AUG. MONTHLY INVESTMENT COMMENTARY

"When I meet God, I am going to ask him two questions. Why relativity? And why turbulence? I really believe he will have an answer for the first." – Werner Heisenberg (reputedly said on his death bed)[1]

RIME OF THE ANCIENT MARINER

The Doldrums are parts of the Atlantic and Pacific Oceans with unusual weather patterns. Most of the time, these low-pressure areas, banding the equator, have almost no wind. Because of radiation from the Sun, hot air rises vertically; there is virtually no wind most of the time because the rising air does not blow other than straight up. There can be no wind for weeks. However, the rising air, coming from the ocean surface, is moist. Once it reaches altitude, it travels to the horse latitudes, north and south, eventually returning to the doldrums as the trade winds. This moist air can cause sudden heavy storms, including hurricanes and savage tropical storms. It is a binary state of nature: there is either no activity or frantic activity.[234]

> "Colloquially, the 'doldrums' are a state of inactivity, mild depression, listlessness, or stagnation."[5]

The Doldrums were particularly important in the age of sail where ships could become stranded for days or weeks without any viable wind.

> "All in a hot and copper sky,
> The bloody Sun at noon,
> Right up above the Mast did stand,
> No bigger than the Moon.
>
> "Day after day, day after day,
> We stuck, nor breath nor motion;
> As idle as a painted ship
> Upon a painted ocean."[6]

In a related vein, there is also turbulence:

> "Just like a fast-moving river swirling against the riverbank, where the edge of the jet stream interacts with slower moving air, there may be some mixing of the air which causes turbulence."

I mention these because both the Doldrums and turbulence apply to the markets we have seen since March.

> "The techniques I developed for studying turbulence, like weather, also apply to the stock market."[7]

This is where markets lie, stuck in the Doldrums with very little wind (or, real dispersion) to capture, all the while with hedged parties caught in the turbulent eddies at the fringe of the stream. And hedge funds luff about waiting for the wind, occasionally getting whipped around by a sudden squall, while long-only, passive investors steam slowly, ploddingly through the ocean. In more normalized markets, hedge fund operate more efficiently transforming the wind of volatility into profitable distance.

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[1] Scienceworld.wolfram.com http://scienceworld.wolfram.com/biography/Heisenberg.html
[2] WFMZ, http://www.wfmz.com/weather/What-are-the-doldrums/186892
[3] Wikipedia, http://en.wikipedia.org/wiki/Doldrums
[4] Steve Allright, The Telegraph, "What causes turbulence, and is it dangerous?", 3/18/13, http://www.telegraph.co.uk/travel/travelnews/9937719/What-causes-turbulence-and-is-it-dangerous.html
[5] Wikipedia, op. cit.
[6] Samuel Taylor Coleride, "The Rime of the Ancient Mariner," http://www.poetryfoundation.org/poem/173253
[7] Brainyquote.com http://www.brainyquote.com/quotes/keywords/turbulence.html

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All of which suggests the obvious question, when will these doldrums and their attendant turbulence end, or at least die down?

It is an axiom of finance, a verifiable pattern of history, that volatility is statistically persistent.

When markets are volatile, they tend to stay volatile for a while. When markets are relatively calm, they tend to stay calm for a while. This is called serial dependence, or serial correlation, where the volatility in time period t is correlated with the volatility in period t-n, for some number of periods n.

If you want to understand how difficult it has been for hedge funds this year, consider the characteristics of turbulence that Mandelbrot describes in his excellent book, The (Mis)behavior of Markets:

> "The tell-tale traces of turbulence are plainly there, in the price charts. It has the turbulent parts that scale up to echo the whole. It has a set of numbers – a multifractal spectrum – that characterizes the scaling. It has a long-term dependence so that an event here and now affects every other event elsewhere and in the distant future. It shows turbulence in a wild kind of variation far outside the normal expectations of the bell curve; in a concentration of changes here and there; in a discontinuity in the system jumping from one value to another; and in one set of mathematical rules that can, in large measure, describe it all … it all comes together in the metaphor of turbulence."[8]

When organized by market capitalization, four out of five quintiles in the Russell 2000 index are down year-to-date.

Reference: BTIG Research[9]

The bottom, presumably least liquid quintile, is down 14.1% vs. the S&P 500 with its year-to-date total return of 8.9%.

Small caps have outperformed large caps disproportionately since at least Thanksgiving 2000,[10] in the wake of the bursting of the dot com bubble and the ensuing research scandals and investigations. The ripples of this burst bubble may be affecting markets today.

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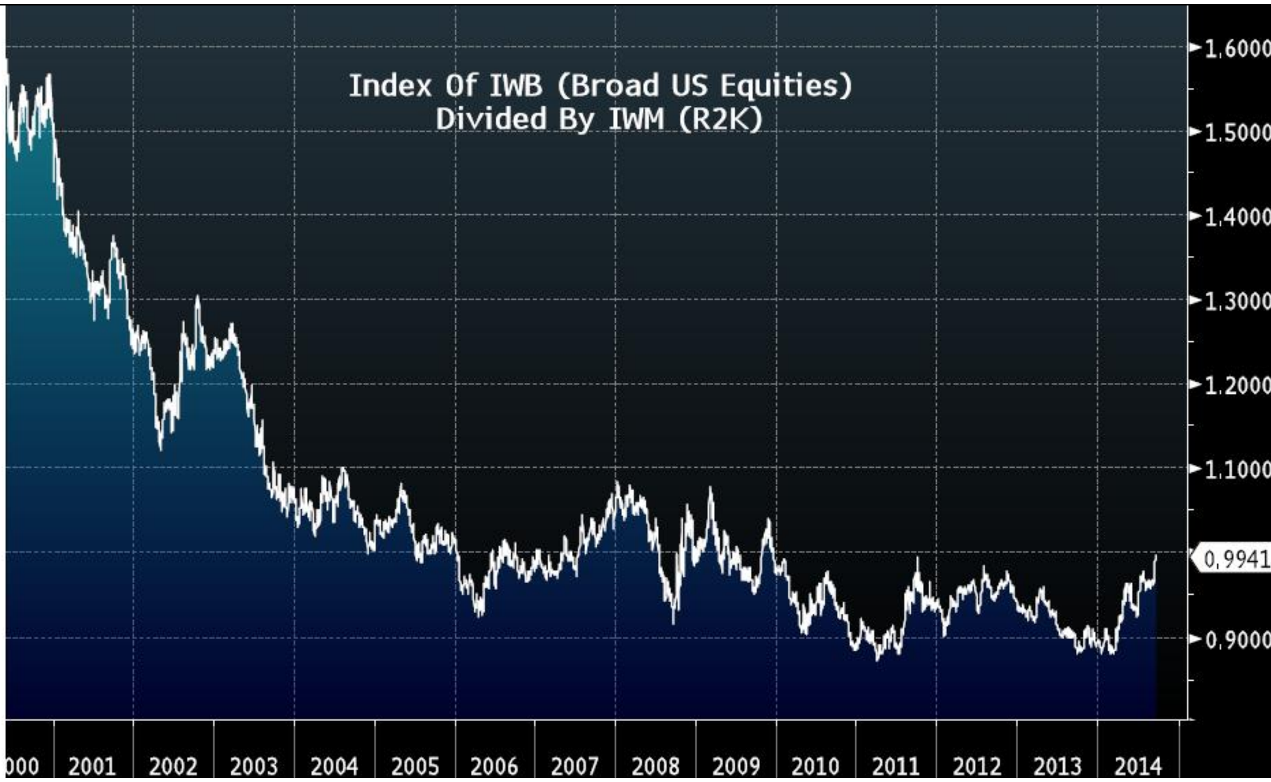
[8] Benoit Mandelbrot and Richard L. Hudson, The (Mis)behavior Of Markets, p. 227-228

[9] Dan Greenhaus, BTIG Research, "Bedtime with BTIG: More on Small Cap Underperformance," 9/23/14 http://www.btigresearch.com/2014/09/23/9-23-bedtime-with-btig-more-on-small-cap-underperformance/#more-50977

[10] Price data for the IWB and IWM are not available before May 2000. However, my working thesis is that large caps may have outperformed small caps during the dot com bubble with the rise of large capitalization technology stocks.



Reference: Bloomberg

Given the oft-repeated script that hedge funds conduct research on undiscovered or under-covered companies, it makes sense that performance-hungry hedge funds would have a strong experience and background in under-covered small-capitalization and mid-capitalization names. It is reasonable to assume that hedge funds have had a ***persistent*** and large exposure to small-caps and mid-caps.

But, why did this opportunity exist? It existed because of large scale cutbacks in equity research and credit research at the investment banks and because of the changes in policy to comply with a new stricter regime, all effected by policy makers in the name of investor protection. What it meant in practice was the elimination of research coverage for whole swathes of the small-capitalization and mid-capitalization universe, leaving investors to fend for themselves without any semblance of educated commentary. It also meant that banks were far more conservative in their research communications than they had been in the free-wheeling go-go antebellum days before the investigations by the New York State Attorney General. If the Street is a casino, hedge funds, with their quick intellect and growing experience, made their money from being the shill at the small capitalization poker table.

But, the easy money from playing small cap names against large cap names ran out of gas sometime in 2011, apparently putting in a sustainable low at the beginning of this year. Perhaps this is because the retail investor has been spooked out of the markets in the aftermath of the financial crisis. Perhaps, this is because the market began to anticipate the end of easy monetary policy and began to worry about historically tight credit spreads. The general perception is that larger corporates with their greater administrative capacity would be better able to manage the stresses of an environment in which, *at the margin*, credit would become less available and more expensive for years to come. It is reasonable to assume that there are limits to how much more available credit can become or how much cheaper it can get. Or, it could be that large capitalization names have diversified their sourcing and financing globally to develop

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sophisticated natural foreign exchange hedges whereas small capitalization names that have benefited from globalization are principally domestic in form and, by extension, more exposed to foreign exchange volatility.

But from the perspective of a hedge fund investor, there are even broader implications. Let us assume that most hedge funds have a balance of large capitalization and small capitalization plays in their portfolio, that they are not purely exposed to small capitalization names. Their small capitalization trades would be spread across a variety of hedge fund strategies including long/short value, long/short growth, merger arbitrage, distressed (if there was any significant volume of distressed left), and special situations.

Here is the kicker**.** ***To the extent that hedge funds have small capitalization and mid-capitalization trades that are infected by the disease of the end and reversal of the small capitalization outperformance theme, there will be collateral effects rippling across all other strategies <u>independent</u> of capitalization.*** You can run, but you can't hide.

The transmission mechanism is intuitive. When you have something in your portfolio that is bleeding, septic and difficult to treat (i.e. illiquid), the portfolio manager doctor first seeks to stabilize the patient. In this case, if you cannot sell the pain-inducing investment, you sell what you can. ***The cold icy finger of the risk manager tapping the portfolio manager on the shoulder with instructions to sell what he can, immediately and without any concern for market-moving effect, spills across and, paradoxically, takes down the most rational of event-driven trades, and disrupts the most carefully crafted long/short value investment thesis.*** Not for any reason, other than contagion.

How does this end? It is going to end when hedge funds start to believe that the large capitalization names will outperform the small capitalization names. It is going to end when the variability of hedge fund monthly returns settles down and there is less need for disruptive risk management trades to ripple through the market. There will be no signal that our long market nightmare has ended. The pain will merely be over.

One encouraging sign that we are closer to the end than the beginning is the fact that the Russell 2000 index is getting hammered and everyone is talking about it. We need a short small capitalization mentality to become pervasive and consensus and clichéd. I think that we are most of the way there.

One corollary implication is that large capitalization trades may be able to continue their bull market, or at least not go down too aggressively. This is certainly consistent with the conundrum affecting many in the hedge fund community and the general market who cannot reconcile weak small capitalization equities with a bull market in the broad indices such as the S&P 500. The sense is that if small capitalization names are going down, then the whole kit-and-caboodle ***must*** follow.

We are going to focus our attention on constructing a portfolio that takes this dynamic into play by focusing on large capitalization special situations on the long side and small-to-mid capitalization names on the short side, wherever practicable.

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AUG. MONTHLY INVESTMENT COMMENTARY

Long: Canadian Pacific Railway Limited

What: Canadian Pacific operates a transcontinental railway in Canada and the United States. CP offers customers freight transportation services, logistical solutions, and supply chain expertise. CP has a network of 14,400 miles in the US and Canada. Bulk goods (grain, coal, fertilizer, and sulphur) made up 42% of 2013 revenue; merchandise (industrial and consumer products, automotive, and forest products) made up 36% of 2013 revenue; and intermodal made up the remaining 22% of revenue.

How: The Company owns and operates railway lines, locomotives, and rail cars (box, flat, and special use). CP also rents rail cars or uses cars owned by customers (oil cars). The business is based on funneling traffic from feeder lines and connectors, onto the high density mainlines. CP has extended its network and reach by establishing alliances and connections with other North American railroad networks.

Why: Canadian Pacific underwent a comprehensive turnaround after activist investor Bill Ackman took a large stake in the Company, appointed seven new board members (including himself), and replaced the CEO and other key operating personnel. Critical to the turnaround was the appointment of Hunter Harrison as CEO. He implemented an efficiency program to focus on margin expansion that was substantially effective. The Company has reduced its operating ratio excluding certain significant items from 90.6% in Q111 down to 65.9% in Q414. In addition to cost cuts, volume and price increases, increased average train length, increased average train weight, and higher average train speed have contributed to revenue growth, while terminal waiting time is down materially. Fuel prices continue to work in CP's favor, as has the declining Canadian dollar. A $0.01 drop in the Canadian dollar improves revenue by $35m and EPS by $0.05.

When: The Company's upcoming analyst day should be an opportunity to present the next shift in strategic planning: a move to focus on growth, now that the Company has obtained the most significant efficiency gains possible. This comes at a time when the Company is beginning to see ship (intermodal) volumes increase, as well as the lucrative business of transporting oil by rail with its greater flexibility, its quicker time to market, and its existing environmental approvals helps to keep the North American fracking revolution robust.

Red Team Analysis: This investment will not work if economic activity in North America slows significantly, agricultural volumes decline (potentially because of the weather), or fuel prices and/or the Canadian dollar strengthen unexpectedly.

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AUG. MONTHLY INVESTMENT COMMENTARY

Short: Asbury Automotive Group, Inc.

What: Asbury Automotive Group, Inc. operates as the 7th largest franchised automotive retailer in the United States. It offers a range of automotive products and services, including (i) new vehicles (57% of revenue and 21% of gross profit); (ii) used vehicles (27% of revenue and 14% of gross profit); (iii) vehicle maintenance, replacement parts, and repair services (12% of revenue and 42% of gross profit); and (iv) aftermarket products, such as financing, insurance, and service contracts (4% of revenue and 23% of gross profit). As of August 2014, it operated 81 retail auto stores, encompassing 102 franchises for the sale of 29 brands of US, European, and Asian automobiles. Asbury Automotive Group, Inc. is headquartered in Duluth, Georgia.

How: The Company sells new vehicles to individual retail customers and commercial customers while used vehicles are sold to individual retail customers and other dealers at auction depending on the age and condition of the vehicle. Brand mix is skewed toward imports and luxury which together represent 85% of vehicle revenue. Most dealerships are located in the southeast (Florida and Georgia represent 32% and 16% of revenue, respectively) as well as the south (Texas represents 13% of revenue). The used retail vehicle and parts and service businesses generally have higher gross margins than the new vehicle business. Gross profit from the sale of used vehicles depends primarily on the ability to obtain a high quality supply of used vehicles (from off-lease and trade-ins) and inventory management. ABG's retail dealer network is made up of dealerships operating primarily under eight locally-branded dealership groups. Within the finance and insurance business, ABG arranges and receives commissions for third-party financing of the sale or lease of new and used vehicles to customers. Additionally, the Company will offer a number of aftermarket products such as extended service contracts, GAP protections, prepaid maintenance, and credit life and disability. ABG will typically earn a sales-based commission from third-party lenders, including manufacturer-affiliated finance companies, on substantially all of the financing that it arrange on behalf of customers. It may also earn spread income on certain products in which the financial company earns an excess spread on funds invested to meet future liabilities.

Why: Used car prices will be pressured over the next couple of years as more used car supply comes to market due to (i) the recent strength in new car sales which is leading to an increase in trade-ins and (ii) an increase in off-lease vehicles which are coming off their 24-month and 36-month leases. Easy credit, low interest rates, and a mildly recovering US economy have contributed to strong US new-vehicle sales. These have averaged a seasonally adjusted annual rate of more than 16 million. The downward pressure on used car pricing may also lead auto manufacturers to boost new car incentives to maintain the high sales rate of new cars. Additionally, the US consumer finance regulator is launching reviews of auto lenders' lending practices with respect to subprime borrowers. This investigation may result ultimately in limitations on the spreads lenders can charge subprime borrowers, and by extension the availability of subprime credit. Note that the dealers have discretion to extract additional spread above a scheduled rate and the CFPB is investigating this practice for its particular "disparate impact" on minority subprime borrowers, in particular. Approximately 25% of ABG's financing arrangements are for subprime borrowers who are typically more profitable for the lender as well as for the dealer.

When*:* Value realization will occur gradually upon an earnings miss or the release of negative used car pricing data. To this end, the August 2014 Manheim Used Vehicle Value Index was down 0.7% month-over-month for the fourth consecutive month of declining prices.

Red Team Analysis: In the future, we may write that this investment did not work as pent-up demand for high quality used cars offsets the increased supply, keeping used car prices stable, thereby propping up residual values, reinforcing the easy credit-by-lease that has driven much of the v-shaped recovery in auto sales.

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AUG. MONTHLY INVESTMENT COMMENTARY

Short: Visteon Corporation

What: Visteon Corporation provides climate and electronic systems, modules, and components to automotive OEMs worldwide. The Company's climate business (62% of revenue) is the world's second largest supplier of automotive thermal energy management solutions. This business offers integrated heating, ventilation, air conditioning systems, and components that provide cooling and climate control for the vehicle's engine and transmission, as well as for batteries and power electronics on hybrid and electric vehicles. Products include evaporators, condensers, heater cores, climate controls, and fluid transport systems. The climate business is operated via a publicly-traded Korean affiliate, Halla Visteon Climate Control (HVCC). Visteon owns 70% of HVCC shares. The electronics business (38% of revenue) is one of the world's top three electronics supplier of connectivity, infotainment, driver information, and controls products to the auto industry. Products include audio/infotainment products, amplifiers, rear seat family entertainment systems, instrument clusters, and displays. In an effort to expand the electronics division, VC recently purchased Johnson Controls' electronics division for $265m in July 2014.

How: The Company designs and sells products to a range of entry-level, midline, and luxury vehicle manufacturers including Ford Motor, Nissan/Renault, and BMW. VC also sells products for use as aftermarket and service parts to OEM for resale through independent distribution networks. The Company typically enters into agreements with its customers at the beginning of a vehicle's life for the fulfillment of customers' purchasing requirements for the entire production life of the vehicle. These agreements generally may be terminated by customers at any time. Regionally, VC generates its revenue from Asia (47% of revenue), Europe (30% of revenue), and North America (20% of revenue). The Company's manufacturing and engineering footprint is principally located outside of the US, with a concentration in low-cost geographic regions. VC spends approximately $325m annually in research and development expenditures.

Why: After emerging from Chapter 11 protection in October 2010, the Company embarked on a successful multi-year value creation plan, including (i) consolidating and streamlining the climate operations; (ii) purchasing JCI Electronics to bulk up the high growth electronics business; (iii) selling the low margin interiors business; (iv) reducing costs; (v) balance sheet refinancing to take advantage of low rates; and (vi) share repurchases. Additionally, VC benefited from a cyclical recovery in US auto sales, which resulted from easy credit conditions, pent-up demand, and low oil prices following the recession in the US. However, after a period off strong auto sales, the US auto cycle may be due for a correction in terms of new vehicles sold as: (i) the availability of subprime credit becomes more restrictive; (ii) credit becomes more expensive due to rising interest rates; (iii) used car inventories grow due to an influx of incoming supply from off-lease cars; (iv) pent-up demand for new cars is exhausted; and (v) the US economy remains vulnerable in the face of a strengthening US dollar

When: Value realization will occur gradually upon the release of new auto sales data suggesting that US vehicle production growth may slow down in the face of waning demand. Sales of US cars and light trucks in August recorded a strong SAAR oof 17.5m vehicles, which will be difficult to maintain with rising long-term interest rates.

Red Team Analysis: In the future, we may write that this investment did not work due to strengthening auto sales in China which offsets any weakness in new car sales in the US or due to strength in VC's electronics business driven by new technology adoption and increasing connectivity in the automobile.

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