July 25, 2016

2016 Q2 Partnership Letter

Dear Partner,

Our net performance for Q2 was (5.8)%, vs. indices (in order of relevancy for comparison) of: 1.4% HFRI Hedge Fund Equity Index, 3.8% Russell 2000 and 2.5% S&P 500. Our portfolio was approximately 10% net short on a beta adjusted basis for the quarter; our longs detracted 10.8% to returns while shorts contributed 5.0%. Our market neutral portfolio helps us focus on our business operations and ignore the headline driven, frothy stock market. "*The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs*." – Warren Buffett

	Meson Net	HFRI Equity	Russell 2000	S&P 500
Q2 2016	(5.8)%	1.4%	3.8%	2.5%
YTD 2016	(3.5)%	(0.4)%	2.2%	3.8%
2015	4.0%	(1.0)%	(4.4)%	1.4%
2014	4.7%	1.8%	4.9%	13.7%
Since Jan 1, 2014	5.2%	0.4%	2.5%	19.7%

This quarter continued our streak of being negatively correlated with the stock market while we continued to make solid progress on operations within our businesses. Our portfolio positioning shined briefly during the "Brexit" debacle where the major indices were down 8% in two days – we were *up* 1% during the same period. In general we will not stand out when the market is reaching all-time highs. By design, our portfolio components will complement each other so we rarely get too excited or too worried. When the overall market moves sharply upward, the (short term) winners tend to be those that take the most imprudent risks.

The primary reason for our negative print for the quarter was due to the nearly 30% decline in one of our largest positions, InfuSystem. This was despite INFU posting a strong quarter with continued growth in the business – the stock has rebounded significantly this month and as of this writing, our portfolio is ahead of the indices. Medicare announced a regulatory change in reimbursement for infusion pumps during the quarter which we are working through to modify the business model. This is an area we have experience with, having dealt with ongoing regulatory changes since we joined the board in 2012. For better or worse, regulatory changes often have unintended effects including making it more challenging for the smaller market players to comply – often resulting in shuttering and market consolidation. For context and comfort, InfuSystem is the market leader and over 4x larger than its closest direct competitor.

The Self-Immolation Defense to Dealing with Activists: A First

We have a long history with helping companies solve problems and creating value for shareholders. Rarely do the companies ask for said help. It typically needs to be catalyzed by a displeased shareholder but once companies get to know us they realize we're on the same side and can be quite helpful. An outside perspective and our network and resources often can cut through the deadlocks within a company to unlock growth and value. This quarter was the first time we have seen a company so uninterested in help from the outside that they decided it was better to fold the tent and wipe out the shareholders completely.

diaDexus was a diagnostic test product company that we have owned a small portfolio position for over a year. They had a modest amount of debt and had been in the midst of launching a new product that had received significant positive coverage in the news to help the early detection of heart disease. Working with another larger long term shareholder, we nominated several directors in order to preserve our rights early this year and met with the management. Our initial meeting was quite positive and we were verbally invited onto the board. And that's where it started going downhill… The next day rather than a board agreement, we were introduced to their legal process to 'apply' to be a director. We played nice and gave references but after getting the run around from their legal team and nom/gov committee we were told our candidates didn't make the cut. Keep in mind that two of our three candidates could have bought out the entire company with their checking account and we had offered to help refinance the company!

The company went silent for a month, did not announce a date for the impending annual meeting as scheduled the prior year. Then out of nowhere the company announced they were filing for Chapter 7 bankruptcy and liquidating the company and shareholders were wiped out! Never have we seen such anti-social conduct by a board and management teams. Fortunately, it was only about a 1% portfolio position (we recognized the risk and also saw 10X potential so it was sized appropriately). Also, this type of behavior by management and directors is highly predictive of *future* value destruction and we expect to make short lemonade out of lemons (directors) by keeping up to speed with their future ventures.

Catching the White Whale

Our "white whale" in our portfolio that we have been chasing for 6 years now is SIGA Technologies. We initially purchased a position in early 2010 around $7 per share after it was confirmed they were awarded a large government contract. The company discovered a small molecule cure for smallpox which has great value in the event of an outbreak by bioterrorists. Since 2005, there has been an ongoing lawsuit with a competitor, PharmAthene (PIP) that resembled the dynamic between Facebook and the Winklevoss twins made famous in The Social Network movie. In short, in 2005, SIGA had a drug but needed money, PIP lent some money and they had discussions to merge; SIGA had a breakthrough, got sellers' remorse and walked, PIP sued. 10 years later… after numerous appeals, the lawsuit was finally completed, new case law was established at the Supreme Court of Delaware. Although there was no binding contract to merge with PIP, SIGA was found to have acted in bad faith and the new case law was that the damages should right the wrong based on the expected value and SIGA owes PIP over $200mm with interest.

We were never positioned to 'bet' on the outcome of the unpredictable lawsuit, because both were public companies we were able to hedge that risk by simply owning both companies proportionately over time. After SIGA rose from $7 to $15 shortly after we acquired it in 2010 (we thought it was worth $30/share then, as we still do today). Then things took a turn down in the suit and the painful uncertainty of the ongoing lawsuit depressed the stock to a low of $0.35 at the end of 2015. We were averaging down all the way and managed to lower our cost basis to under $0.75/share! We take investing intestinal fortitude and persistence to a whole new level, playing to our competitive edge. At each step of the way we would double check the facts and the progress: Mr. Market is your opportunity, not your council. Along the way we worked with other investors to make appearances and motions to the court to prevent an unfavorable outcome towards the equity holders which resulted in a number of good governance changes to the restructuring plan following the lawsuit.

As of this writing the stock is now roughly 3 times our cost basis and on its way to recovering. Due to the relatively riskier nature of the business vs some of our other concentrated activist holdings, we will moderate the position size relative to the portfolio. It will certainly be more satisfying to trim the position all the way up than it was to average down all the way from $15 to $0.35!

Why Are Interest Rates So Low And What Does It Mean?

Global macro dynamics continue to dominate headlines and drive investment returns. We are fundamentally business people who just want to make our companies and customers lives better and make money. That said – it is not easy to hide from the powerful forces that have been shifting the investing landscape over the last several years. The first requirement to trying to change the world is to understand it so here is my attempt.

Firstly – unlike many outspoken value investors, I think the central banks are doing the right thing by keeping interest rates low. As much as it pains our short book by allowing zombie companies to stay alive, if rates were higher, then we would be in the next Great Depression right now with deflationary forces accelerating even more than they are.

Secondly – there is only so much the central banks are responsible for regarding low interest rates. They can only really manipulate short term rates but the long term rates (10 and 30 year) are much more determined by market forces, central banks are a drop in the bucket for the supply/demand dynamics for these markets. The 30 year US Treasury bond has a 2.29% interest rate and interest rates around the world are the lowest they have ever been in the entire history of capitalism.

To sound out there for a moment: I believe that rates will most likely stay low and even get more negative for the indefinite future. How is that possible? There is no natural or economic law that says interest rates need to be positive. It feels unbelievable because it's different than the past but thinking in terms of first principles can help provide illumination. In the days before capitalism and accounting were invented, in nature: 'interest rates' on savings are *very* negative – think how quickly unrefrigerated food spoils, for instance.

So what is causing persistently low and declining interest rates? Here is my theory and how we are adapting as investors.

Interest rates, just like any price, are a function of the fundamental forces of supply & demand.

On the supply side of the ledger you have unprecedented demographic trends – people living longer and retiring with savings to last 40 years rather than 5-10 as recently as just half a century ago. This is a big 'savings glut' and population growth in the developed world has essentially ceased.

Supply of capital trending up → interest rates trend lower.

Before exploring the demand side, let me introduce a helpful concept: the world is made of A) raw materials (atoms) + B) information (i.e. patterns). An ounce of gold is worth $1,000 because it is made of rare atoms but they are scattered randomly, the information component is $0. An ounce of 16gb DRAM chips is worth $1,000 today because of the $999.99 of information about how the atoms are organized and $0.01 of silicon atoms.

On the demand side: technology is also going through a transition that the world has never seen before. The first service or 'asset-light' business went public only about 60 years ago, before that every single company needed a large amount of tangible financial capital to build a factory, buy inventory, etc.

Now an increasing number of businesses are service oriented and do not need much, if any tangible financial capital. Google, Amazon, etc are very tangible capital light businesses. They rely on human capital / information patterns as their value, not raw materials. Unless you are being aggressive with your accounting, the 'information component' doesn't show up on the balance sheet – you spend the money on salaries and then it's gone, expensed in each period, intangible.

With AI, automation, cloud computing, etc. the world is moving at an accelerating pace towards an intangible, information based world. Just look at the trends of millennials buying cars and houses. Nobody cares! They just want to take an Uber from their apartment and play Pokemon go, buying virtual Pokeman balls! Marc Andreessen wrote a famous article in 2011 along these lines "Why Software is Eating the World." This is not a state of the world that existed when Adam Smith wrote the Wealth of Nations.

Demand for capital down = interest rates lower.

Can you name a market force that is causing supply of capital to go down or demand to go up? I have a hard time thinking of anything meaningful. The world is even becoming less war torn as sovereigns hash out their differences in suits at the UN rather than in the capital eradicating battlefields of old. The fact that interest rates averaged 5% over the last 250 years is in some ways an accident of history. The industrial revolution allowed tangible capital to be accumulated and stockpiled and the population to grow exponentially. Now we are in the early innings of a second industrial revolution where the marginal cost of supply for information-based value approaches zero and the math changes. Value accrues to those who are dynamic and always making the next score, rather than the one with the ball right now: to use a basketball analogy – the shot clock of capitalism is speeding up.

In short: get used to it, it's never going to be like it used to be and that's a good thing for those of us who are PHD's ("Poor, Hungry and Driven", to quote Mario Gabelli). If all you bring to the party is financial capital and moving pieces of paper around then the supply/demand dynamics are not in your favor. But if you're an entrepreneur who can create information and ideas to generate value, you've never been in a better position. Competition is fiercer too which is great for consumers and the declining cost of goods and services only help. This is why we're focused on modernizing & adapting older, proven, public companies with unique strategic positions and high barriers to entry. We're working to capture VC like upside without the risk of not knowing if the business has a reason to exist or not.

Driving Operating Improvements to Ignore a Challenging Market Environment

The data continues to indicate the market is at or near all-time high valuations which means *low* return expectations for the average investor going forward 5-10 years. The supply/demand balance of financial capital is not favorable to those that can merely move paper around. A more proactive approach to generating value is required. As the IMF warns of slowing global growth, our approach of focusing on investing in the right people at smaller companies can charge forward regardless of macro issues.

I was proud to be elected last quarter to the board of Trans-Lux (TNLX) after being nominated by Mario Gabelli. The company has a storied history going back nearly a century with irreplaceable customer relationships. The exponentially declining cost of LED lighting is a big tailwind for them to take advantage of as that market grows and their input costs decline. We'll have more to report on that next time.

I continue to have virtually all of my investable net worth committed alongside investors in the Partnership and am excited to be growing the firm. Please email me at rmorris@mesoncapital.com or call at 415-322-0486 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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