Pinnacle Capital Management, LLC

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PAGGE
INVESTOR LETTER

The year just ended was quite extraordinary for investors. While corporate earnings went essentially nowhere for the year, having declined in the 3rd quarter and likely in the 4th, the S&P 500 returned 31.5% inclusive of dividends. If markets went up and earnings went nowhere, then the only explanation is that the multiple that investors are willing to pay for each dollar of earnings expanded significantly during the year.

This was particularly true when it comes to growth stocks. For the 3rd consecutive year, the Russell 1000 Growth index outperformed the Russell Value index. The cumulative difference over the past 3 years in performance between these two indexes is 43 percentage points. That's the widest differential since the 1996 through 1999 time frame. Prior to the current 3-year run, the two indexes had roughly equal returns since their 1978 inception (including that outperformance by Growth in the 1990s).

So let's talk about PAGGE. PAGGE is an investment limited partnership that utilizes a long and short strategy. Specifically, there is a target of 130% of the net asset value invested long in the market and 30% of the net asset value being short the market. The short position hedges a portion of the long.

While the objective of PAGGE is to outpace the market over time, it is based on long practiced, fundamental disciplines. These disciplines include a focus on company fundamentals and valuations. PAGGE is not a go-go, momentum fund that chases the hottest ideas.

As such, there are certain times when these disciplines are likely to result in outperformance and certain times when that will not be the case. In periods when valuations cease to have meaning, when fundamentals are ignored, and when "stories" dominate investment performance, it will be extremely difficult for PAGGE to keep pace with the markets. In our opinion, this, like the late 1990s, is one of those periods. PAGGE returned 16.26% net of all fees and expenses in 2019.

In this environment, it has been very difficult to implement our strategies. While we will not chase the hot stocks of today, we do have to be cognizant of how stories are moving the market. For example, Tesla Inc., has a good shot to become a consistently profitable automobile company. But its road to consistent profitability will be long and its need for outside capital huge. The valuations in early 2019 suggested that it was already hugely profitable and had no need for cash. As its financials deteriorated, we shorted the stock. But as they successfully raised money, ***we closed our position at a profit even though we felt the valuations absurdly high***. This proved to be the right move as the stock has doubled since its mid-year lows. While the story has improved, we can see no rational basis for its current valuation.

Likewise, we took an initial short position in Netflix as we saw the cost of their content going up and competition likely to keep a lid on the price of their offerings. Despite believing the stock grossly overvalued, we took quick profits in the stock. Since then the stock price has rebounded. With the stock price back up, towards year end, we initiation another small short position.

On the long side, we've had a number of successful positions. CACI Int'l, Zumiez (a stock we were once short), Hess, ITT, ATT, United Technologies, and Mondelez all had returns in excess of 40% in 2019. But at the same time, some valuations have fallen so low we don't know what to think. Tenneco is a manufacturer of auto parts, it is profitable, and it is trading at roughly three times earnings. Yes, they have some debt and some problems. The valuation suggests the market believes it will go bankrupt – a scenario we don't believe likely. Judging by the price of the company's bonds, debt holders don't appear to agree with that dire outlook either. A narrative, not fundamentals or valuations, is driving the stock price.

Beyond the vagaries of the markets, and some of the successes mentioned above, we do acknowledge some mistakes. For example, we bought Nokia in expectation that it would benefit from the shift to 5G standards in telecommunications. But it became quickly clear that the company could not managed the shift. We sold the position at a loss. As the trade wars heated up, we also closed our position in Eastman Chemical. This stock was a disappointment for 2019.

Going forward, we will watch for any shifts in sentiment. In our opinion, 2020 will likely bring positive, though smaller, returns in the stock market compared to 2019. We see the economic expansion continuing, albeit at a slow pace. Some are afraid that after a long run upwards, there is only one way to go – down. But we don't liken the markets to a mountain where we reach a peak then have no place to go. Instead, we like to think we've climbed high and are now on a ridge. Yes there are risks that can knock us down on either side. These include trade wars, shooting wars, Fed mistakes, impeachment, the presidential election, etc. But there is still a potential upward sloping path along that ridge from which to profit.

Prepared for such an environment, we are maintaining our investment position. But we are also looking for opportunities on both the long and short side of the PAGGE portfolio. On the long side, we have a long list of stocks we'd like to buy. However, we won't chase stocks that we think are too pricey. In short, we're being conservative. We also have a long list of stocks to potentially short. But we don't want to be too aggressive until sentiment changes. We are prepared to hedge in the event that markets fall significantly. However, that is not our outlook for now.

I want to personally thank you all for being investors in PAGGE. I wish you a successful and healthy 2020!

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