their all-time highs, being defensive proved to be quite unprofitable. Several "risk-on"[2] currencies that I see as being particularly vulnerable should the global economy sour, and in which the fund has short positions – most notably the British pound and New Zealand dollar – have continued to trade at or near multi-year highs (see Exhibit 1).

*"Inactivity strikes us as intelligent behavior."*

*- Warren Buffet*

Exhibit 1. Nominal Performance of NZD/USD Exchange Rate Mar. 2009 — Mar. 2014




[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] By a "risk-on" currency, I mean one that generally performs well in a macroeconomic environment characterized by optimism and/or investor complacency. For example, the period of 2003-07 prior to the credit bubble bursting was a time when "risk-on" assets performed quite well. This contrasts with "risk-off," or defensive, currencies which are seen as "safe haven" currencies for times of investor fear and general asset market declines.

The second reason for the extent of our negative performance in 1Q 2014 was the fallout from Russian intervention in the Ukraine. Some of you may have read my October 2013 essay on currency investing appearing in the *Gloom, Boom and Doom Report*. In it, I made the case for the fairly bright medium-long-term prospects for the Russian ruble. While not the largest position in the fund, the ruble is one of the larger holdings.

The ruble went from being rather stable prior to the ousting of pro-Russian Viktor Yanukovych as Ukraine's president at the end of last year, to plummeting rather dramatically throughout the quarter as the world was left to ponder what the ultimate extent of Putin's intervention in the region would be. All told, the ruble declined more than 7.5% over 1Q 2014**.**

By way of explanation (as opposed to making excuses), the first three months of the year were a bit of a perfect storm. The fund's the macroeconomic bias was towards defensive currencies, which performed poorly in a quarter where risky assets were rewarded, but the one primary "risk-on" currency held in the fund (the ruble) was crushed due to country specific circumstances.

## A Brighter Big Picture

When stepping back from the throes of the last two quarters in which much higher volatility and net negative returns have reared their ugly heads, broader fund strategy and performance are encouraging. With almost two full years of returns, Whitmore Capital LP, even after recent setbacks, is up 48%, net of all fees, through March 2014 (see Exhibit 2).[1]

By way of comparison over the same time period, even the high-flying S&P 500 is "only" up 43%, despite 2013 being the best year for the index since 1997. Looking at our chosen benchmark, Whitmore Capital LP is up three times the 16% returns achieved by the Credit Suisse Hedge Fund Index.[2] Finally, our returns truly crush Barclays Currency Traders Index (BCTI; which contains nothing but currency-based funds and is thus the best pure benchmark for the fund), as the average currency fund actually lost a bit of money over the last 22 months. The return of -.3% actually overstates the average currency fund's performance, since the BCTI reflects "survivorship bias," meaning that funds that either closed or did not report due to poor performance are not included in the index.[3]

Overall, I continue to be pleased with how my model and various analytical overlays have performed. Frankly, it is still very early in the fund's lifecycle. But as we accumulate

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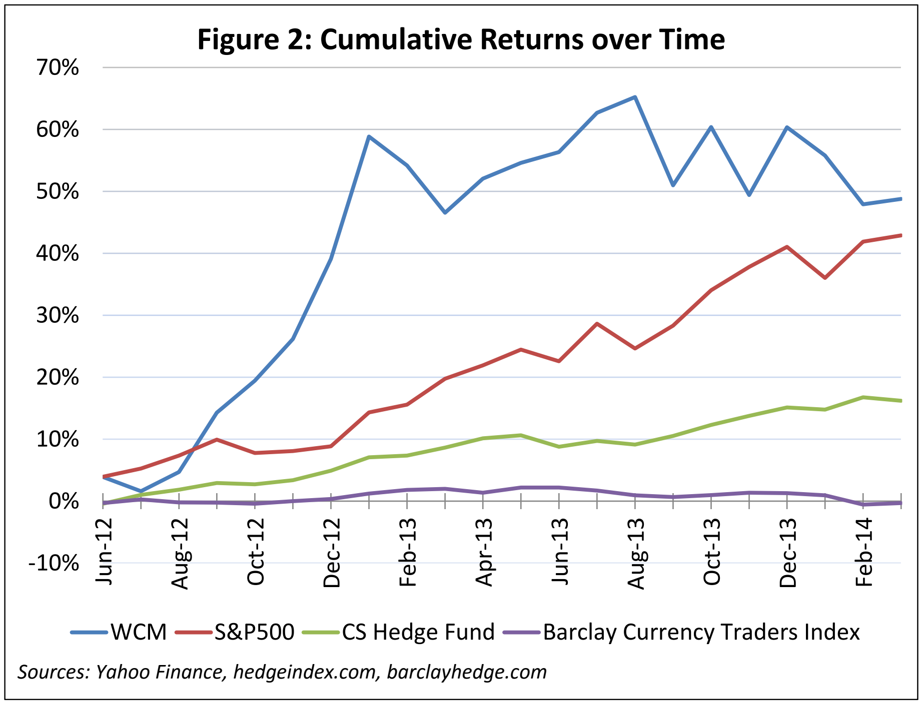
[2] About the Credit Suisse Hedge Fund Index. This index is compiled by Credit Suisse Hedge Index LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database, which tracks approximately 9,000 funds and consists 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.

[3] About 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.

Exhibit 2. Whitmore Capital LP Since Inception Performance Against Select Benchmarks




***"I remain convinced that the very best investment approach is to treat short-term, non-catastrophic losses as "noise" at worst, and opportunity at best."***

returns over a longer period of time, encompassing various market cycles, we will have a better basis for assessing the success of fund strategy.

### But What Have You Done for Me Lately?

I know it must be frustrating for most if not all investors in Whitmore Capital LP to see me touting the longer-term success of the fund and its strategy, while every outside investor has only been able to participate since April 2013 at the earliest. Since that time, returns have been fairly flat. Worse still, investors arriving at the end of last summer are actually seeing losses.

I certainly do not take short-term losses or underperformance lightly. I am also acutely aware that even "paper" losses that have not been realized can be extremely disconcerting for investors. Being by far the largest limited partner in Whitmore Capital LP, I do not like seeing even ephemeral losses from a personal net worth standpoint.

I am, however, reminded of a section of the very first quarterly report I penned last year:

> *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 experienced the greatest gains in my portfolio following months of losses.*

Accordingly, I remain convinced that the very best investment approach is to treat short-term, non-catastrophic losses as "noise" at worst, and opportunity at best. The kind of inactivity Buffett is alluding to in the quote at the beginning of this piece is refusing to let the short-term whims of the marketplace induce you to engage in reactionary trading, usually out of fear. The older (and hopefully wiser) I get, the more I appreciate the importance of *thought* over action. Many of us feel a need to *do* something in the face of adversity or a perceived crisis. Yet finance study after finance study demonstrates that investor actions in the face of losses are almost always ill-conceived ("the sky is falling"), and thus ill-timed (buying high and selling low).

### From the Vault

But let me draw an important distinction lest you think I am advocating a mindless "buy and hold" approach, the kind that led most retail investors off a financial cliff in 2008-09. While knee-jerk reactions should be avoided, 1) thoughtful reflection and reassessing one's assumptions and strategies should be occurring constantly; and 2) when such reflection and reassessment leads one to conclude the one's existing investing strategy is no longer optimal, **meaningful action** must follow.

To demonstrate how I have implemented this approach personally in the past we must start with the basics and build from there. My general investment strategy was, and continues to be, **that I only want to own undervalued assets that have a likelihood of appreciating in the medium to long-term**. From 2002 through 2006, I owned many equities (however, few of them were US companies). The combination of three things produced compelling values in many equities throughout the world at the beginning of that time period: 1) the tech bubble bursting; 2) commodity prices being at multi-decade lows when adjusting prices for inflation; and 3) the ongoing fallout of the 1997-98 East Asian Crisis.

By the end of 2006, as part of reassessing my portfolio in light of my strategy, I determined 1) commodity prices had gone from cheap to relatively expensive; 2) the US market had fully recovered from the tech bubble; 3) most emerging market stocks in Asia and elsewhere had increased in value between 100 to 800% since the East Asian crisis; and (most disturbingly) 4) a growing credit bubble, centered in the US mortgage market, but having tendrils throughout most of the world, threatened to torpedo the global economy.

These determinations in turn led me to draw four conclusions. First, my portfolio no longer contained "undervalued assets." Second, even to the extent I did find a few remaining new investments that might be deemed to be undervalued, the growing credit bubble meant that when (not if) it popped, the fallout might create such a poor investing environment that there would not be a high enough certainly that those undervalued assets would appreciate even in the medium term. Third, any bursting of the credit bubble would certainly create a "fire sale" on most, if not virtually all, financial assets. Finally, specifically related to the currency markets, a credit-induced financial crisis would crush "risk-on" currencies (particularly that of the British pound given the degree to which London, and hence the whole country, is tied to the health of the financial services sector), while causing "safe haven" currencies such as the Japanese yen and US dollar to soar.

In light of my conclusions, I took four specific actions. First, I sold most of my longs. If personal financial assets are no longer cheap nor likely to appreciate over the medium to long-term, why own them?

Second, being a rather aggressive investor (I was single with no kids at the time), I shorted US companies levered to the housing and/or mortgage lending markets. I should note that shorting is something I would not advise for anyone without significant financial sophistication as well as the ability and willingness to weather the practical effects of having unlimited downside should things break in the unanticipated direction.

Third, I made sure I had a decent cash war chest. If one aspires to be a "vulture investor" (something I maintain to be a far more noble endeavor than the name would indicate), it is imperative that one possess the thing that most people in the midst of asset bubble collapses do not – liquidity! If one

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anticipates a high probability of significant future dislocation, as I did at the time, it is very prudent to set aside a greater amount of cash than you would otherwise be inclined to hold so that when asset prices do crumble, you have plenty of spare powder in the keg. Another reason to hold extra cash: If one is aggressively positioning one's portfolio to take advantage of an expected future downturn, one may face large interim losses if the timing of the collapse takes longer to play out than one anticipates.

Fourth, I shorted the British pound (GBP) against the Japanese yen (JPY) and generally increased my own portfolio towards more currency exposure. I do believe that alternative assets like currencies become even more compelling when traditional assets that normally have positive returns face the prospect of subpar or, worse still, negative returns.

The following year (2007) proved to be rather awful. Not only did I divest my equity holdings, which proceeded to have a spectacular year, hitting all-time highs through the first ten months of the year, but I was also taking losses both with my housing/mortgage shorts and my currency positions. This was the first year I took substantial losses in my overall portfolio. My GBP/JPY position was particularly painful, going from about 230 yen to the pound and appreciating almost 9% to 250. That might not seem like much on first glance, but considering my leverage exceeded 10-1, you can do the math to calculate the brutalizing my portfolio endured.

So put yourself in my shoes in October 2007. The market had been essentially beating me upside the head, with the vast number of market participants laughing all the way to the bank, happy to take the other side of my bearish investments. I had used most of the extra cash I initially had on the sidelines backing up my theretofore losing positions. What to do? Cut losses and run? Double down? Stay the course? Take the bar exam again and return to law, washing my hands forever of this seemingly ill-conceived professional detour into investing?

### Turning Losses into Gains

This is where systems, structures and discipline are so absolutely vital to successful investing. Conversely, it is also illustrative of the importance of divorcing oneself from emotions when making investment decisions. All kinds of excellent research shows that fear alters brain chemistry and physiology in ways that are extremely deleterious for rational decision-making. Fear drives activity in the amygdala, a roughly almond-sized set of neurons contained within the medial temporal lobe, deemed by scientists to be the "reptilian" part of our brains. We are thus induced into primal, binary decision patterns such as fight ("all-in") or flight (sell it all). Simultaneously, fear impairs activity in our prefrontal cortex, the executive center of the brain responsible for planning and problem-solving.

As a side note this is yet another reason I eschew "trading" and believe implementing a sound long-term investing strategy to be an inherently superior way to make money in asset markets. Traders are forced to make myriad "in the heat of the moment" decisions, and even the most equanimous among us may make decisions out of fear (or greed) which we would have avoided if given the luxury of dispassionate reflection. Indeed, I cannot think of a major investing decision I undertook that had not been the result of days, if not weeks, of consideration.

But back to our dilemma. Certainly seeing a decent chunk of net worth go up in flames was tough to endure, and there was a strong desire to end the pain by whatever means possible. But by employing my systems that I had remained true to regardless of the investing environment, I made the following determinations:

1. If stocks had been expensive almost a year earlier, and they are now priced yet more dearly, they are even less attractive from an investing perspec-

tive.
2. Increased housing capacity in the US was outstripping population growth by more than 3-1, with average equity people owned in their homes dropping precipitously while new buyers were unable to afford purchases but or “liar,” zero-down and/or interest-only financing. As such, the magnitude of the coming housing/mortgage financing collapse was going to be even greater than it would have been just ten months earlier.
3. The finance bubble in England had eclipsed that of the US when accounting for the relative size of the two economies, making the pound even more likely to tank.
4. Given the explosive move to the upside, and the indeterminable nature of the global finance bubble (as *the Economist* noted about bubbles, there are only two things one can ever be sure of – they last far longer than anyone ever anticipates, and they always burst), it would be imprudent to increase exposure/leverage, as I could not determine when bearish positions would turn around.

In light of these conclusions, I thought it would be folly to capitulate. At the same time, for the reasons just mentioned, it was too risky to “double down” and essentially go all-in. By process of elimination, staying the course, or Buffett-style “inactivity,” as unpleasant as it was at the time, was the only logical course of action.

In the end, thanks to sound systems, structures, processes, analysis and discipline, the strategy, and the manner in which I executed it, proved to be very successful. The years 2008, 2009 and 2010 were the three most successful individual years I have ever had as an investor. While everyone knows what happened to housing and mortgage stocks, making for some very profitable shorts, the fate of the GBP/JPY is probably less well-known. Shorting the GBP/JPY went from being the most unprofitable currency investment I ever made, to being the most profitable by far, declining more than **45%** from its high of about 250 yen to the pound to 130 by January 2009. This was a move of almost unprecedented magnitude between a major currency pair within 18 months.

## Takeaways

My intent is not to detail a brutal, if ultimately self-congratulatory investing “war story.” Rather, I hoped to provide something tangible to illustrate what I believe to be timeless investing principles concerning capital losses:

1. As an investor, all you can do is make the very best decisions given the information available to you at the time.
2. Superior investors have in place an investment strategy at all times that is reflective of the best medium to long-term opportunities capital markets offer at any given time. Individuals not managing their own money have investment managers who can articulate to them their strategy and investment plan to identify and take advantage of the best opportunities for medium to long-term profit in a manner that both manages risk and provides sufficient diversification.
3. There will be times that, either through extrinsic events or pure market sentiment in the “wrong” direction, you will suffer losses and it will not be fun.
4. While your instincts may prod you to act (or, more correctly, react), you are best served to reflect, analyze and then reassess your strategy. Regarding investment managers, have them explain unexpected losses to you. If they cannot explain those losses, or appear to have no plausible plan as to how they will turn losses into eventual gains, consider pulling your money.
5. If after careful and dispassionate reflection you determine that your original strategy is no longer valid — either due to extrinsic events changing the fundamental investing landscape, or because your original thesis/strategy was flawed — change your strategy accordingly.
6. If you determine that your strategy is

***“As an investor, all you can do is make the very best decisions given the information available to you at the time.”***

still sound, you have extra liquidity and you perceive that the overall investing landscape is not dangerously volatile or about to become so, you may be well served to dollar-cost average into your losses. Assuming you are correct in the medium to long-term, you will actually profit from the initial losses by having a lower cost-basis for each unit of your investment.

7. If you determine your investing strategy is sound, but you either do not have surplus cash on hand, or perceive there to be danger of significant volatility, *stay the course*.

## Going Forward

So in light of the aforementioned strategy and investing principles, what do I conclude to be the best course to set for the fund? The parallels to 2007, not just in terms of finding myself with capital losses in a portfolio but also the macroeconomic backdrop, are striking. Several facts that I find rather disturbing include:

1. Equity investor complacency in the US is at shockingly high levels. One very good proxy for this is the available cash to investors on the New York Stock Exchange. When investors are (over) confident about future returns, they take on margin debt. Two of the previous three spikes in negative available cash over the last twenty years occurred in 2000 and 2007. Recent negative cash levels eclipsed those of 2007 by 100%. Moreover, according to Investor Intelligence, bearish sentiment among investors just reached its lowest levels since **1987** (right before the 25% stock market crash in October of that year). Finally, according to Rydex, the percentage of investors going long its levered funds versus short reached a new six-year high in 1Q 2014.
2. Even big financial institutions are beginning to sound the alarms. Such enterprises do not have an impressive history of warning investors when danger is nigh (and of course it is rarely in their financial interest to do so). Nevertheless, Blackrock's investor risk gauge (which examines enterprise value, EBITDA and volatility levels versus stock prices) just hit a new five-year high. Citigroup has a proprietary panic/euphoria model intended to be a contrary indicator of future price movement. Last November, it entered the "euphoria" zone and has recently continued to advance much further into that territory. According to Citigroup Investment Research, we have now entered the "Bubble Zone."
3. Global risks have not abated, and appear, by some measures, to have increased. Despite it being a country with no viable way of paying off its crippling debt, Greek ten-year government bonds have recently seen the interest rates go below 6.5%. This is below pre-collapse levels. Such pricing of Greek government debt indicates (over) complacency in the Eurozone. In Asia, the economic fate of China is even more disconcerting. According to Standard Charter, credit growth in China has increased **175% in less than five years!** The bank concludes that, if properly measured, total debt in China is more than 230% of GDP. Private sector debt exceeds the level in the US prior to our credit bubble bursting. Especially noteworthy is that *no country in the history of the world has seen credit in all its forms grow at China's pace without suffering a financial crisis*. More troubling still is the fact that the greatest growth of credit is coming from the "shadow banking" sector that includes many dodgy entities doling out high interest loans and deposits without capital reserve requirements and the myriad other regulatory safeguards intended to prevent a banking sector collapse.

I might also remind investors of the research and analysis contained in our last quarter's report indicating that five- to ten-year returns in US stocks are likely going to be *very* disappointing based upon very high present valuations. So, applying the approach to capital losses detailed above to the fund, I am left to draw the following conclusions:

Redacted as proprietary to Whitmore Capital L.P. investors.

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## The Best for Last

First let me say that for those of you who were able to join me for our first (of what I hope will be many) annual investor forum/ wine tasting, I thoroughly enjoyed meeting with you all and getting a chance to get to know each of you a little better. Those in attendance heard me announce that Whitmore Capital LP has its first full-time senior analyst, Evan Tuck. I have had the pleasure of knowing Evan for a couple of years now. Evan graduated with high honors from USC, majoring in international relations and philosophy. He went on to receive a Master of Science from London School of Economics in economic history (with merit), one of the finest institutions in the world when it comes to producing outstanding economic scholarship. He has most recently been working as an advisor at Crosswater Realty Advisors, providing consulting services to institutional investors.

Evan has already collaborated with me on a couple of writing projects, particularly my essay on currencies as an asset class from last October. He has also produced some fine analysis for me concerning correlation coefficients among currency pairs (a topic in which, shockingly, I do not find much interest at cocktail parties). He will also be coming on as a junior partner in Whitmore Capital Management. In light of the fact that our fund is only as good as the intellectual capital we can bring to bear on the currency markets, I am confident that our enterprise has taken a giant step forward by adding Evan to the team.

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## *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

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AN INVESTMENT IN THE FUND IS SPECULATIVE AND INVOLVES A HIGH DEGREE OF RISK. 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.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

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