MESON CAPITAL

January 29, 2018

2017 Annual Partnership Letter

Dear Partner,

For the year, Meson Capital LP's net performance was 27.9% vs. indices of 4.8% HFRI Equity Market Neutral Index, 14.7% Russell 2000 and 21.8% S&P 500. Shorts contributed 0.5% net of borrow fees while longs added 27.4% for the year. Our monthly-liquidity spinout fund, Meson Gravity LP was launched August 1 and performed -7.0% net for the year. As a reminder, as of the end of the year the two funds are substantially identical except for our concentrated active long positions in Meson Capital LP which necessitate a rolling lockup. Meson Gravity LP has full monthly liquidity and no lockup. The difference in returns can be attributed to 1) the Aug 1 starting date for Meson Gravity LP and 2) performance of concentrated long positions in Meson Capital LP where we realized an exit in Q4. Both funds are market neutral and approximately 100% long and 100% short for zero stock market exposure and zero market correlation.

Net Returns	Meson Capital LP	Meson Gravity LP	Meson Constructive Capital LP	HFRI Equity Mkt Neutral	Russell 2000	S&P 500
2017 YTD	27.9%	-7.0%*	129.8%	4.8%	14.7%	21.8%
Q4 2017	4.0%	0.4%	-0.6%	1.9%	3.3%	6.6%
Since Inception CAGR	8.7%	*	52.0%	3.6%	8.7%	12.0%
Inception Date	Jan 1, 2014	*Aug 1, 2017	Dec 1, 2015			
Market Exposure	Neutral	Neutral	Long-Only	Neutral	Long-Only	Long-Only

We are happy with the results of Meson Capital LP and understanding of the results of Meson Gravity LP given the market environment. The negative results In Meson Gravity LP were almost entirely from September where the Russell increased by 11% in a violent run up. We implemented a number of improvements to the strategy starting November 1 to improve performance in a wider variety of market environments. It is paying off in this continuing straight up market and we have not seen losses since that uniquely harsh September. There are no (legal) equity investment strategies that I am aware of that perform uniformly well during all conditions. We have carefully designed our funds to perform well over a wide range of market environments by being able to achieve absolute returns from both the long and the short side. We target returns over a several year period and in the 4 year track record for Meson Capital LP since it has been run as market neutral we have not had a money losing year.

By design, we expect to perform best during volatile market environments (read: market crashes) due to our short book of low quality companies. In most environments there should be enough dispersion to find good longs and shorts that standout. The one environment that we have so far been unable to find a high returning strategy that does not expose us to too much risk is during "melt-up" type periods as we have encountered recently. It would of course be very easy to generate returns by simply being long momentum stocks during these periods but as we remember well from 2000 – there is no countdown clock to midnight when the party ends. The top performing fund managers from 1999 lost 80% of their investors' money in the subsequent two years and we have no interest in losing purchasing power when things get interesting.

The Market Environment Today

We are not market timers or macro investors and have no "call" on the direction of the stock market. We are business analysts who dive deep – and occasionally assist as entrepreneurs – into individual companies to understand how their value and stock prices will change over time. The market environment is important to understand because the opportunity set of companies that are interesting longs or shorts is finite and context is important, especially given that we intend to be in business for a very long time.

At the November, 1999 annual Allen & Co. Sun Valley Conference, Warren Buffett presented[1] to a group of billionaires and industry leaders a simple slide: "DOW JONES INDUSTRIAL AVERAGE Dec. 31, 1964: 874.12 Dec. 31, 1981: 875.00." The Dow had 17 lost years as valuation multiples compressed after a rapid expansion leading up to then despite US GDP growing 370% during those 17 years. His warning was that given the high valuations in 1999, investors expecting a continuation of 19% per year stock market returns may want to re-evaluate. His favored 'Buffett-metric' US market cap to GDP peaked at 148% briefly in March 2000 before the market declined 50%. Last week this level was exceeded for the first time ever and now sits at 150.6%. Quoting Buffett from the same Nov 1999 speech (link below): "*Sometimes, incidentally, it's much easier in these transforming events to figure out the losers.*"

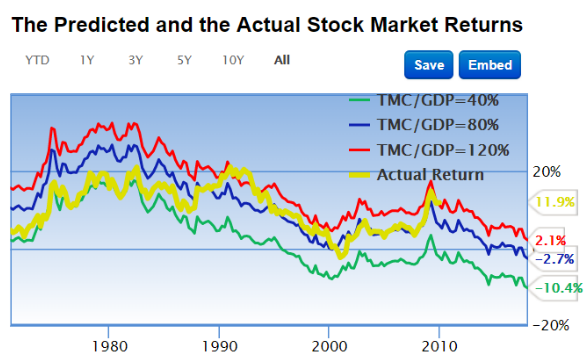


Figure 1 Credit: GuruFocus

The S&P 500 had no down months in 2017 which has never happened in history before. But the world is *not* the same as 1999 – history rhymes but never repeats exactly. In many ways this environment is *far* more difficult to understand from a conventional investment perspective and one that I believe we are

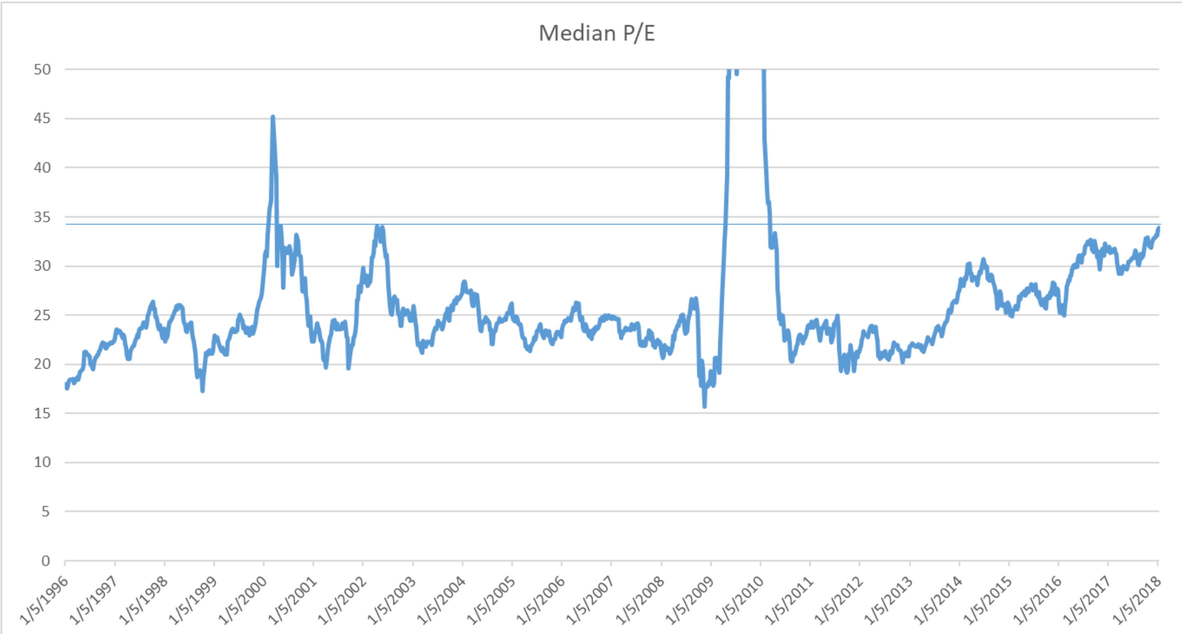
[1] http://archive.fortune.com/magazines/fortune/fortune_archive/1999/11/22/269071/index.htm

uniquely equipped to navigate well over the next several years thanks to the capabilities we have spent years developing.

The 1999-2000 Internet Bubble market, like today, had a small group of highly successful tech stocks driving the majority of the rise of the indices. If you don't own those leaders (today: "FAANG" stocks, 1999: MSFT, Cisco, GE, Pets.com, Enron…) it's been virtually impossible to keep up with the market. However, in 1999 there were still many companies from the "old economy" that represented great values that were simply left behind and performed very well over the subsequent 3 years (Buffett's Berkshire being an example though most were small caps). A number of these smaller company stocks actually declined during the doubling of the NASDAQ during '97-'99 as can be seen in the chart below of % of stocks that declined in a given year. The recent market rise has been much broader based (excepting 2015 which was a great year on the short side for us). *(All data is for the US stock market >$50mm mkt cap from CapitalIQ and is Point-In-Time so does not have survivorship bias)*

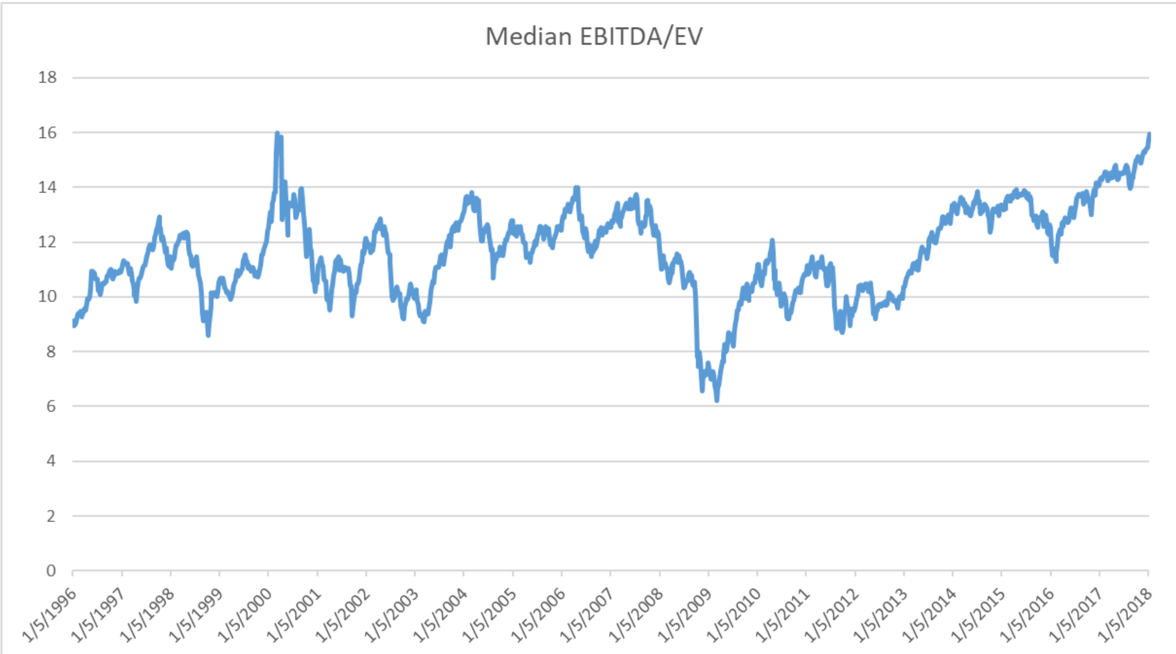
The total sum market capitalization of all stocks is now at a new high vs GDP but as bottoms up stock pickers we don't care about the index per se, we just need to find a portfolio of stocks that is maybe the best 1% longs and best 2% of shorts out of the universe of ~5,000 stocks. Median or quintiles are a more descriptive measure of the opportunity set for a bottoms-up stock picker – what picture does that present?

Many in the "the market is not expensive" camp point to Price / Earnings ratios not yet being at peak 2000 levels and with strong growth and corporate tax cuts there could be more room to expand. One data point relevant for that is that the new tax overhaul is estimated to increase corporate after-tax earnings around 7% which is about how much the S&P has increased in January already…

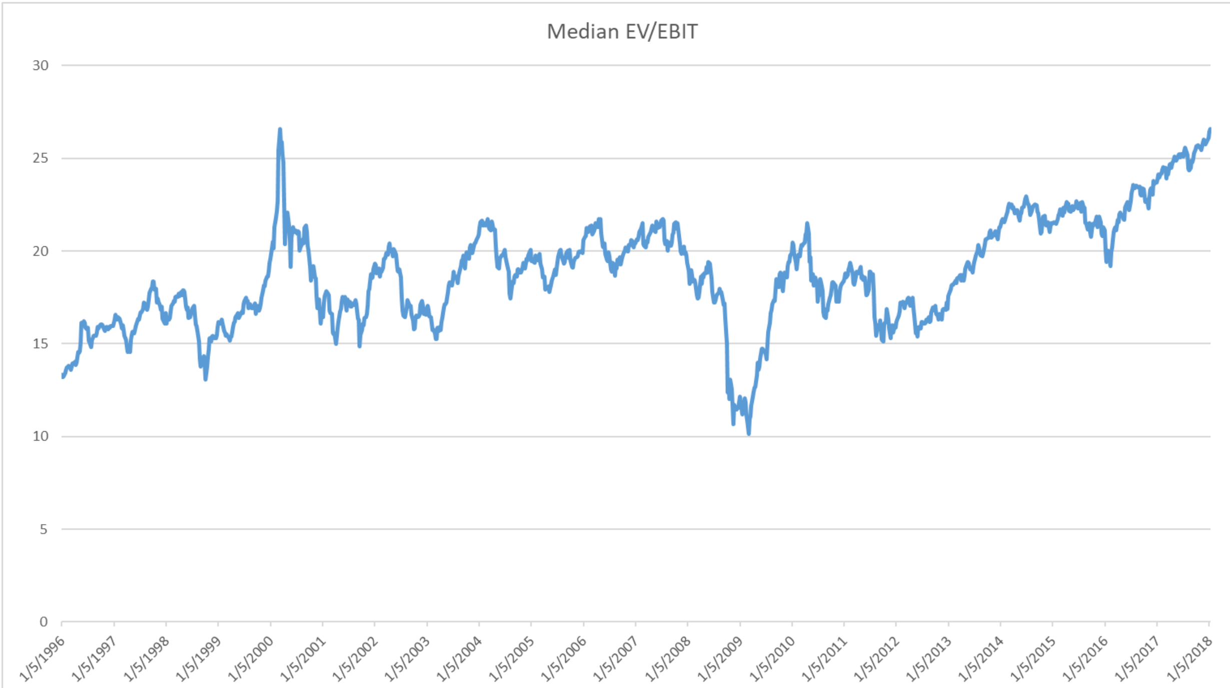


There has indeed been some fundamental earnings growth but the median P/E has expanded from 20 to 33 in the last 5 years which accounts for most of the rising stock market. To be fair to the Great Bubble of 1999, the median P/E was exceeded for about 6 months when it spiked above 35. Note the late 2002 and 2009 spikes up are due to "E" being driven down temporarily – first by the beginning of expensing of stock options and the recession and in 2009 by the Great Recession.

P/E can be a useful metric but <u>companies have balance sheets</u> not just common equity – EV/EBIT and EV/EBITDA are more descriptive measures of intrinsic value as they are the lens that someone acquiring the whole business would look through. P/E is easily distorted by the cash or debt on a company balance sheet. What do these metrics tell us about the opportunity set today?



Ok so this may be more concerning than the not yet peak P/E since we are now at Peak EV/EBITDA. Counterpoint: interest rates *are* lower now than in 1999 so companies can handle more debt. Interest rates are rising now and the Fed recently announced they will likely have 3 or 4 hikes in 2018. This is a healthy thing as it is in response to growth. Weak companies that have boosted their earnings with inexpensive leverage (like in 2007) will not just see their earnings decline in a rising interest rate environment. Weak companies will see their earnings go negative from rising interest costs and their weak/leveraged balance sheets will limit their options. This “brush fire” clearing out the weeds to make room for the strong trees happens every credit cycle.

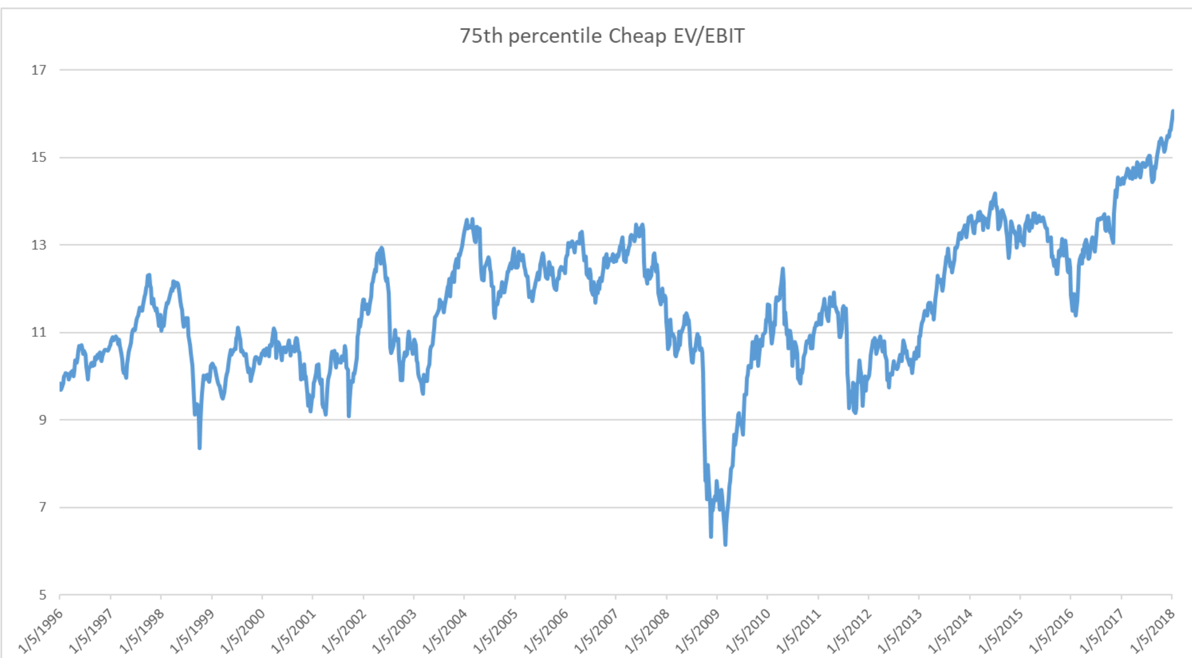


EV/EBIT is consistent with EV/EBITDA – note the difference between the two charts is "DA" or depreciation and amortization. Companies are still capitalizing investments to amortize them over time consistent with GAAP accounting.

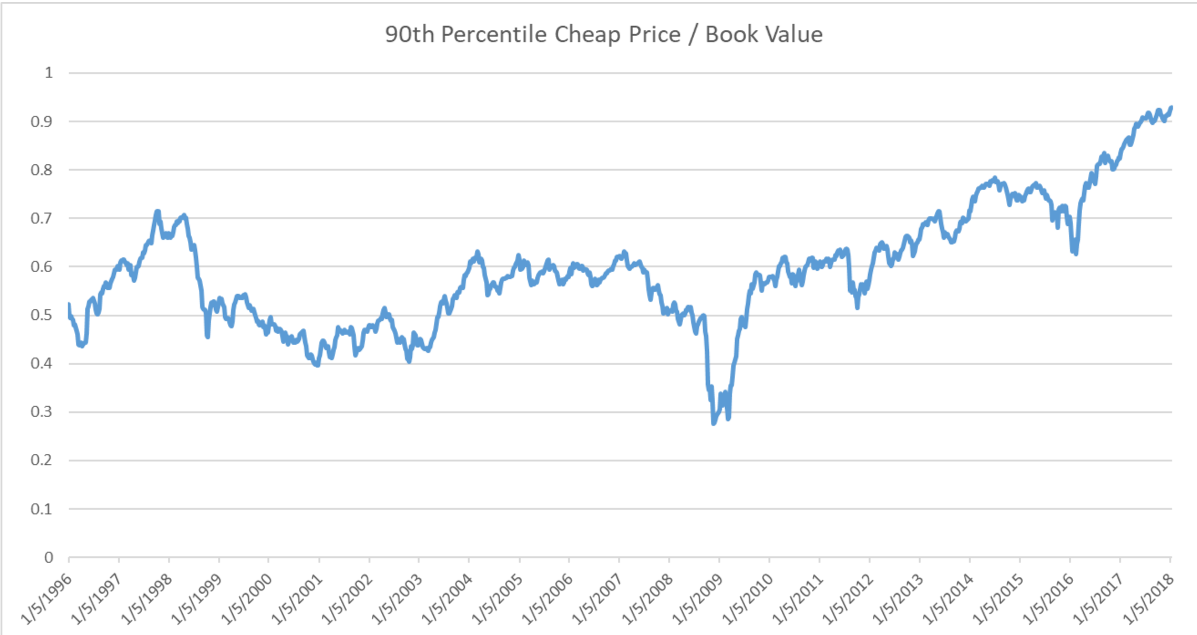
What About the "Cheap Stocks"?

The common screening metrics for value investors are to look for statistically cheap P/E, EV/EBIT (or EV/EBITDA), and P/B. Price is what you pay, value is what you get. Getting more earnings or more net assets per dollar spent purchasing a stock should be a good thing. These are all historic numbers of course but inasmuch as historic earnings are predictive of future earnings and maybe these cheap stocks are just temporarily out of favor this is a reasonable idea. What does the data show us about this investment opportunity set today? We look at the 75^{th} percentile and 90^{th} percentile (i.e. if you ranked all stocks by their P/E highest/expensive to lowest/cheapest this is the cutoff point).

Note for P/E the 1998-2001 period there were abundant inexpensive companies to choose from despite the peak overall market valuations. Not the case today and we are setting new highs – i.e. the cheap stocks are less cheap than ever before.



The more descriptive EV/EBIT that includes the balance sheet dynamic also shows the abundance of cheap stocks in the 1998-2001 period. EV/EBITDA chart not included as it looks similar. The shocking finding here is just how far above historical levels we are in the world of cheap stocks. Today, you are getting *15% less* EBIT per dollar spent buying a company than at any previous peak level and about 35% less EBIT per dollar vs historical averages.



We spend less time looking at book value as it is the most historic of the valuation metrics and less descriptive of the activity of the business. That said, it can be useful to get a sense of if you can buy assets for less than historic or an estimate of replacement cost and then repurpose them then that could be profitable. We use 90th percentile as the cut off here because if you are going to assume assets are being repurposed you generally want to aim really cheap. Today you almost have to pay full historic price for the cheapest book value. What value does an old factory have when a new production process has been invented that relies on automation? Zero? Less than zero due to environmental cleanup costs? As the intrinsic value of more and more business becomes the information component that does not show up on the balance sheet, we think the relevance of book value will continue to shrink unless GAAP is substantially modified.

What Does this Environment Imply for Investors?

Why are things so much different this time? There are a number of factors – interest rates being low is certainly a contributor both in that companies have borrowed more money to repurchase shares than ever before. A similar pattern happened in 2007 and most of those leveraged ("self-LBO") lower quality companies ended up bankrupt once the business climate declined into 2008 and 2009. A newer phenomenon that has never existed before and is likely here to stay is the "Smart Beta" movement.

Approximately $1 Trillion of assets is now managed by funds that are essentially index funds but tilted towards statistically "cheap" stocks based on the metrics above. While value investors may have been a rare breed during 2000, the secret was certainly out by 2007 when these valuation metrics peaked last time. Now the situation is even more extreme with $1T of *forced buyers* accumulating any stock that falls into the bottom quartile of a valuation metric (!). This of course raises the price above its otherwise unaffected level and so raises the P/E since E is not impacted by who is buying or selling your shares.

My general feeling is that smart beta and indexing is here to stay as a phenomenon and it has permanently ended the arbitrage game of simply buying statistically cheap stocks. Many active fund managers purporting to preform deep research often just rely on this shortcut and may indeed be performing research but not the type that leads to any insight or competitive advantage.

Make no mistake – intelligent investing is *still* and always will be about purchasing a security for less than its intrinsic value (i.e. the value of the cash flows it will produce over its life discounted back at an appropriate rate). However, as the *snapshot* view of intrinsic value has become too easy to calculate via screens and has been arbitraged away by the popularity of value investing and the sheer mass of Smart Beta capital deployed, the competitive plane moves up a layer.

Increasingly and essentially now – understanding the *dynamic* intrinsic value is what is important to have an edge. What company is losing money today and doesn't show up on any value screen but will increase their earnings because of predictable fundamental business operations changes tomorrow and will have a flock of "Low P/E" buyers bid up the shares en mass? Where will the future of a company not look like a simple consensus extrapolation of the past? That is the key question that must be answered now to have any hope of an edge. It also happens to be dramatically harder to do than simply being disciplined about buying bottom quartile metrics that everyone else can easily calculate.

How we are positioned and have adapted to this new more competitive paradigm is as follows:

- We can produce entrepreneurial alpha via our active engagements improving companies – the best way to predict that profits will rise and operations will improve is by taking action to cause this to be true.
- Through our experience we know the business patterns that are unsustainable and likely to lead to longer term business performance declines and systematically short the lowest quality companies. The current environment that is pushing up the valuations on all companies is excellent for providing a margin of safety on the short side. These shorts are nearly certain to have disappointing future performance and likely to be catastrophic if there is an overall business environment decline.
- Boding well for the short side: interest rates are rising, labor costs are rising, and tax deductibility of interest for highly levered companies has been limited by the new tax bill
- We are positioned market neutral to hedge away things we cannot control like the overall market trends. Given where market valuations are it seems difficult to imagine the market continuing to outperform GDP growth.
- Our positioning should provide us ample purchasing power during the next downturn to acquire good quality businesses that have temporary valuation declines. Today, we are focused on investments such as Software Motor Company (SMC, discussed in Q3 letter) that can use growth capital to accelerate performance as the cost of capital is historically incredibly cheap.

Our Owner Operator Approach and Asset Duration Alignment

I treat Meson Capital like a family office: long term and something I feel comfortable having my entire net worth managed by. Most funds are sold as an investment *product* with an aim of sales traction satisfying an in-vogue investor demand. Since founding in 2009, my goal has been to optimize for continuous learning and to build upon timeless and universal first principles of investing and business. Investors earn excess profits ("alpha") as a *consequence* of being both correct and non-consensus – or put another way, from having a competitive advantage that others cannot easily copy. Until this year, our resources to execute our strategies have been extremely limited and have consisted merely of myself, occasionally one analyst, and self-made software tools. Despite these limitations, we have compounded 8.7% net to investors since 2014 while positioned market neutral, which is about 5% per year in excess of the much better resourced hedge funds that constitute the benchmark. Today we have 5 full time people (including myself) and highly advanced modern software and computing tools. I believe we can do much better going forward.

Our approach is sometimes hard to explain to investors expecting to check a cleaner "strategy box" in their taxonomy of strategies. If I had to frame it like that, I would say our strategy is to check the "competitive advantage" box when we invest. We have focused on public equities to date as we know this world well but also have private equity investments when appropriate. Investors flock to private equity more than hedge funds during market declines because of PE's less onerous drawdown reporting requirements where bizarrely: the **in**ability to withdraw capital provides comfort (*out of sight out of mind…)*. But we think our structure at Meson Capital LP combining value-added longs with our diversified and profitable short book achieves the best of both worlds and will do better over the full market cycle. In addition, we created Meson Gravity LP to provide an avenue for institutional investors who require monthly liquidity because of their own stakeholders. Meson Constructive Capital LP exists to take outsized co-investment positions in our highest conviction longs.

A Challenging Market Environment for Long-Only Stock Pickers, Better than Ever for Entrepreneurs:

The current environment of high valuations and rapid technology change should provide tailwinds for both sides of our strategy. On the long side, it has never been better to be an entrepreneurial business builder. Cost of growth capital is as low as any point in history and the amplification effects of technology make human willpower and intelligence more economically potent than ever. On the short side – increased competition and technological disruption is making the lifecycle of poorly run companies shorter than ever. The inflated valuations across the market allow for attractive short entry points, which should offer a better value proposition for shorting stocks of poorly positioned companies.

Ever since I founded Meson in 2009, I have taken the path knowing that I would be doing this for 50 years. I have always reinvested our management and incentive fee revenues for the long term to improve our investment process and am tremendously excited for this new chapter. I'm proud to be building the team as we work to institutionalize the firm. We are now up to 5 full time professionals and over $30mm AUM, nearly triple vs. one year ago even after distributing nearly $10mm in profits to investors in Meson Constructive Capital LP, our private equity vehicle. I believe we are uniquely positioned to take advantage of the current market environment and have built processes that are adaptable to whatever future market environments we encounter.

I continue to have virtually all of my investable net worth committed alongside investors in the Partnership. Please email me at rmorris@mesoncapital.com or call at 415-322-0486 if you have any questions or are interested in investing. Our minimum investment has increased to $500,000 in Meson Capital LP and $1,000,000 in Meson Gravity LP. This is the last month we will be offering the Founder's class reduced fee structure to investors for Meson Capital LP. We are also pausing on taking new capital in Meson Capital LP until April 1 as we work through a key investment. Meson Gravity LP remains open. As always, thank you for reading.

Sincerely,

Ryan J. Morris

President
Meson Capital Partners, LLC

***Reproduced from Q3 2017 Letter:* The Natural Evolution to Machine Learning & Artificial Intelligence**

Philosophical Quiz:
1) How does an investor learn and become "better" over time?
2) What does it even mean to be a "better" investor?

Let's take the second question first since it's easier – as Warren Buffett says, there are no "called strikes" in investing. You don't need to have an opinion on every stock, you just need to have (*valid*) confidence in the ones you pick. *It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so… –Mark* Twain. Buffett calls this the "circle of competence" and highlights that the important thing isn't how large your circle is but rather knowing where the boundary of it is and then only investing inside that circle. The problem for most, especially today, is that the world has changed a lot and many investors are only confident during a certain set of conditions that do not presently exist (e.g. clearly undervalued stocks with good prospects and good management). To summarize a good #2 answer: "The ability to validly define and assess confidence in a wide range of different investment situations."

Back to the harder question #1, and *warning*: this will go deep.

Joe v0.0

Let's start with a v0 model with a hypothetical investor and let's call him *Joe*, because Blade Runner 2049... Joe wakes up one day knowing zero about investing and opens today's newspaper. He picks a company on the front page and looks up the stock: Company XYZ. He researches XYZ intensely – reads all its past SEC financial filings, looks at the historical stock chart, looks through the valuation multiples it trades at today and has traded at in the past, etc. Buffett says "accounting is the language of business" and Joe will learn to read the English language in those filings and conference calls later in v3.0.

Based on this financial data he has now acquired about XYZ, he forms an opinion about its prospect as an investment and decides to buy some shares. Then he waits.

One year later, XYZ stock is up 10%. But S&P is up 12% during that year. While Joe has learned *something*, it's clearly not a lot. This has also been a somewhat expensive lesson because Joe actually risked capital in order to learn. Our v0 example is a bit like trying to get good at golf by playing once a year and sadly analogous to how most non-professional investors approach things.

Joe v0.1

Let's take it a step further. Now v0.1 Joe is a voracious reader. Instead of just looking at one stock XYZ, the day he wakes up with zero knowledge of investing, he looks at *every* stock that trades in the US (except pink sheets because who even trusts the numbers…). He reads through all the financial numbers in *every* historical 10-K of every company alive today, looks at every valuation multiple, etc. Then for each of the ~5,000 stocks, Joe decides if he likes it as a long or a short (or neither) and constructs a portfolio of all 5,000 stocks (with some being allocation zero where he has no opinion) based on the data he acquired about each company.

Again, Joe waits a year.

After a year goes by, he has 5,000 outcomes – some stocks up, some down, some bankrupt, some acquired… Joe can start really building a framework of what "works" as an investor – at least with respect to what the world was like over the last year, in an up 12% market… And again it was somewhat expensive because he had to risk some capital and time. How many MBA grads does it take to do 5,000 case studies? How much do they cost?

Joe v0.2

Joe v0.2 is a bit wiser. He realizes that Joe v0.1 was onto something by looking at *more* stocks at a time but is less patient with this waiting idea. So Joe v0.2 goes to the Library of Congress which has all the historical public SEC filings of companies that have existed over time – even if they don't exist today because they were bought out or went bankrupt. After waking up with zero knowledge of investing, he starts in the 1996 section (when the SEC went electronic with EDGAR) and starts reading 10-K and 10-Q filings for *every* stock in the US. He's very careful to note the date on it when it was *published & publicly available* (Dec 31 reports are usually published by March 15 the following year for example). Then after reading all the numbers in each filing, Joe looks up the historical stock price on the *day after the published* filing date, the valuation metrics (anything that incorporates the stock price: P/E, P/Book, EV/EBITDA, etc.) and for good measure the stock chart prior to that date, while taking extreme care to not peek into the future after that date! Next, based on the data Joe now knows about each company on that date, he makes a prediction for each stock – will it go up, down or no idea over the next year?

Then, Joe v0.2 turns over the page in the stock market listing for the answer! Where was he correct? Where was Joe wrong? He repeats this deliberate practice, case study method while carefully not biasing himself by viewing any future information and works his way from 1996 up to Oct 23, 2016 (i.e. 1 year ago today since the "correct answer" to the case study is 1 year in the future) and *only then* does he actually build a portfolio on real money. For those counting: that's about 7,500 companies (there used to be 10,000 public companies in the US, now only 5,000) * 21 years * 4 filings per year = 588,000 case studies just using quarterly numbers. You could even snapshot the investing world every trading day or more frequently since price changes influence valuation metrics every instant. Each case has 50+ important metrics (revenue, margins, growth, return on assets, valuation, momentum, etc.) just on the GAAP financials and we haven't even got to the conference calls, industry specific metrics, insider trading form 4's, analyst coverage, executive and board track records, etc.

Joe v0.2 comes up with a prediction for every case study and importantly – he writes down his *confidence* in that prediction. Really screaming shorts he's 90% certain the stocks will go down over the next year, other stocks that seem unclear he puts down 51/49 because he can't form a strong opinion. As you may have guessed: Joe v0.2 does *not* have time for a girlfriend, or any friends, or a body. Joe v0.2 is literally a machine whose sole purpose is to learn how to invest.

But now back to #2: how do we *know* that Joe is learning the right things? How do we *know* that Joe is becoming a better fundamental investor over time? Unlike short term daily trading strategies – we need to wait *at least a year* to know if we're "correct" about any particular fundamental long or short pick. Good thing Joe v0.2 keeps track of his confidence levels for each prediction he ever makes…

Joe v1.0

Now we get to Joe v1.0, a full version upgrade! Joe v1.0 is just like v0.2 but he's not just a machine but now he's completely made of software. Because he's just made of software, we can do a couple things: 1) We can make *exact* copies of Joe and 2) We can simulate Joe's 'world' and he can't even tell he's in the Matrix because it's 100% realistic. Joe v1.0 wakes up one day and its January 1, 2007. He starts just like Joe v0.2 by going down to the library of congress and reading through all the financial metrics, valuation metrics, etc. for every single US public company since 1996 and does his case study learning method on all of them, all 330,000 of them or so (11y * 7500co's * 4Qs/yr). Then he takes a look at all the companies that trade today, there are fewer than before because of all the PE buyouts and lack of IPOs lately but still over 6,000 stocks to choose from (there were more stocks then than today…). Based on his experience with all the historical case studies he makes his predictions, including his confidence levels. Joe has honed and calibrated those confidence levels after 330k+ case studies to be verifiably accurate in the past – but what if the world changes in the future?

Now, on Jan 1, 2007, Joe takes his 6,000 * 2 predictions (one confidence probability that it's a good long and one confidence % that it's a good short net of borrow costs) and builds a portfolio with his $10mm in his brokerage account of his highest conviction 2% longs and the highest conviction 4% shorts of the market. He's careful to keep his exposure market neutral and not attempt to put a lot of money into illiquid or impossible to borrow stocks. He puts in his trades for the week, trying to minimize market impact by never being more than 5% of the volume: some get executed fully, some partially because the price moves outside his limit order. The next week Jan 8, 2007 he incorporates what he learned the previous week (he's got a whole week of new case studies now!) and then rebalances his portfolio to be the best 2% longs and best 4% shorts (with a slight buffer to minimize trading costs and we track his returns on "real" money – in the simulated, Matrix-like world. Nearly 11 "years" go by and Joe v1.0 has compounded money at 22% per year with his worst drawdown being about 15% when there was a really sharp rally that hurt his short book especially.

Remember though, Joe v1.0 is pure software and we built *The Matrix* and rewind or fast-forward time (though Joe *has no memory of anything in the future* so he isn't the wiser) and re-run history as many times as we want. How do we measure how good of an investor Joe v1.0 is? Well watching his entire career in the super realistic Matrix is pretty good and about the most you could ever hope to ask from any investment manager. But let's take advantage of the tools available and go one step further. Let's say you meet an investment manager and he's got great returns but you're skeptical: he's had a big chunk of his portfolio in Amazon for the last 10 years! That's been the best performing stock – was he super smart or just lucky? The simulation of the entire investment process is extremely important to do correctly for a strategy that incorporates shorting. As legendary investor Howard Marks reminds us about the “6 foot tall man who drowned in the 5 foot average depth river” – even having a valid 90% confidence in a short does not protect from it increasing 10X along the way and bankrupting you.

Let’s try this: let’s make 100 parallel *Matrix* simulated worlds and dropout a random 20% of all companies that ever existed in each one. No two are exactly alike. In one world there is no *Coca-Cola* case study for Joe to learn from, another one doesn’t have an *Amazon* stock that Joe can buy because it doesn’t exist and he’s never even heard of it. How is Joe’s performance in each of these slightly different parallel simulated worlds? Well if he just got lucky with his performance: you’d expect the outcomes to be wildly different right? If he in fact is a deeply good fundamental investor then the outcomes should be pretty similar.

The opportunity set is a bit different so it will never be precisely identical but if his long term track record is always between 17% CAGR and 19% CAGR in ALL 100 worlds (always lower than 22% because the entire opportunity set is smaller than the “real world” of course) then that’s a pretty good sign of a robust investment process. To be conservative, let’s take the *worst* track record out of the 100 parallel Joe v1.0’s as our metric for how good Joe v1.0 as an investor. The *only* tools and information we gave Joe when he was ‘born’ Jan 1, 2007 in each world was telling him what we thought the *important* data points were that we as human fundamental investors believe to underlie actual cause-effect relationships in investing. So net margins are in, first letter of CEO’s last name is out. Joe had access to all the case studies to learn on his own and let the actual data speak for itself about what works to predict the next investment.

We also could look more deeply at Joe’s specific predictions to see if they really make sense to us based on the cause-effect relationships in business and investing. Here’s an example of a stock Joe picked: 1) higher than average revenue growth, 2) higher than average margins, 3) lower than average P/E multiple, and 4) really high and growing accounts receivable. Looks like a lot to like here – especially to a simple ‘value’ investor but what about the A/R issue? Joe is short this stock and 70% sure it’s a good short. Interesting – but think about it: is growth good or bad if you’re not getting paid by your customers? Pretty insightful. And literally an impossible relationship to mathematically capture with a linear model like those used by traditional ‘quant’ investors.

Joe v1.0 has one main limitation – he only knows how to read the numbers. And while accounting *is* the language of business, the performance of a business is driven by the people running it. And the stock price moves up and down with the supply/demand dynamics that are external to it. So while Joe may be a highly optimized fundamental investor, there’s more to the world than *just* the company specific fundamentals.

Joe v2.0 has access to more than just the Library of Congress, he also has *all* the insider trading track records, corporate transaction records, track records of every executive and director at every other company they’ve been at before, and all the other structured data that’s publicly available for US public companies over the last 20 years. Joe v2.0 also has ‘brothers’ – actually thousands of them that all work as hard as him but specialize in a certain type of stock (i.e. industry or market segment). We invest based on a confidence weighted algorithm that synthesizes their different predictions.

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