Oct 6, 2014

<u>2014 Q3 Partnership Letter</u>

Dear Partner,

Our net performance for Q2 was 12.1%, bringing our YTD results to 14.2% vs. YTD indices (in order of relevancy for comparison) of: 4.2% Barclay Hedge Fund Index, -5.1% Russell 2000 and 7.1% S&P 500. Our portfolio was approximately 75% long and 75% short for the quarter with longs contributing approximately 2% to our returns and shorts contributing 10%. I am pleased with our results to date and the balanced manner in which they have been achieved. The market rally over the last two years has often rewarded the most speculative stocks while punishing cautiously positioned investors.

With our strategy, monthly return data is more noise than signal given that companies report information on a quarterly basis. We only focus on longer term 1-3+ year stock price discrepancies from our estimate of intrinsic value when making investment decisions. That said, it is interesting to observe that we have been negatively correlated with the market on a monthly basis – i.e. we do well in 'melt down' months like September and not well in market euphoria months like August.

The general reason for this is that we invest in fundamentally good businesses that are undervalued and unpopular with Mr. Market: they lack excitement but should do quite well and improve with time. These companies steadily chug along creating capital but will decline with everything else when the market does. Declines for even high quality small companies can occasionally be sharp, a hazard (and opportunity) inherent to investing in small companies where short term liquidity can rapidly evaporate.

To balance this, our short book consists of similarly sized companies (to hedge out the general small company liquidity risk) that are fundamentally weak and deteriorating long term, but at the moment are popular in the market. These stocks really fall out of bed when the market declines as Mr. Market loses his appetite for more speculative upside as risks become more visible. The true beauty of the short book is actually not the returns it can directly produce, but the large increase in purchasing power it enables during sharp market declines. Being in a position of strength at exactly the time when others are overextended and forced to liquidate is the source of greatest upside over the long term and sounder sleeping in the interim.

The goal of this approach is not to minimize monthly volatility, which is meaningless noise, but to allow long term results to be a product purely of business specific *entrepreneurial* factors that are uncorrelated with the broader market. In a world where: 1) The broad equity markets are at all-time high median valuations *ever* and 2) Investors can gain equity 'exposure' for a 0.15% fee from a Vanguard Index fund, it is essential that we produce a differentiated source of returns.

Our results provide validation for our revamped strategy implemented this year, enabled by our activist experience and investment sourcing software, both of which required years of upfront development.

Lump of the Quarter: Bankruptcy Coils the Spring

The bullet points of a position we have held for some time:

- Pharmaceutical company with unique scientific achievements in a large potential market
- A paying customer, little to no scientific or research risk (i.e. the product is proven)
- Cash in the bank exceeds the market cap and liabilities are nominal trade payables
- TTM free cash flow exceeds the market cap of ~$80mm (i.e. P/E of <1)

I believe this stock is too cheap and have believed so for some time. It will not show up on a standard stock screen as a growing company with an excellent balance sheet with a P/E <1 for a very specific reason. SIGA Technologies, a defense contractor that developed a working cure for smallpox, has been in a lawsuit since 2005 after they reneged on a nonbinding merger agreement with Pharmathene (PIP) after having sellers remorse. They have deliberately (legally) been using highly conservative accounting to mask earnings and look ugly during this lawsuit.

SIGA declined by 50% this quarter after an unfavorable development in the PIP lawsuit and filed chapter 11 bankruptcy protection in order to take advantage of the automatic stay, allowing an orderly appeal.

The case is analogous to the Facebook / Winklevoss lawsuit made famous in the movie *The Social Network*. If the Winklevoss twins were awarded a $100 billion cash judgment because the parties expected Facebook to eventually be a huge company back in 2010: that is roughly where PIP sits today.

SIGA's chapter 11 case is similar to Texaco's bankruptcy in the 80's that was one of Carl Icahn's first big scores on the equity committee. SIGA is even using the same lawyer: Harvey Miller. I am currently working to form an equity committee to maximize protection. Given the earning potential of the company, I believe the lawsuit is a drop in the bucket to the total enterprise value. Notably: even in the worst case judgment of $230mm, SIGA has $110mm cash now and should receive another $200mm over the next two years to pay the award in full and still leave the equity unimpaired without a capital raise. Non-insolvency driven chapter 11 cases are one of the best sources of returns as few investors are steeped in the legal intricacies and simply panic-sell on reflex.

Some investors derive their decisions from Mr. Market's price signals thinking that 'he must know something' and others, like ourselves, focus on the business fundamentals and try only to take advantage of silly prices. SIGA has been an unusually long journey because of the nuances of the legal system but it has a place as a *modest* position in our balanced portfolio. With our sourcing platform and strategy, we have an abundance of opportunities to focus on and have no need to take concentrated risks where there are risk factors beyond our scope of influence.

Transformation Investing

Turnaround investing is focused on taking 'patients' that are in the emergency room, bloodied and bruised, and getting them back out onto the streets. We have plenty of experience with this and have successfully helped guide InfuSystem from a perilous state in 2011 to stability in 2012-13 and finally to a thriving growth company today under the leadership of CEO Eric Steen. We are still working on the patient that is Lucas Energy and I expect to have more to update there in the near future.

Over time, we have evolved towards what I think of as *Transformation* investing rather than *turnaround investing.* Think 'Good to Great' rather than 'Return of the Living Dead'! Experience has taught me that signs of trouble on the outside are highly likely to indicate far more undisclosed trouble on the inside; a lack of candor indeed is often the *cause* of this trouble. We now search for 'solid but sleepy' companies rather than seeking out distress. Troubled businesses are easy to find – just look for the cheapest stocks: many are terminal. Finding unpopular but solid businesses is more subtle and challenging but if you are willing to put in the work and help drive change yourself as an activist, things can work out quite well as they have so far at Sevcon where we joined the board last December. This is also far less risky and less likely to have hidden unpleasant surprises.

The final category is understanding fundamental changes that are occurring on their own but are nonobvious from the trailing financial numbers. Some current examples of this profile we own include Hooper Holmes (HH) and ID Systems (IDSY), both mentioned in prior letters that have new CEOs who are competent, energetic, and appropriately incentivized to drive positive change at their respective businesses. Geeknet (GKNT) is another example that has recently has had its stock decline to highly attractive levels as profitability is obfuscated by up front expenses to expand infrastructure.

Our pattern recognition roughly begins with the following points and then proceeds to investigation and confirmatory diligence:

- Solid and growing sales base – so you know there is product-market fit
- New management or board – we would do it ourselves but coat-tailing works too
- Not obviously cheap relative to earnings – otherwise we must be missing something if everyone can see it is cheap and yet, it's still cheap… (exception: market downturns)

We have dozens of these companies we look at on an ongoing basis and hone in on the ones with the best risk/reward. We aim to hold 20-30 of these at any given time during their 1-3 year transition period before they are bought out or their progress becomes obvious to the market and their stocks are re-rated upwards. Each individually will have fits and starts but a portfolio of these should progress well.

A Short Example: The Gun Bubble and the TTM Mirage

One of the most heavily utilized metrics by investors is the P/E ratio. Some investors begin as operators of businesses, having gone through the efforts and pain of making a profitable sale, and others have taken a traditional academic path where growth plans are made in Excel rather than pounding pavement. For the operators among us, the idea of simply slapping a multiple on a profit – thus implying it will annually be repeated indefinitely into the future – can feel a bit too "easy". Whenever you see "easy money" your eyes should actually read "hidden risk"! Just as we seek out businesses with a string of unlucky events depressing long term normalized profitability, there are plenty of times in business where a confluence of positive events lead to better than normal conditions temporarily.

> *When shortages exist, however, even commodity businesses flourish. The insurance industry enjoyed that kind of climate for a while but it is now gone. One of the ironies of capitalism is that most managers in commodity industries abhor shortage conditions - even though those are the only circumstances permitting them good returns. Whenever shortages appear, the typical manager simply can't wait to expand capacity and thereby plug the hole through which money is showering upon him. This is precisely what insurance managers did in 1985-87, confirming again Disraeli's observation: "What we learn from history is that we do not learn from history."*
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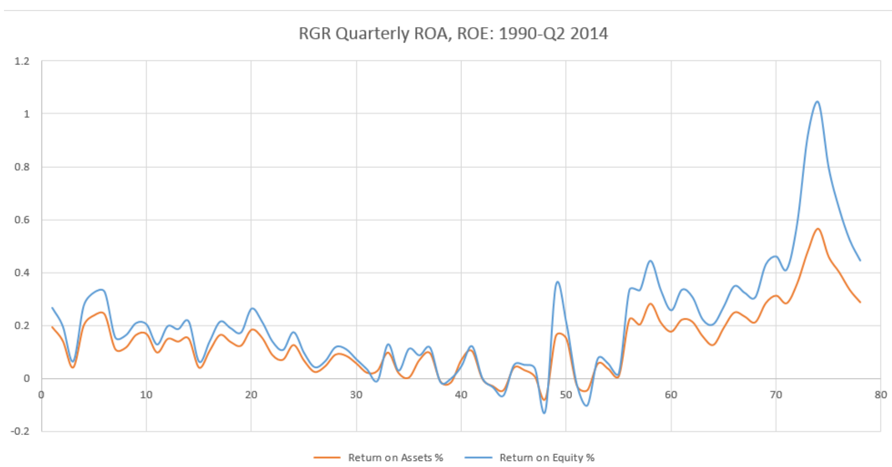
> Warren Buffett, 1987 Shareholder Letter

We have been short gun manufacturers – Ruger and Smith & Wesson for the better part of this year on the basis that their intrinsic value, based on normalized numbers is far below their stock prices. The stock prices were (and are) elevated because their trailing earnings benefit from temporary factors. In fact, research reveals that the earnings were nearly 4 times higher than would be expected on a historical basis due to shortages caused by a temporary spike in gun demand. Thus a P/E of 10 which appears cheap, actually represented a P/E of 40 on a more normalized long-term basis: not cheap. The stocks have declined by half but we expect have another 50% downside to go. Moreover, we were able to establish our short position after the mean reversion was already firmly in place. Earnings are always a lagging indicator of the deeper, more fundamental business drivers.



Ruger (RGR) Return on Assets over the last 20 years: What is more likely: A permanent step up increase in gun demand (with no competitive response) post Sandy Hook or a temporary blip?

As Buffett's quote foreshadows, in response to this spike in demand both Ruger and Smith & Wesson massively increased their production capacity. If demand continues to normalize, these expenses will increase the fixed cost structure of the business and could leave the businesses worse off than before or with write downs if they choose to shut in capacity. In any case, the durable nature of guns and the large inventory buildup means returning to growth will take considerable digestion. As example, the housing boom STILL has depressed levels of production nearly a decade later due to excessive inventory.

Short positions like this are certainly not terminal. This contrasts to our short in Odyssey Marine (OMEX) for example, which we do not expect to cover as it continues its march towards $0. There is a reason for gun manufacturers to exist and they will continue to be in business for years to come. We have a balance of different reasons for shorting companies but in general they will fit some variant of “bad to worse” to hedge and balance our “good to great” long book.

Positioned for Any Environment

We continue to see data indicating the market is at or near all-time high valuations which means *low* return expectations for the average investor going forward say 5-10 years. We have spent the last 5 years building a cumulative framework to be anything but average, with occasional demonstrations of capability along the way. I’m proud of our performance to date and very excited about our positioning to make above average returns regardless of the overall market or economic climate.

We have a robust book and deep pipeline on both the long and short side and welcome a market environment that I expect will create discomfort for less well equipped investors. As I now feel comfortable enough to perform in a variety of environments going forward, we are beginning to expand our research infrastructure and have hired an analyst and a programmer. Our trading and financials continue to be managed by a best in class prime broker BTIG and our third party administrator Opus, respectively.

We are opening up to new and existing investors with a founder’s class fee structure for a capped amount of capital, as I believe our return potential is highest on a smaller capital base and I hope to reward early investors. I continue to have virtually all of my net worth invested alongside investors in the Partnership.

Please email me at rmorris@mesoncapital.com or call at 607-279-5382 if you have any questions or are interested in investing. As always, thank you for reading.

Sincerely,

Ryan J. Morris

President
Meson Capital Partners LLC

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