Q3 2020 Investor Letter — October 28, 2020

TO THE INVESTORS OF PRAETORIAN CAPITAL FUND;

During the third quarter of 2020, the fund appreciated by 29.32% 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, our core portfolio appreciated moderately. These returns were augmented by continued gains in our Event-Driven Book, which made up the majority of our gains in the third quarter.

During the second quarter, I mentioned how our Event-Driven Book suddenly experienced strong performance for the first time since this fund's inception. This performance has continued, despite reduced overall market volatility during the third quarter. As a reminder, the goal of Event-Driven trading is to utilize our excess capital to capture unique and discrete events that are short-term in nature (ranging from a few days to a few months), liquid, actionable, and recurring. The key is that no one position should matter much to our overall performance—particularly on the downside. Instead, we should experience gradual gains as a result of consistency in correctly selecting these events and the opportunities that they create. That said, I tend to let winners run, and we did have a few outsized Event-Driven winners during the third quarter.

As a result of continued profits in Event-Driven positions and a hesitancy to add to new long positions leading up to the election, the Event-Driven weighting in our portfolio has gradually increased. Along the way, as I've increased my focus on Event-Driven trading, I've been surprised to realize just how many incredible situations I've missed over the past year. In an effort to improve the consistency of our returns and ensure that we miss fewer opportunities, I have been working with a friend to develop a matrix to track the dozens of potential strategies that I have traded over the years.

While there is a lot of work still to do, particularly as the most lucrative data-series must be compiled manually, we have gotten to the point where we've built systems to track quite a number of discrete data-series. This data has now migrated from excel spreadsheets to a weekly PDF that I share with a few dozen friends. The benefit to sharing the information, is that I in turn crowd-source information, share opinions and ensure that I miss fewer potential opportunities, particularly as the weekly PDF is frequently in excess of 70 pages covering many hundreds of potential opportunities. This remains a work-in-progress, but our weekly progress has been rapid and gives us a rather dramatic and proprietary edge when compared to funds that are often much larger than ourselves. As we improve this process, I believe we will miss fewer opportunities and hopefully improve upon our Event-Driven returns as we take on more overall positions.

With this discussion out of the way, please do not think we're becoming an actively-traded investment vehicle—the majority of our portfolio remains static on a quarterly basis. We are invested in smaller companies undergoing some sort of inflection, often with a global micro tailwind. With our Event-Driven Book using a rather small portion of our capital, we've been earning unusually high returns each month and that capital is compounding quite rapidly. That said, I have dramatically scaled back our Event-Driven Book as the election nears.

The Chaos

In case you haven't been paying attention, American society seems to be fracturing. Things that we took for granted only a few years ago are now being questioned by large segments of society and the differences in viewpoint are so extreme as to be irreconcilable. At the same time, institutions that we assumed would mostly be centrist impartial arbitrators, professionally diffusing crisis (city and state governments, media, judiciary, various government acronyms) have instead become unusually politicized, further polarizing society. Recently, some groups have felt emboldened by the lack of consequences for their actions. Anyone who has studied history would know that there's almost certainly a response coming; in my mind, it's simply been deferred. I believe the coming election may be the catalyst for the reaction. I don't know what form it will take as it depends on who wins and the perceived legitimacy of the result, but I fear something nasty is coming. It may not be immediate, but these things have a way of festering, blowing up, and then calming down in cycles of anarchy. This won't be a civil war in the traditional sense—there won't be front lines. Instead, there will be random violence and bedlam. Every violent action will be legitimized by a prior action from the other side. I cannot see how this is bullish for asset values, though money printing will likely paper much of it over (bad pun).

In my mind, a lot of the current frustration is related to rapidly increasing inflation and a lack of opportunity for large segments of our society. I'm not here to fix our country's problems (that may be impossible), but I intend to clearly diagnose the outcome. Governments will respond to increasing inflation by printing money and handing it to voters in the hope of buying peace. Oddly, that will make the problem worse by elevating inflation and hurting those who are often at the front lines of this violence. As a result, inflation will be a cycle that will be hard to break once it really gets going, much like the twin cycle of violence and retribution.

But what inflation am I talking about? I'm not talking about the price of potatoes and gasoline. That sort of inflation only matters to impoverished countries. Instead, I'm talking about middle-class inflation: health insurance, housing, college education, and a bevy of random fees and taxes that seem to multiply at will. This inflation is occurring at a time when offshoring and overregulation have shredded middle-class US wages. I believe the work-from-home situation we are in will soon shred upper-class wages. Neither party seems particularly capable of fixing the problems as both parties are complicit in making these issues worse. Now, devoid of solutions that do not harm big donors, they've distracted voters with a toxic brew of amorphous problems like race and global warming. I suspect it all boils over soon and this summer's riots will have been merely a dress rehearsal for more violence. It's sad when a mob burns their own neighborhood. When a mob burns someone else's neighborhood, that neighborhood will defend itself, which will eventually include preemptively attacking those who threaten it. I believe that more violence is coming soon, and with it, unsolvable chaos. You can only push people around for so long before they have no choice but to fight back. Unfortunately, I see few winners once this process gets going, yet I see no one in any form of political leadership trying to diffuse the coming crisis—instead everyone sees it as an avenue to power.

So, how are we going to make money in The Chaos? We're going to be long inflation, geo-political volatility, and The Chaos plays, while keeping a de-grossed book to take advantage of unique Event-Driven opportunities. Going into the election, we have the least exposure we've had since the summer of 2019. It's possible that we may miss out on some upside if the election goes off without a hitch. However, I prefer the flexibility that liquidity brings in case The Chaos rears its head—this sure doesn't seem like a time to push our exposure. I don't know when The Chaos starts, but it feels oddly inevitable, and the coming election sure feels like a flashpoint that will be hard to get past. That said, I'm not saying society falls apart after the election—rather, I'm saying that it's a choke-point to get through and if not, after the election, there will certainly be another event that unleashes The Chaos. Meanwhile, a low level of violence will continue and force people to take sides—making everything worse.

Position Review (top 5 positions at quarter end)

Bitcoin (GBTC – USA)

Bitcoin is many things to many people. To me, it's an elaborate Ponzi Scheme. During the third quarter of 2020, GBTC acquired approximately 70,000 bitcoin or 1% of the total free float of roughly 6 to 8 million Bitcoin. Further restricting the float, MicroStrategy (MSTR – USA) purchased 38,250 coins while Square (SQ- USA) purchased an additional 4,709 coins. I'm confident that other large corporations are actively purchasing or considering purchasing coins. As the float restricts, it takes less incremental capital to move the price higher and once Bitcoin hits a new all-time high, the momentum crowd will surely begin chasing. While I know that Bitcoin is fundamentally worthless, I suspect that it goes much higher over the next few years as it thrives on my core macro thesis of inflation, volatility, and chaos.

We've already seen that Bitcoin seems to respond positively to money printing and political volatility, particularly capital flight. I assume that before The Chaos ends, every prominent rich guy will have a few thousand coins, just in case he has to flee tomorrow—especially as the US Government has weaponized the Dollar. Nearly a century ago, my relatives fled Europe with gold crafted as mechanical tools, covered in grease—the border guards never searched those. Wouldn't it have been easier if they had an anonymous wallet instead? I have to assume every despot, oligarch, and trivial millionaire is thinking the same thing—meanwhile the Ponzi scheme aspect of Bitcoin continues to consume the free float.

St. Joe (JOE – USA)

While Bitcoin is functionally worthless, JOE is the most undervalued large company on the US stock exchanges. Together, they make an up a unique and oversized duopoly in our portfolio.

JOE owns approximately 175,000 acres in the Florida Panhandle. I see no plausible way to come up with a net asset value per share that is less than $100 and many models come out much higher. It has been widely known that JOE traded for a tiny fraction of fair value for years, but without a catalyst, it was always perceived to be "dead money."

Over the past few years, the population of the Panhandle has hit a critical mass where the Panhandle now has a center of gravity that is attracting people who want to live in one of the prettiest places in the country, with zero state income taxes and few of the problems of large cities. In many ways, the Florida Panhandle reminds me of the Hamptons out on Long Island when I was a kid. If you owned those potato fields that eventually became estates, you made a fortune. JOE owns the Hamptons of the South and every metric that matters, including: lot sales, commercial leasing, hospitality, revenue cash flow, etc., is going parabolic.

The oddity of the current disdain for so-called "value investments" is that many of them are actually growing quite fast. I see JOE growing revenue at 30% to 50% each year for the foreseeable future, with earnings growing at a much faster clip. Meanwhile, the shares trade at a high single-digit multiple on AFFO looking out to 2022, while you get over $100 per share in asset value tossed in for free.

Besides the valuation, growth, and high ROIC of the business, why else do I like it? For starters, land appreciates rapidly during periods of high inflation—particularly an inflationary period where interest rates are suppressed by The Federal Reserve. More importantly, I believe we are about to witness a massive population migration as people with means choose to flee The Chaos for somewhere peaceful.

The Panhandle does not have big city problems, nor is it anywhere close to a city. It doesn't hurt that Florida has zero state tax as well.

I suspect that every convulsion of The Chaos will launch JOE shares higher and it will ultimately be seen as the way to "play" the stream of very wealthy refugees fleeing The Chaos.

Dillard's (DDS – USA)

Dillard's was an oversized Event-Driven position that we purchased for less than the value of owned properties and working capital, net of debt. However, we didn't buy a dying department store chain due to valuation—that was merely what let us get involved with low risk. Rather, we bought into a situation where there were more shares short than in the effective float. We increased our position when the borrowing cost for shares increased dramatically as the company rapidly repurchased shares, and we sold our shares a few weeks later for a very attractive return. As we've exited this position, I don't think it makes sense to detail it any further, except to say that it was a very high return Event-Driven situation that worked out quite well for us.

Teekay Tankers (TNK – USA)

While tankers remain a disappointment, I haven't given up on them. Rather, I've consolidated our position into the cheapest one, which is Teekay. Teekay has hedged roughly a third of the fleet at attractive rates and the NAV is in the high $20s, as compared to a current quote around $10. I don't know when rates will recover, but they will, and in the interim, Teekay is far less exposed to current rate weakness due to the hedges that they have in place.

Dorian LPG (LPG – USA)

Dorian is a Very Large Gas Carrier (VLGC) company with low financial leverage, trading at roughly a third of Net Asset Value. VLGC rates remain elevated as a result of rapidly increasing propane demand in Asia. I don't know why LPG is this cheap as the macro fundamentals remain quite strong and it is trading at roughly two times cash flow. We've owned LPG for quite some time and while the result has been disappointing, the Net Asset Value continues to build. In my experience, if that continues to happen, the shares will eventually revalue.

In summary, during the third quarter, we experienced decent returns on our capital—primarily as a result of our Event-Driven positions. Subsequent to quarter end, both Bitcoin and JOE appreciated dramatically and October is off to a strong start. We've since de-grossed our Event-Driven exposure quite a lot as the election nears so that we can retain maximum flexibility. While I don't know what will happen, I worry that the weeks following the election could be calamitous. For those of you wondering, my worry-level is always high; this election and its ramifications have the potential for high variability. I believe our fund should prepare for that variability to the best of our abilities. Therefore, given our solid returns this year, unless an investment is tied to The Chaos, why own it when we are so close to such an obvious flash-point? I intend to evaluate everything again in early December and assuming that peace prevails, we'll re-gross our Event-Driven Book.

Sincerely,

Harris Kupperman
Chief Investment Officer