PRAETORIAN CAPITAL

Q2 2020 Investor Letter July 20, 2020

TO THE INVESTORS OF PRAETORIAN CAPITAL FUND;

During the second quarter of 2020 the fund appreciated by 54.32% net of fees. Given our concentrated portfolio structure and focus on asymmetric opportunities, my expectation is that during most quarters, the fund will be up or down roughly 10%—followed by quarters where one or more positions move dramatically and impact overall returns. During the second quarter, there was extreme volatility within the portfolio as many previously-oversold positions recovered dramatically from their panic COVID-19 lows, offset by continued declines in our oversized tanker basket. Additionally, we experienced very substantial gains in a basket of natural gas equities that I initiated during the last few days of the first quarter and mostly exited during the second quarter after they appreciated substantially. Finally, our Event-Driven book (ED Book) did surprisingly well given the extreme volatility that the market experienced.

Event-Driven Book

I have not spoken much about our ED Book as it has shown rather muted returns prior to March. Given the extreme volatility we have witnessed in the markets during the first half of the year, the ED Book has produced surprisingly good returns over the past few months and I owe you an explanation of what goes on within that book.

While this is only conjecture on my part, the reason for our recent strong returns is due to many event-driven funds suffering cataclysmic losses during the COVID-19 crash. You see, most of the event-driven situations that I follow are widely known to the broader investment community. As a result, the risk vs. reward equation dramatically compresses over periods of low volatility, like we've witnessed over the past few years as more capital is deployed into these strategies—much of it highly-leveraged capital. When COVID-19 hit, small losses in these discrete and theoretically uncorrelated events were magnified by this leverage and many players dramatically scaled back their exposure—leading to substantial losses for those involved. I believe strongly in going where others fear to tread (or cannot tread). As a result, we've allocated a lot more of our capital to these strategies. I do not know how long this window of opportunity will persist for, but I intend to dial back exposures if the opportunities become less attractive. Unlike many other investors, we will not try and grind out small returns while taking on risk, just to keep capital deployed. Until then, our ED Book is likely to take up a larger percentage of our book than in past or future periods.

What sorts of event-driven opportunities are we involved in? To start with, the most prosaic is simply writing puts on undervalued securities that we're happy to own outright. Using simple math, if a stock is trading at $20 and you are perfectly willing to own it at $20, you should be thrilled if you can sell the $18 put for $1. That means you'd end up owning it at $17 ($18 - $1) or a 15% discount to the price you've already decided you're happy to own it at. Additionally, should the put expire worthless, you will earn a 5.9% return ($1 / $17 of capital at risk). As you can imagine, monthly yields like this add up rapidly. Unlike many short volatility funds, we do not simply target high implied volatility names nor use high leverage on far-out-of-the-money puts—both shown to lead to catastrophe. Instead, we target companies we're happy to own at discounts to today's prices, while ensuring we have the capital to buy the shares if EVERY SINGLE PUT was assigned to us tomorrow. In fact, we'd cheer if that

happened as we'd buy companies at incredible prices. Finally, we largely avoid short calls (unless we're long the stock already). We are currently experiencing an unusually high volatility regime due to COVID-19, the ongoing economic depression, extreme fiscal and monetary intervention, the coming election in November, and myriad other geopolitical issues. We also have an army of newly-minted day traders who are drastically overpaying for call options—all of which are leading to higher implied volatility. If volatility is overvalued, I want to take the other side of that in a constructive and unusually low risk way by writing puts on undervalued securities.

Moving to other event-driven strategies, these range from buying post-bankruptcy mispriced securities like PG&E (PCG – USA) where we also wrote puts to buying mispriced warrants on various high-flying SPACs to IPO unlocks to spin-offs to widely anticipated secondary offerings to a host of other unique opportunities. I'm happy to share more details of what we've done with clients of this fund, but prefer to be a bit abstract in a letter that tends to get forwarded around as these strategies are proprietary.

The key point I'd like to make is that we're in a unique market environment where an economic depression is being offset by extreme fiscal and monetary stimulus. Most securities are likely to be range bound as these two forces fight for supremacy and, rather than taking on investments that primarily do well when the overall market is appreciating, I have instead focused on the incredible opportunities in niche subsectors of the market like overpriced small-cap volatility and various other idiosyncratic events. As always, my goal here is to never have one position dramatically impact our returns positively or negatively. Rather, I intend to run a diversified book that in aggregate should do well as there is some randomness to the returns on each discrete event. In any case, as long as it is working, we'll focus more attention and capital here.

On a somewhat related tangent, in the two decades that I've been an investor, I have noticed that during periods where my long book does well, the ED Book tends to underperform and during periods where the long book struggles (like today) the ED Book excels and produces gains that we can use to average down on positions. In summary, they tend to offset each other quite well. Just as importantly, during the times when the ED Book is struggling, it rarely loses much more than a few hundred basis points a quarter—if anything, the bigger loss is that it ties up our capital. This makes it a powerful tool for us to utilize in volatile periods and is rarely a drain on returns during weaker periods.

Value Is Underperforming

Turning to the overall markets, over a century of economic history tells us that over almost any multi-year period, a basket of small-cap companies, particularly in the "value" subset, should outperform a basket of large-cap "growth" companies. In fact, depending on which datasets are used, the outperformance can be quite surprising. However, there are times when "value" drastically underperforms, and unfortunately, we are witnessing one of those periods.

Above is a chart of the Nasdaq 100 ETF (QQQ – USA) and the Russell 2000 Value ETF (IWN – USA) with QQQ in yellow, IWN in white and green as the ratio between the two. While you can quibble with how certain companies have been classified within these indexes, QQQ is a proxy for large-cap growth and IWN represents small-cap value. The spread between the two has been widening, and the pace of that widening is accelerating into something of a crescendo.

S&P 500 Median Results Through July 3, 2020

Company Size	Market Cap	P/E	P/S	P/FCF	P/B	YTD Returns
Top 10	$848.5 billion	31.4	6.3	33.2	6.3	9.6%
Top 50	$198.7 billion	28.7	4.6	23.3	5.5	2.4%
51-100	$77.6 billion	26.0	3.8	25.0	5.3	-5.7%
101-150	$49.5 billion	22.9	3.9	23.6	4.1	-1.9%
151-200	$30.5 billion	26.4	3.0	23.5	4.1	-6.7%
201-250	$24.6 billion	24.4	2.6	20.0	3.2	-9.3%
251-300	$20.2 billion	23.2	2.6	21.8	3.3	-5.5%
301-350	$14.9 billion	23.9	2.8	22.8	2.5	-8.5%
351-400	$11.8 billion	22.1	1.8	18.4	3.0	-17.6%
401-450	$8.9 billion	13.3	1.4	12.8	1.9	-22.6%
451-505	$5.1 billion	13.9	0.8	10.0	1.2	-38.5%
S&P 500	$21.8 billion	22.8	2.4	20.4	3.0	-11.0%

Souce: Ycharts

I'd also like to draw your attention to the table above of the S&P 500, where a similar dynamic is playing out as the largest companies are experiencing all the performance upside and even the smaller large-cap companies are seeing their share prices pressured. There are many theories about why this is happening, from large-cap stocks becoming bond proxies to cross-ownership within ETFs to an old-fashioned financial mania. We can debate the why, but what's important is that it is happening and

history tells us that one day it will unwind. That unwind will likely be violent, with capital once again flowing towards the smaller companies that I focus on.

If you can sense some frustration on my part, that is because I am indeed frustrated with our performance since I launched this vehicle. I am a true believer that the most money in investing comes from when you can find an undervalued company that is about to experience dynamic change—for lack of a better term: inflection investing. We've caught a surprising number of inflections since this fund's launch and despite this, we're only up 4.29% since our inception in 2019. While that's a good deal better than the negative 15% return of IWN, likely a good representative of the pond where we tend to fish for opportunities, I remain focused on absolute performance and that performance remains wanting. That said, it's been difficult to overcome the incredible force of a tide which is rapidly going out for all value names. Fortunately, history remains on our side and when value makes a comeback, it will likely be sudden, impossible to time and violent. We are well-prepared for when that happens.

Position Review (top 5 positions at quarter end)

Tanker Basket (DHT – USA, EURN – USA, INSW – USA, STNG – USA, TNK – USA)

I have been baffled as to why tanker stocks have not performed better since we purchased them. The current narrative is that recent excess earnings were purely related to floating storage caused by COVID-19. However, sellers forget that we've had about a half-dozen supposedly one-time events in the past six quarters that all took a tight market and sent rates to the stratosphere. By this point, it should be obvious that it isn't the events themselves, it is the tight market that is leading to strong rates. That said, at the inflection from a decade-long bear market to a bull market, one should expect volatility, skepticism, and fear of false dawns.

Either the market is correct and these tankers will never again earn a profit, or I'm right that the market is tight, the global fleet is the oldest it's been in nearly two decades and the order book is miniscule. Even better, as we begin to open up from COVID-19, US oil demand will recover to nearly pre-COVID-19 levels (we're almost there already); meanwhile US production will be down by many millions of barrels per day. We will have to import that missing oil production from somewhere and it's almost inevitable that most of it comes from the Middle East—which will dramatically increase tanker demand at a time when the global fleet is not growing much and possibly even shrinking due to scrapping of older vessels.

Tankers remain our largest exposure; we've traded around the position a bit to take some off on moves higher and we've bought back on moves lower. We've sold puts and calls from time to time and earned some healthy dividends along the way, but for the most part, this position has been a massive drag on our performance. I don't know when that changes, but we are in the 2nd year of a bull market in charter rates and despite all the consternation amongst longs, Q3/2020 will likely see sizable increases over average rates in Q3/2019. Meanwhile, NAVs continue to increase due to retained earnings. To give you some sense for just how cheap these stocks are, Teekay Tankers (TNK – USA), the fund's largest position, effectively earned its current market cap in the three quarters starting with Q4/2019 and now trades at about 35% of its NAV in the low $30s. Despite six quarters of excess earnings, the shares have returned to levels where it traded when bankruptcy was a clear possibility—meanwhile today the company will have minimal net debt by yearend.

As rates recover, I suspect that this long-suffering tanker basket will finally perform for us. If not, the companies will likely repurchase a substantial percentage of the shares outstanding and close the gap between NAV and today's quote. Either way, I think we'll do quite well here.

Bitcoin Basket (GBTC -USA), (GLXY – Canada)

Bitcoin is a Ponzi Scheme as the only reason it has value is that more money is going in than out. In my mind, it's fundamentally worthless. That doesn't change the fact that it trades 24 hours a day with surprising liquidity and a core set of fanatical believers. More importantly to us, it seems likely that Bitcoin will break over $10,000 and start a new bull market cycle in the near future.

If you look at the past two cycles, they were driven by retail investors. This one will be driven by institutional investors as well. Paul Tudor Jones blessed Bitcoin by saying he was long; there will be many more admissions of ownership soon. However, our ownership is driven by simple math—the Greyscale Bitcoin Trust (GBTC – USA) is hoovering up Bitcoins at a surprising rate.

If you were to treat Bitcoin like a traditional stock, there's a core long group of true believers—many of whom have been long since the beginning (equivalent to insiders). There is debate as to how many coins belong to this group, but a good guess is that over half are owned by hard-core devotees who will never sell. Then, there's another ten or so percent that's been "lost" forever as people forgot how to access their wallets. What's left is the free float, and I'm guessing that it's somewhere around 6 to 8 million Bitcoins.

The dark blue line above shows the rapidly increasing share-count of GBTC.

GBTC purchased approximately 83,800 coins during Q2/2020 and now controls approximately 386,500 coins or between 4.8% and 6.4% of my assumed float and purchased in excess of 1% of this float during the second quarter. GBTC is designed as a vehicle that only sells coins to pay management fees. Therefore, once a coin disappears into GBTC, it will take a long time to re-emerge. Based on that logic, with continued large purchases, GBTC will have increasingly purchased a larger percentage of the free float—which should force the price higher. Everyone is watching for that $10,000 level. If it breaches

that, I suspect all sorts of spectators suddenly have an urge to chase at a time when the float is reduced and expected to be further reduced by future GBTC purchases.

Once again, I find Bitcoin to be a Ponzi Scheme and bubble, but you can make a whole lot of money buying into a bubble, as long as you are disciplined and know to sell if it appears to be deflating.

In addition, we own shares of Galaxy Digital (GLXY – Canada), which is an investment bank in the crypto space. We purchased our shares for less than the value of their cash and crypto holdings. I do not know if it will prosper or not, but getting into a hot sector with a charismatic promoter CEO for less than tangible book is always an attractive way to round out exposure.

Looting Basket (RGR – USA), (VTSI – USA), short puts in (DGLY – USA), (CXW – USA), (SWBI – USA), (VSTO – USA)

The first day of the riots was a Friday and I had a hunch that things would spiral out of control over the weekend. As a result, I asked myself who does well as cities burn and anarchy reigns. It was an easy decision to build a basket of the two main US gun makers and Vista Outdoor (VSTO – USA), a major bullet producer, on that Friday afternoon. This proved to be a surprisingly prescient call as the riots over the weekend sent gun demand in America parabolic. Since then, we've realized very substantial gains in Smith & Wesson Brands (SWBI – USA) and VSTO and have been writing puts with the hope of re-purchasing them should they pull back (see above for notes on put writing). We still have our Strum, Ruger & Company (RGR – USA) as, unlike SWBI, RGR hasn't yet announced explosive earnings (that's coming soon). In addition, we wrote puts in CoreCivic (CXW – USA), an unusually cheap prison operator. It seems almost inevitable that a nation that is as divided and enraged as ours will see repeated rounds of violence spiraling out of control—particularly in large cities that are focused on defunding their police forces instead of protecting citizens. People who previously saw no need for self-defense weapons are now becoming active acquirers. I see no sign of this trend abating—if anything, unfortunately, it will accelerate. Investing in anarchy feels somewhat odd, but I don't select the social climate that we live in, I simply find the trends and ride them. I have a feeling that this will be an ongoing trend of ours for quite some time—especially as it leaves us structurally long domestic volatility.

Dorian LPG (LPG -USA)

Dorian owns Very Large Gas Carrier (VLGC) ships. These VLGCs carry propane. Book value is in the low $20s per share and the company will be using most of its cash flow on buybacks at roughly a third of book. As you can imagine, this is wildly accretive to shareholders. While current VLGC rates have come off from peak levels, I believe they'll return to prior levels as Asian demand for propane continues to grow rapidly despite the economic crisis, and someone has to transport this propane.

While Dorian often trades with a high correlation to our tanker basket, I actually see this as a natural hedge to our clean tanker position. You see, when naphtha prices increase, propane is substituted and propane demand spikes, which is great for Dorian, though less good for our clean tanker owners. As a result, Dorian ought to hedge out our clean tanker exposure while being unusually cheap in its own right.

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One Anonymous Positions

We have been actively purchasing shares of a company with substantial property holdings trading at a discount to those property values. The position declined as its hospitality businesses shuttered due to COVID-19. This position made it to the top-5 list and I'd prefer that it remain anonymous for now.

In summary, the second quarter saw a dramatic recovery from the first quarter. We own a basket of unusually-undervalued securities that mostly declined in value since the start of the year—offset by sizable gains from natural gas positions and our ED Book. Should our core long book simply recover to January levels, we'd have a surprisingly strong year. Hopefully capital cycles back into small-cap value as the year progresses; if not, I believe our ED Book should power us forward.

Sincerely,

Harris Kupperman
Chief Investment Officer

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