



Q2 2020 Investor Letter

Performance Summary

For the second quarter of 2020, McLain Capital Fund I, LP returned -15.4%, net of all fees, bringing our YTD performance to -11.9%, both comparing unfavorably to the S&P 500.

	Q2	YTD
McLain Capital Fund I, LP	-15.4%	-11.9%
Benchmarks:		
S&P 500	+20.5%	-4.0%
MSCI World	+18.8%	-6.7%
HFRX Equity Hedge Index	+8.1%	-6.3%

Historical Performance

2020	Jan.	Feb.	Mar.	Apr.	May	June	YTD
	-3.9%	-4.4%	+13.2%	-1.5%	-5.8%	-8.9%	-11.9%

While frustrated with our performance in what was a humbling quarter, the recent headwinds we've faced seem highly unlikely to present the same obstacles going forward. Our current drawdown can be primarily attributed to the following factors:

- 1) Running a negative beta (approx. -.2) was a hindrance for performance in Q2 given the S&P 500's 20% rally, it's best quarterly performance since 1998.

- 2) 2020 has witnessed the worst relative performance of “value” equities since 1999... putting today’s valuation gap between “value” vs “growth” at its widest in history, now surpassing the widest levels seen in 1999-2000 during the height of the dot com bubble.
- 3) Significant negative attribution from short positions in stocks that have become (stunningly) wildly popular with retail investors, which coincided with a broad rally in speculative, high-beta, story stocks with highly questionable fundamentals and underlying businesses.

We’ll dive into each one of these themes in further in detail below.

Positioning & Portfolio Update

The fund is currently positioned 30% net long, with gross positioning at approximately 80% long, 50% short. Presuming a beta of ~1.0 on our long book and ~2.0 on our short book, the fund’s current beta is approximately -.2, giving us a small negative correlation to the market. This number ordinarily would be closer to zero in a normal market environment, but as risk/reward in equities seems skewed meaningfully to downside, we are more defensively positioned than usual.

Our long book currently consists of 36 positions at 2-3% of capital each, with no single position exceeding 3.5% of capital; our short book consists of 100 positions predominately sized around 50bp, with no single position currently occupying more than 1.5% of capital.

As a result of a handful of troublesome short positions this past quarter, I’ve chosen to cut our individual position sizing on shorts in half - from 50-60 ~100bp sized positions to 90-100 ~50-60bp positions. I believe that running a hyper-diversified short book is better risk management with minimal drag on long term returns, especially in an environment with an extraordinary level of single stock volatility.

This market environment has been quite unrewarding to fundamental investing, but we haven’t strayed at all from our core strategy of buying high return on capital businesses at low multiples and shorting unprofitable, cash-burning businesses at stretched valuations. Our long positions, predominantly small & mid cap foreign developed equities, trade at an average EV/EBITDA of 2.8x, FCF Yield of 21%, and ROIC of 17%. Notably, 6 out of our 36 long positions currently trade at a negative enterprise value, meaning that current levels of net cash (cash – debt) exceed the current the market capitalization. Stated otherwise, this means the market is offering the operating business at a price less than zero. These are all growing, highly FCF generative businesses. The one common denominator these have, along with most of our long book, is they’re well down the market cap spectrum in markets that currently do not receive a great deal of attention from active investors, especially in comparison to US markets. In a world of historically elevated asset prices, it’s truly surprising to me that one is able to find this level of value by simply venturing off the beaten path and looking where 99% of others don’t bother.

“What a man wishes, that also will he believe.” Demosthenes

Are we allowing price action to dictate the narrative?

Given the market’s price action during the last two quarters – the most volatility equities have seen in 80+ years -- and the current economic backdrop, it is quite remarkable that COVID-19 has not created a greater appreciation for risk among investors. In many ways, it has had quite the opposite effect as many investors have exhibited highly speculative behavior in recent months as certain pockets of the market seem to have become completely untethered from fundamentals and have entered bubble territory.

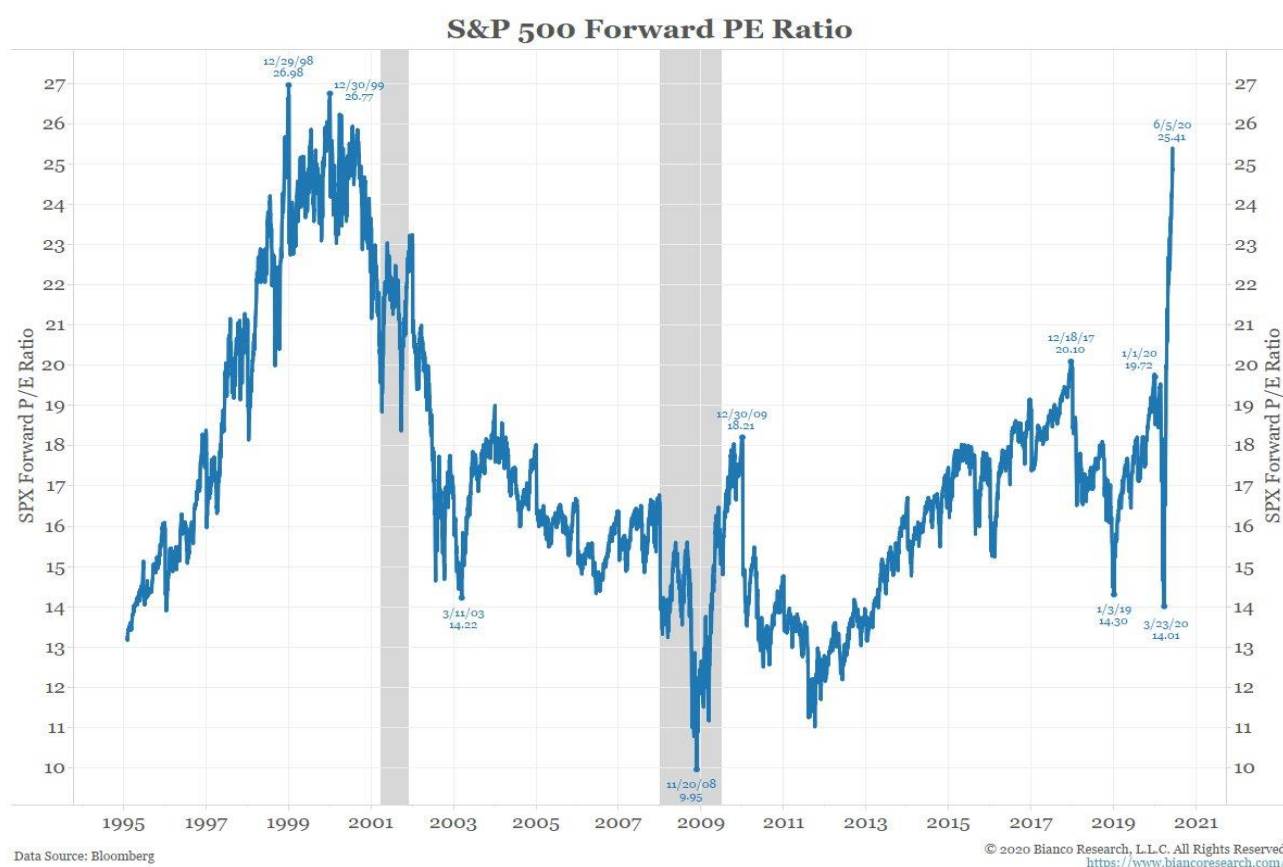
When I last wrote to you in early April, 10 million workers in the United States were unemployed and receiving unemployment insurance. Since then, that number has tripled. With approximately 33 million Americans currently collecting unemployment benefits, approximately 20% of the labor force, economic uncertainty remains extreme, especially with the prospect of the CARES act unemployment insurance enhancement of \$600/week expiring later this month, unfortunately presenting some 30 million Americans with the possibility of a roughly 60% pay cut.

With regards to the economy, it seems that some of the worst of what we feared most in March has arrived, but with the NASDAQ now up 22% YTD, and the S&P 500 now flat on the year, markets have chosen to ignore the hard news and assume the best in a quick “V-shaped” recovery in the economy and corporate earnings, leaving little cushion for disappointment. Despite the myriad risks presented to investors since the onset of COVID-19, investors have demonstrated a staggering lack of discipline in public markets, particularly in the more speculative corners of the market.

As a reminder, if the market were to simply demand the equity risk-premium to be a mere 2% higher per annum, then prices must fall over 30% from current levels.

Call me old-fashioned, but an intelligent investor must question the wisdom buying US equities at near record valuations in the middle of a severe recession, despite the palpable level of excitement and FOMO around the recent rally.

- Stocks have significantly decoupled from the path of forward earnings estimates - by nearly any metric, valuations based on trailing earnings for US equities remain above the 90th percentile of the market's history, while the economic backdrop is at its worst since the 1930s. The current forward P/E of 25x for the S&P 500 remains close to the highs we saw during the dot com bubble. Considering that 40% of companies have dropped earnings guidance, the "E" in the equation could easily disappoint:

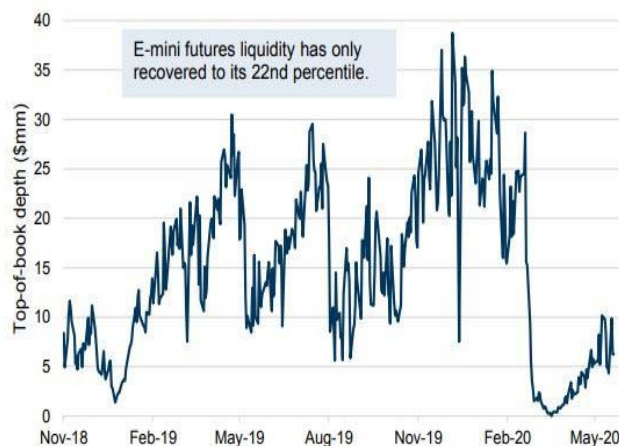


Record volumes & little liquidity:

Single stock liquidity remains near record lows, while trading volumes are at record highs – largely driven by the huge amount of incremental participation in the market by retail investors. In this kind of market environment, the marginal buyer & seller can have quite an outsized impact on prices – especially when many of those traders are rather price insensitive and are highly attracted to recent upward momentum in share prices, creating a reinforcing cycle of share price appreciation attracting new investors and emboldening current ones. The dominance of passive cap-weighted index investing and “closet-indexing” by quasi-active investors who tightly hug their benchmark only serves to reinforce rather than counteract share price momentum, irrespective of fundamentals.

Exhibit 1: Futures liquidity has only recovered to its 22nd percentile

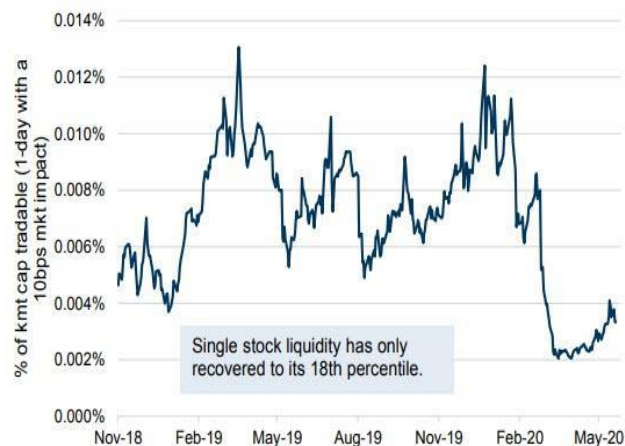
median daily top of book depth; snapshots taken every 5 minutes



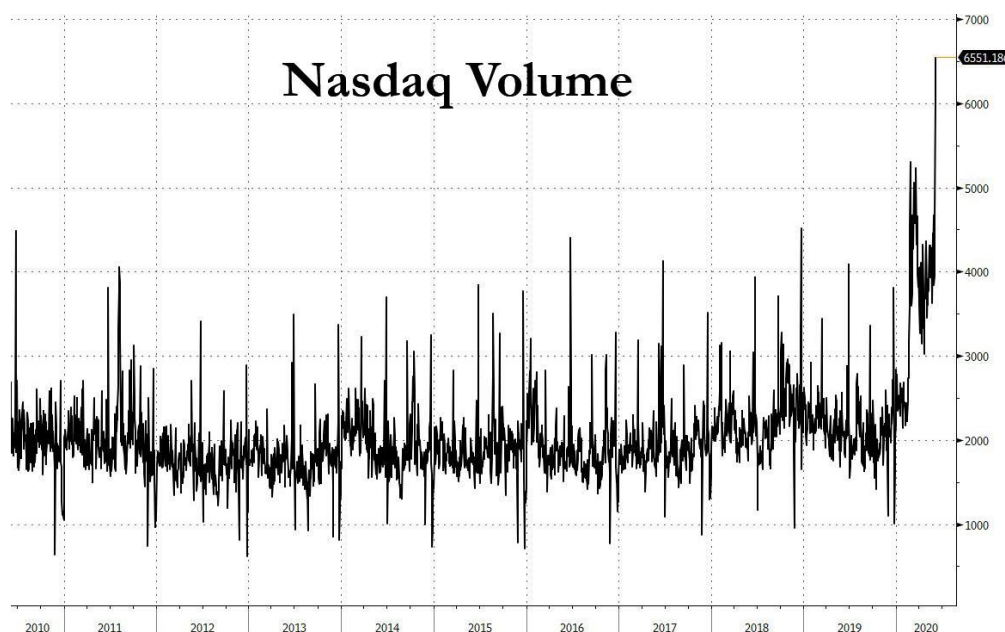
Source: Goldman Sachs Global Investment Research, Bloomberg

Exhibit 2: Single stock liquidity remains below Dec-2018 levels

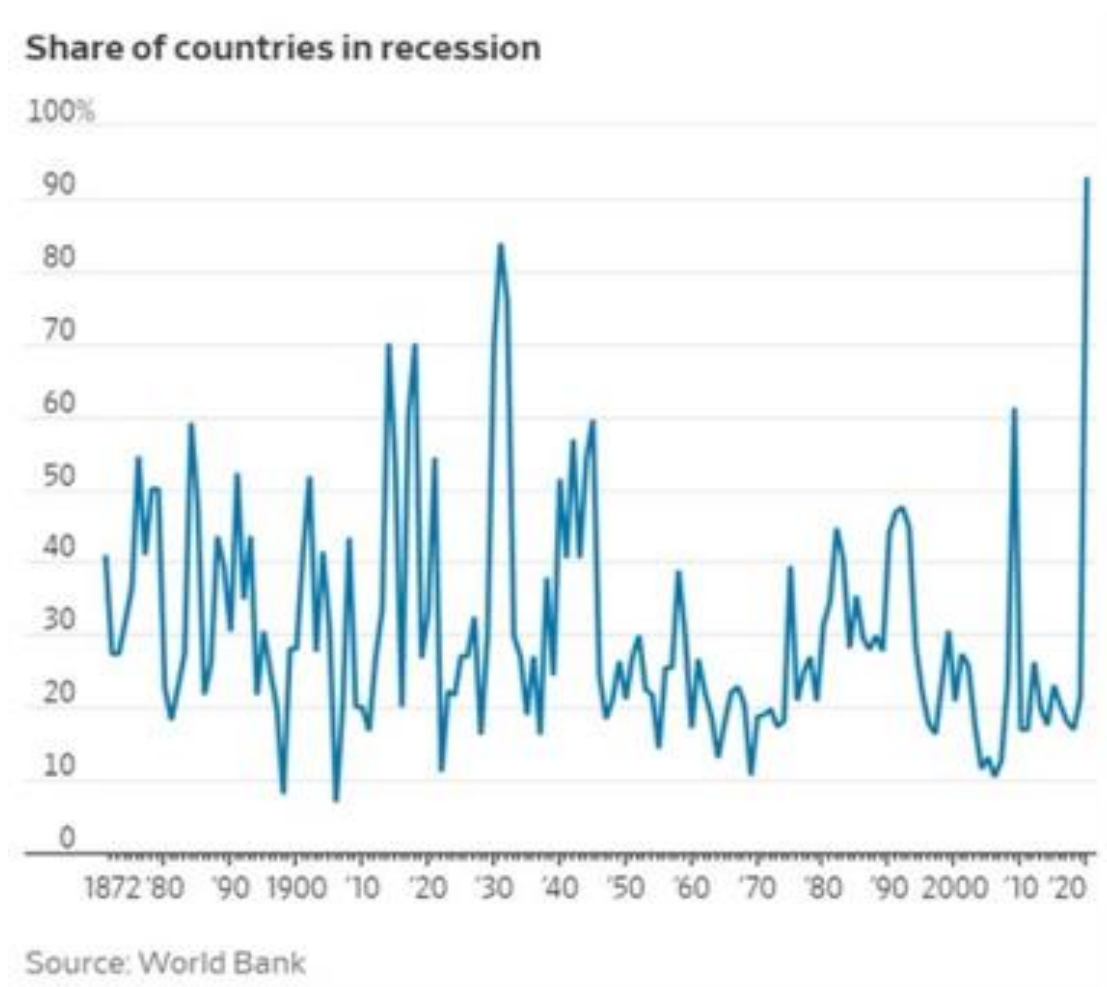
% of market cap of Russell 3000 tradable across stocks for an expected market impact of 10bps



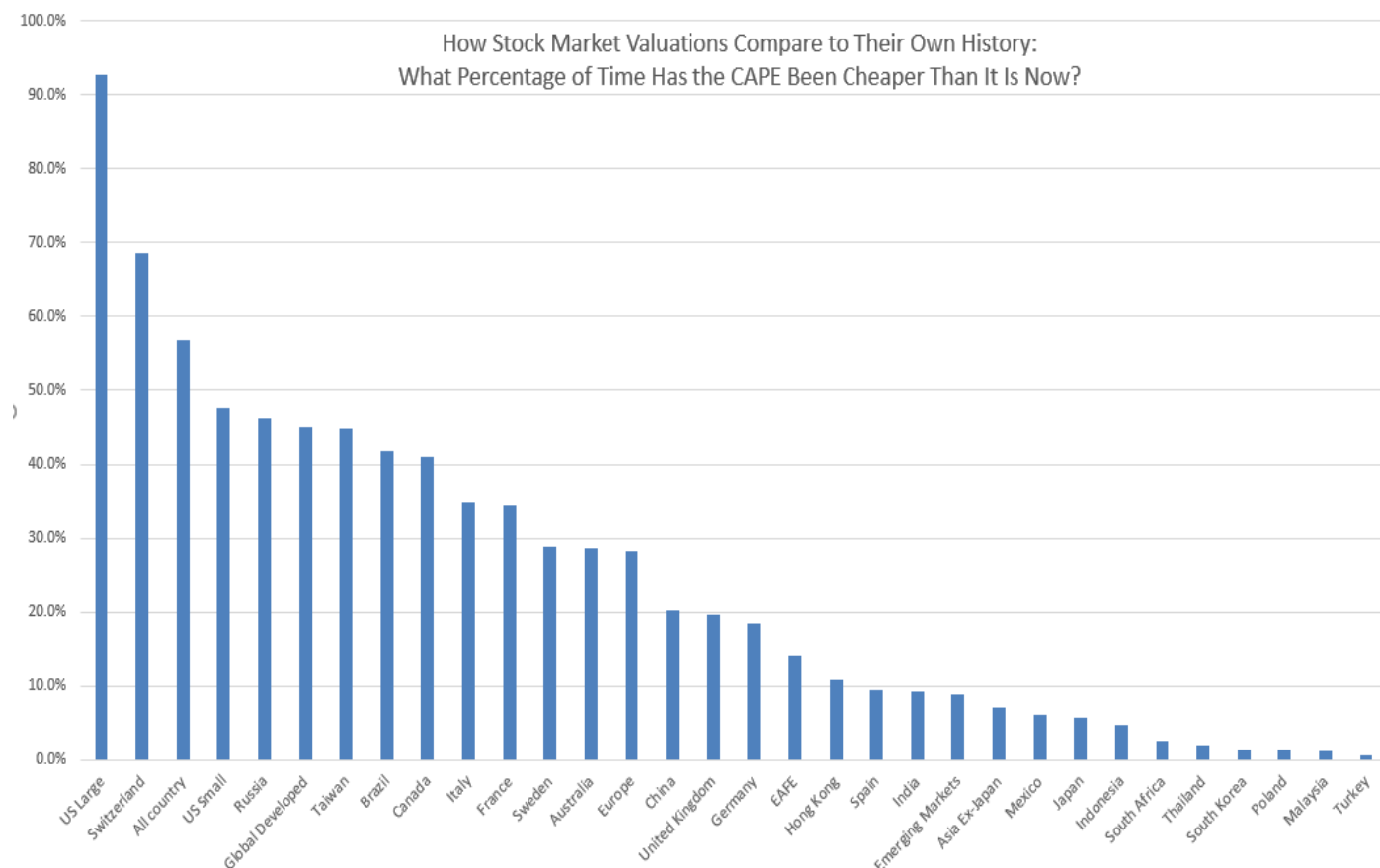
Source: Goldman Sachs Global Investment Research, Goldman Sachs Group Inc.



- Currently 90% of countries are in recession, making the current fallout a much more global phenomenon than GFC of 2007-2009, where rapid growth in China & Asia served to counterbalance the economic malaise in the United States. The World Bank estimates that global per capita GDP contraction will be more than twice as severe as that experienced in 2008-2009.



- Notably, US Equities have never been more expensive relative to Foreign Equities as they are currently:



There's no way to predict what the next few quarters may hold for markets but it certainly is alarming that markets seem as "risk-ignorant" as they currently are, especially considering the unparalleled degree of uncertainty with the global economy. Markets are, of course, forward looking in nature, and the "right" level for the market is unknowable, as stocks are a long duration asset, with uncertain future cash flows, the value of which is highly sensitive to the rate at which they are discounted, presenting an enormous range of justifiable valuations. Given the current combination of elevated prices, a high amount of "known unknowns" with regards to COVID-19 and its 2nd and 3rd order effects, US equities seem to currently present a poor risk/reward and little margin of safety.

Retail Investors and the Dash for Trash

“Individual and institutional investors alike frequently demonstrate an inability to make long-term investment decisions based on business fundamentals.” Seth Klarman

2020 has certainly been a surprising year in many ways, but one development that has caught my eye (along with many others) has been the advent of a highly speculative retail-trading mania in stocks and options, where a seemingly large part of these investor’s focus has been on either frothy, high-flying story stocks with eye-popping valuations, or severely hampered businesses with large rates of cash burn and solvency/liquidity issues. Notably, many of these investors are not only buying stocks, but rather call options which serve to dramatically magnify their notional buying power and, consequently, their potential effects on individual security prices. Last year’s emergence of commission-free trading had already dramatically increased retail investor participation in markets; COVID-19 has seemed to have dramatically accelerated this phenomenon, as bored, uninformed day traders try their luck in the market, creating an environment reminiscent to many of the late 90’s tech bubble. With millions of new investors actively participating on a daily basis, trading stocks has become an American pastime. Through history, this kind of behavior has been a very consistent late-cycle indicator and ought to serve as a warning to investors.

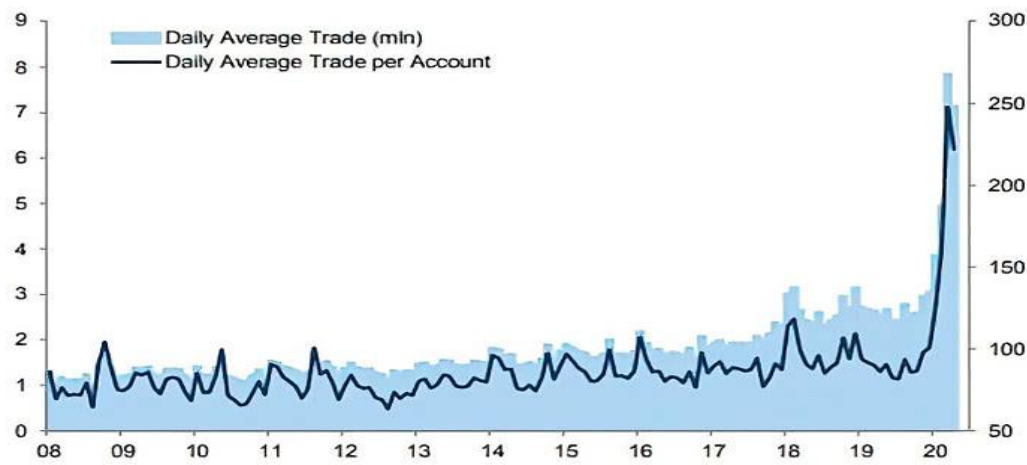
- Retail investor trading in call options has exploded higher over the past few months. These purchases have tended to be highly aggressive in their structure: relatively short expiration, far out-of-the-money calls.

Small options traders are twice as aggressive as the February peak



- Online broker's trading activity, accounting opening, and asset levels are all multiples of the same levels from this time last year:

Exhibit 10: Retail activity in online brokers has spiked recently
US online brokers retail trades

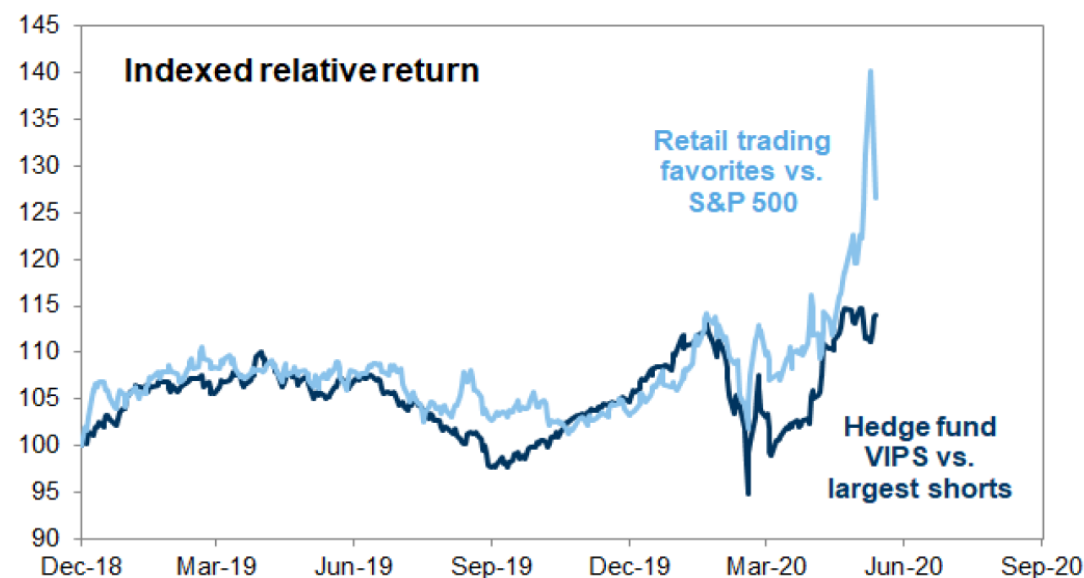


Source: Company data, Goldman Sachs Global Investment Research

- Retail investors have dramatically bid up their own most popular stocks, causing many to names to trade at wide disconnect from a reasonable estimate of fundamental value.

Exhibit 1: The most popular retail trading stocks have outperformed sharply

as of June 11, 2020



Source: FactSet, Goldman Sachs Global Investment Research

A few research notes & headlines really caught my eye in the past several weeks...

"In some popular stocks, like Chipotle Mexican Grill Inc. and Alphabet Inc., small options trades account for nearly a third of total volume." Goldman Sachs, May 2020

"At the heart of the speculative activity are smaller investors, according to Sundial. Small trader call buying made up more than 50% of total [option] volume last week, the highest since 2000, it said." Bloomberg, May 2020

"By every metric we track retail activity is the largest since 99/00. I have been tracking cross asset flow-of-funds for past 16-years. I could never imagine typing the following. 'Yesterday we saw retail, message board traders, stop-out shorts from institutional investors.' " Goldman Sachs, June 2020

"Stocks trading below \$1 per share have an average gain of nearly 80% in the past week, according to a note from the Institutional Equity Derivatives team at Citadel Securities obtained by CNBC. 'This all amounts to what seems like a retail short-squeeze feeding frenzy that has reached blow-off top proportions..' - Citadel Securities " CNBC, June 2020

"Citadel Securities, the market-maker that counts Ken Griffin as its largest owner, said retail traders now account for about a fifth of stock-market trading and as much as a quarter on the most active days." Bloomberg, July 2020

Here are some stock-specific anecdotes & data-points that are illustrative of the strange times in equity markets:

Nikola Motors (NKLA) : The "pre-revenue" electric and hydrogen truck producer with ~350 employees, no prototype, and no current ability to manufacture vehicles, trades at a \$24bln valuation, roughly in line with PACCAR, one of the world's largest truck manufacturers, which produced \$25bln in revenue in 2019 and employs 27,000 workers.

Shopify (SHOP) : The currently fast growing, yet unprofitable e-commerce platform for retailers trades at a \$120bln valuation on \$1.6bln in 2019 revenues, a valuation of 75x sales for a company that ran -8% net margins. Assuming the business will run a normal 10% net margin and trade at a generous 25x P/E in 2030, revenue will need to grow by a factor of 80 times current levels for shareholders to earn a 10% IRR over the next 10 years.

Nio, Inc. (NIO): It's stock up 360% since the beginning of June on no news, and one of our more troublesome short positions, the Chinese electric vehicle manufacturer is valued at a whopping \$17bln on trailing revenue of only \$1.1bln. In 2019, the business ran a -17% gross margin, a -140% EBITDA margin & burned ~\$1.5bln in cash in 2019. The stock has become one of the most popular stocks among retail traders with approximately 250,000 accounts holding the name just on the popular Robinhood trading platform.

American Airlines (AAL) : With a \$6.5bln market cap & adjusting for the current cash burn & incremental net debt, American currently trades at a higher pro-forma enterprise value than it did at the beginning of the year, while revenues are off 80-90%. The two year notes, AAL 5% 6/2022, currently trade 52 cents on the dollar at a yield to maturity of 46%, implying zero equity value for the common stock. At it's current projected pace of cash burn, the company will expend its current liquidity before year end. American is one of the most popular stocks among retail investors.

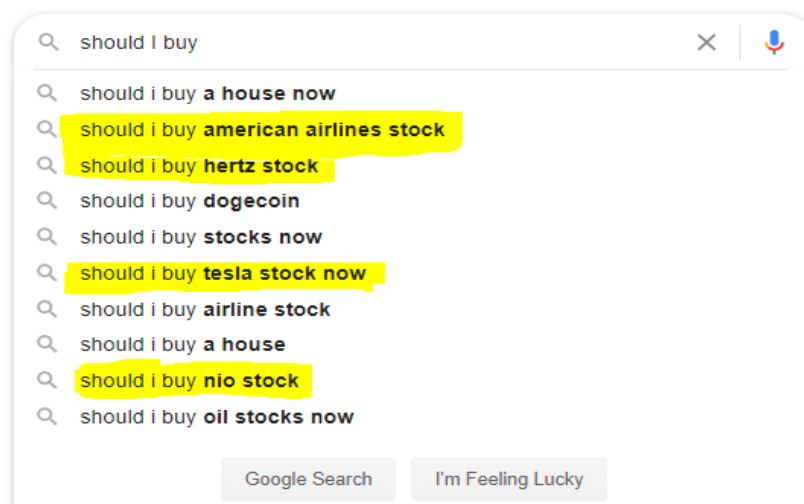
ZoomInfo Technologies (ZI) : Completely unrelated to Zoom Video, ZoomInfo is a "B2B" database platform for sales & marketing professionals that recently IPO'd on June 4th at \$21/share at a valuation of \$8bln on 2019 results of \$293mm in revenue & \$50mm in EBITDA. The stock has more than doubled in price and now trades \$45/share and an enterprise value of of \$20bln, 400x 2019 EBITDA.

Draftkings (DKNG) : The sports betting company is up 200+% YTD, despite the absence of most sporting events. Draftkings trades 16x analyst estimates of 2022 revenue despite being anticipated to run large negative EBITDA margins well through 2022.

Lemonade (LMND): The recently IPO'd "peer-to-peer" property and casualty insurance "disruptor" is currently valued 60x 2019 revenue at a \$4bln valuation. In 2019, The company lost \$109mm on \$67mm in revenue.

Tesla Motors (TSLA) : We can't not include Tesla here! With it's stock up over 200% YTD, despite being perennially unprofitable, Tesla now sports an enterprise value over \$250bln, closing ground on the world's largest automaker in Toyota (a \$290bln enterprise value) despite making only 3% of the number of vehicles that Toyota produces. For a company that still sports a CCC credit rating, makes cars in a tent, has seen a revolving door in the Chief Accounting Officer & General Counsel positions among others, and uses some arguably aggressive accounting practices, it's quite shocking that Mr. Market believes Tesla to now be worth more than blue-chips like Exxon and Disney. Assuming Tesla will trade 15x earnings in 2020 (a higher multiple than any current automaker) and is able to then run 5% net margins (in line with the healthier auto-makers Toyota & VW), Tesla must grow top line revenues by 43% annually (a factor of 35x current levels) for shareholders to earn a 10% IRR from its current share price of \$1400 & forward P/E of over 330x. These assumptions would require Tesla to earn approximately \$850bln in 2030 revenue, roughly triple Toyota's 2019 sales. Sounds like a layup, right? Furthermore, if you account for the dilutive effects of stock based compensation as well as continued equity & debt issuance to fund the capex for this hypothetical growth, the math gets worse.

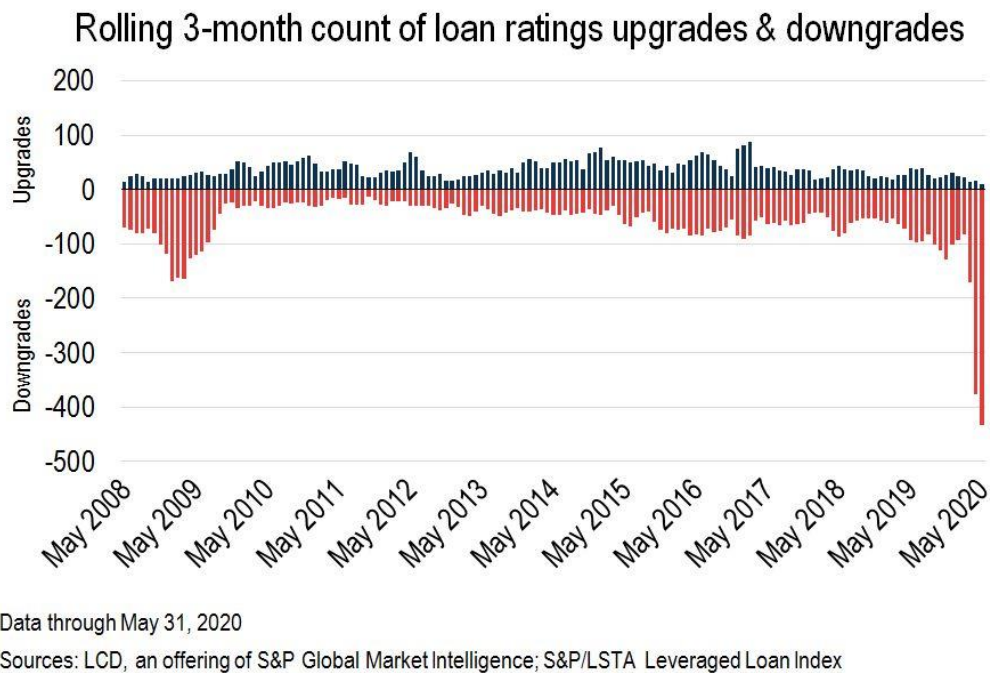
In a market littered with blatant stock promotions, questionable SPACs, and head scratching valuations this list can be much, much longer.



Credit is Smart, Equity is _____

Stock prices for issuers with credit ratings from B3 to CCC, the two lowest notches by Moody's, are, amazingly, only down about 10% year to date, despite a severe deterioration in corporate credit quality and operating performance. It's surprising to see many issuer's stock prices nearly flat on the year while credit spreads indicate seriously impaired capital structures for many issuers.

Stock price changes by issuers' Composite Ratings (%) – 2020 YTD through June 8						
	Test period					
	Start to low		Low to end		Start to end	
Start date	12/31/2019		3/23/2020		12/31/2019	
End date	3/23/2020		6/8/2020		6/8/2020	
Issuer senior unsecured rating	Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.
BB1 to BB3	-46.2	18.5	+74.6	36.8	-10.4	22.9
B3 to CCC3	-51.1	25.6	+108.5	72.7	-9.3	35.4
Different with 95% confidence?	No		Yes		No	
T-statistic	-0.850		2.279		0.143	
P-value	0.3990		0.0264		0.8869	
Count in each sample = 30. Non-distressed only. Excludes Energy.						
Sources: Bloomberg; ICE Indices, LLC.						



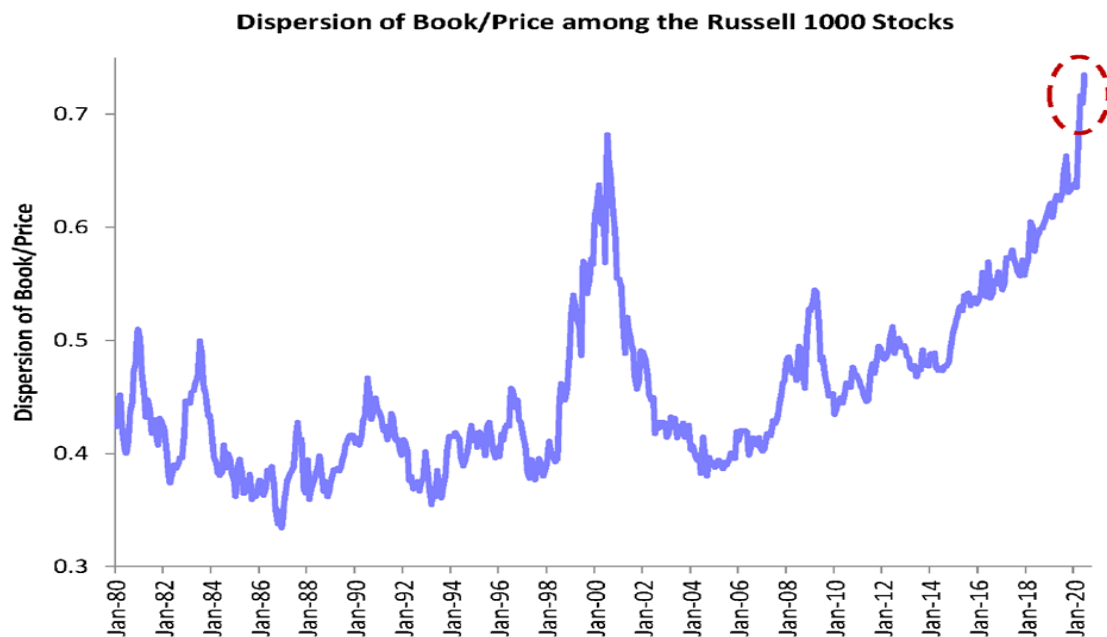
A Tale of Two Markets – Extreme Bifurcation in Growth and Value

“In the short-run, the market is a voting machine – reflecting a voter-registration test that requires only money, not intelligence or emotional stability – but in the long-run, the market is a weighing machine.” Benjamin Graham

2020 has witnessed one of the most severe underperformances of the value factor in market history. As a somewhat crude but simple measure of the value’s performance, the Russell 1000 Value Index has underperformed the Russell 1000 Growth Index by a whopping 26% year to date, with the Russell 1000 Growth Index returning over +9% & the Russell 1000 Value Index down -17% YTD. The same story applies in small caps with the Russell 2000 Growth Index outperforming the Russell 2000 Value Index by 20% YTD. The trend has occurred in international (non-US) equities as well with the MSCI EAFE Growth Index handily outperforming the MSCI EAFE Value Index by 16%.

This performance has now placed the valuation spread between the cheapest decile and most expensive deciles of the market at its widest point in history, surpassing the extremes we saw during the height of the tech bubble in 2000. Simply put, investors have never paid a bigger premium for the stocks they love relative to the ones they hate.

Fig. 2: Valuation Gap Is Still at Extreme Level



Note: Shows the median absolute deviation in the book/price of Russell 1000 stocks, normalized by the median level of book/price among these stocks. Period is from January 1980 through June 23, 2020.
Source: Compustat, Russell, Instinet analysis

- All time wide valuation spreads are not simply a consequence of a few extraordinarily expensive sectors, as intra-industry valuation spreads tell the same story, regardless of the metric used:

Various Value Spreads, Academic Style, Industry-Neutral

December 31, 1967 - March 31, 2020*

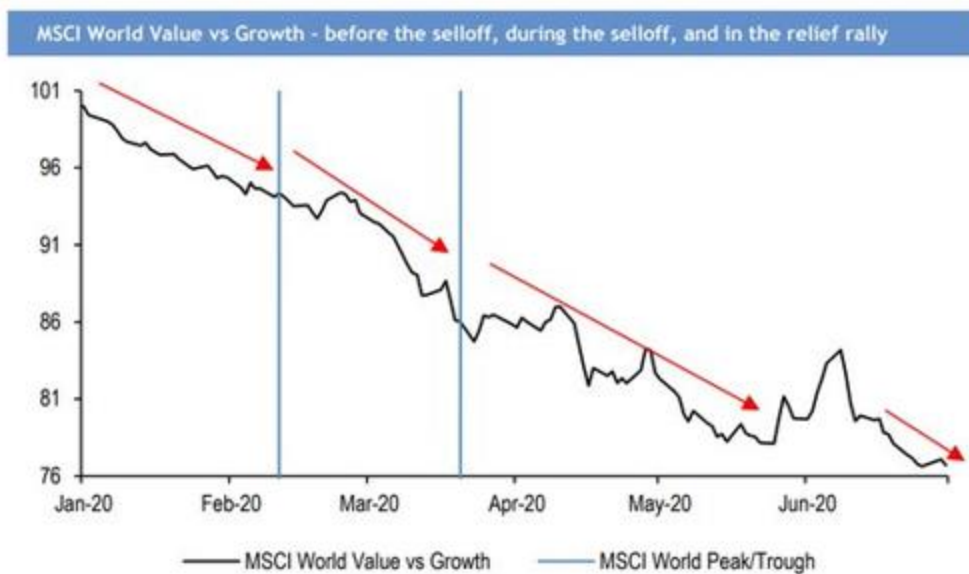
Value Spread Measure	Current Percentile	(Current – Median) / (Max – Median)	Current STD Event
Price-to-Book	100%	98%**	+4.0
Price-to-Sales	99%	71%	+2.8
Price-to-earnings (trailing)	100%	88%	+4.1
Price-to-earnings (forecast)	100%	100%	+6.8***
Composite	100%	100%	+5.0

* Forecasted Price-to-Earnings starts January 31, 1976.

** You see 100th percentile but only 98% of maximum above median because it wasn't really quite the 100th percentile, it just rounded to that.

[Show more](#)

Source: AQR



Source: Datastream

34

J.P.Morgan CAZENOVE

Backing into growth expectations for growth stocks:

Let's peel back the onion of expectations a bit with an exercise. Excluding the biotech & financial sectors, the most expensive 10% of small, mid & large cap US equities currently trade at an average price/sales of 17x, a stratospheric number. Assuming this segment of the market will trade at an average P/E of 20 and run an average net profit margin of 10% in 2030, revenues must grow by 36% per annum (by a factor of 22x) over the next 10 years for investors to earn just a 10% IRR from these levels. To put it mildly, for such a broad segment of the market to grow at such a fast clip over a full decade would be completely unprecedented. It seems the only "new-era" we've entered is one in which investors behavior and expectations have become dramatically more aggressive.

As the data demonstrates, value's recent underperformance is a primarily a phenomenon of value equities becoming less popular, and growth equities becoming much more popular, as investors chase momentum in stocks that have performed well the past few years, without much regard to what they are currently paying. Said otherwise, this recent price action is far more a function of investor's fickle preferences as opposed to fundamental changes in these businesses.

You might be thinking: “Why does this matter”?

Most importantly for us, this level of broad dispersion in valuations creates an opportunity rich environment for fundamental managers and an exceptionally fertile environment for value-oriented long/short managers, as long periods of large outperformance of “value equities” are typically preceded by wide valuation spreads. These factors that have served as a headwind for our performance thus far, ought to serve as a tailwind going forward as our opportunity set has improved.

Closing Thoughts

As stocks remain priced to perfection – with fundamentals reflecting nothing of the sort – it’s important for investors to be cognizant of base rates and historical probabilities and not rely solely on anecdotal evidence and narrative-based judgement. For us at McLain, this means staying disciplined, patiently filtering out the noise, sticking to our process, and focusing where risk/reward profiles appear asymmetric.

Thank you for entrusting me with your hard-earned capital. I’m particularly grateful for your continued trust and support. Please don’t hesitate to reach out with any questions or comments.

Sincerely,

Dave O’Harra

Managing Partner



david.oharra@mclaincap.com

Exposure Summary

As of July 6th

Long	79.5%
Short	-51.2%
Net	28.3%

Geographic:			
	Long	Short	Net
North America	13.4%	-33.4%	-20.0%
Asia/Pacific	57.6%	-13.6%	44.0%
Europe	8.6%	-4.3%	4.3%

Sector	Long	Short	Net
Basic Materials	9.6%	-4.6%	5.0%
Communications	4.2%	-7.3%	-3.1%
Consumer Cyclical	23.3%	-6.9%	16.4%
Consumer Staples/Healthcare	6.7%	-6.9%	-0.2%
Energy	0.5%	-10.9%	-10.4%
Industrial	30.8%	-5.4%	25.4%
Technology	4.6%	-9.3%	-4.8%

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