MERION ROAD

2018 Year End Review

	MRCM Long Short Small Cap	IWM (Russell 2000)
2018	**17.1%**	**(11.1%)**
2017	37.7%	14.6%
2016 (Jul-Dec)	1.6%	18.7%

Note: All returns are net of management and performance fees.

	MRCM Long Only Large Cap	SPY (S&P 500)
2018	**(5.6%)**	**(4.6%)**
Dec 18 - Dec 31	0.1%[1]	(0.5%)

Dear Friends,

A few years ago I took Jessica out to dinner for her birthday. Knowing that she appreciates good food I picked a Michelin star restaurant with rave reviews and a daunting reservation list. When an opening popped up I swooped in and felt lucky to have secured a spot. Hell, I even paid for half the meal upfront! Several courses later our bellies were full, my wallet was a little lighter, and we were left to decide if it was worth it. Regardless of what our actual experience had been, we immediately concluded that we had made the right choice. In hindsight it’s obvious that we would act this way. We had vested time trying to secure the reservation, three months of expectations, and a high price tag. Plus, all the critics adulated the place - how could everyone else be wrong? Writing this today I can objectively state that these external factors skewed our perspective. We justified our actions by pointing to the unmatched ambiance and uniqueness of the flavor. We simultaneously forgot the most important thing: we didn’t like the food itself.

I relate this story not as a warning about fancy restaurants but rather to discuss a few behavioral biases in our decision making process. In subconsciously focusing on the positives of the restaurant we exhibited *confirmation bias*. Specifically we had made a decision to invest our time and money into the restaurant and sought out information that supported our decision. By disregarding the information that our very own taste buds relayed we exhibited *omission neglect*, the tendency to ignore information that goes against a prior decision or perspective. Lastly, our willingness to agree with the critics and other patrons was clearly *herding* which is pretty self-explanatory.

Everyone knows that psychology plays an enormous part of investing and that someone able to go against the grain can do quite well. It’s easy to think about this conceptually but putting it into practice is much more difficult. After all, we have to go against the way our brains are naturally hardwired. Furthermore, the way in which we receive information makes it difficult to consider alternative viewpoints or at least keep them in context. News is geared to maximize eyeballs which leads to hyperbolic reporting. Positive and negative data points are incessantly discussed by the media, which can fuel a self-reinforcing confirmation bias.

I can’t eliminate behavioral errors entirely but a key part of my job is to minimize them. Playing devil’s advocate either internally or with a peer can be an invaluable experience. Limiting how much I listen to the talking heads on TV is another. A question I often ask myself, which my late boss used to ask me, is "if I didn't own XYZ stock would I own it today and how large of a position would it be." I always found this to be a great way to remove anchoring bias and approach my analysis without any pre-existing notions.

While the Q4 drop in the S&P of 14% can be painful to experience, it is important to keep it in context. During the two most recent recessions the S&P fell 49% and 56% from peak to trough. I bring this up not to elicit apocalyptic fears, but rather to point out that volatility is a part of this business. In return for going through these times we should be rewarded with higher long-term returns. From 1928 to 2018 the S&P 500 has compounded at 9.2% vs. 3.4% for 3 month Treasury bills and 4.9% for 10 year Treasury bonds.

I am pleased with our performance over the course of the year. While our long only portfolio was down in-line with the S&P 500, I feel good about the companies that we own and am encouraged by their fundamental developments. It is important to keep in mind that this portfolio is geared to maximizing long-term returns and generally attempts to be tax efficient in doing so. The long-short strategy generated double digit positive returns due to the performance of a few of our long positions and the efficacy of our hedging activity.

I welcomed several new investors into the fund this year and am grateful for their trust. As a reminder, my family and I have significant investments in either strategy and all new capital that comes in is invested alongside our own.

I hope everyone has a happy and healthy 2019!

Long Only Large Cap Review

Our ownership of and subsequent exit from Ubisoft ("UBSFY") generated meaningful positive performance. UBSFY is a French video game manufacturer best known for their Assassin's Creed franchise. Over the last several years technological innovation has greatly altered the way in which the industry operates. Improvements in and proliferation of high speed internet and data compression have allowed manufacturers to largely bypass third party distributors (i.e. Best Buy, Gamestop) and build a direct relationship with consumers. This dynamic has had several consequences including the shift to full game downloads and downloadable content, and the importance of a strong multi-player platform / economy. The benefits to the content creators have been immense. One way to think about it is from a customer segmentation standpoint. A decade ago UBSFY had very little ability to charge customers varying amounts based on their utility of a game. Today UBSFY can release a string of map packs and get more from customers who play the most and less from the others. Additional benefits relate to extending the life of a game and spreading the initial research and development spend over a longer period.

While this trend has been going on for several years UBSFY was late to the party, as indicated by their limited digital penetration and correspondingly industry-low operating margins. Management outlined a plan to address this issue through various initiatives. These included a focus on multi-player functionality, directing R&D spend to a few key franchises, and improving their downloadable content offerings. I invested in UBSFY because I did not feel that the market was giving enough credit for these operating improvements. Furthermore, the company was the subject of takeover speculation from a significant shareholder, Vivendi SA, which created some uncertainty with the stock. The price ultimately appreciated as the company demonstrated its ability to execute on their operating plan. I exited our position as valuation seemed to move beyond my estimate of fair value.

Westrock ("WRK") was a detractor to performance during the year. WRK is a leader in the U.S. containerboard (i.e. cardboard boxes) market accounting for 25% of production. After multiple rounds of consolidation over the last two decades the top four players today represent 75% of the market. Given this dynamic, operators are often more focused on economic returns rather than gaining share, and this results in a fairly rational pricing environment. Furthermore, demand should exhibit GDP plus type growth due to the expansion of e-commerce. Yet despite these positive traits it would be naive to characterize this as a particularly high quality industry. Low barriers to entry and a slew of legacy printing facilities that can be retrofitted to containerboard production tend to put a cap on long-term excess returns. Demand fluctuations and supply growth can lead to pricing swings which, when combined with high fixed costs, leads to meaningful cyclicality.

I was attracted to WRK given the many steps they were taking to improve the company's earnings profile. Notably, the company had announced the now completed acquisition of Kapstone which should lead to $200mm of cost synergies. Additionally, WRK has been making high return investments into their existing asset base. For instance, they are replacing three legacy machines at their Florence South Carolina mill that should increase their production of virgin linerboard and boost margins. Most importantly, management is well regarded and has a proven track record of operating improvements and capital allocation.

Despite results that were roughly in-line with estimates during the year, concerns arose over a series of capacity additions at the same time that the political and macro-economic outlook began to deteriorate. These factors have weighed on the entire industry. Though I am positively inclined to WRK through the cycle, I am increasingly concerned about some of the risks and would rather be on the sidelines for now.

Long Short Small Cap Review

The portfolio had a good start to the year which was somewhat eroded in the later months. Our 7% Q4 fall was partially a function of liquidity and risk-off behavior as the Russell 2000 fell by over 20% during the same period. While I always hope to generate positive returns, I was encouraged that our portfolio minimized losses during this market drawdown through both our hedges and uncorrelated asset selection.

Our biggest winner was Bluelinx ("BXC"), a buildings products distributor to retailers and other dealers. BXC caught my eye last year when Cerberus, a large private equity investor and significant shareholder in BXC, executed a secondary offering for their 40%+ ownership in the company. Given the size of Cerberus' fund and the tiny portion that this accounted for, it is fair to say that they were price indiscriminate. The selling pressure forced the stock down from $10 to less than $8 and I used this opportunity to initiate a position. While my intention was for a quick trade, subsequent work made me realize that there was significant upside in the name. BXC owned a large amount of real estate that was marked well below fair value on their balance sheet. Adjusting for market rates would bring their tangible book value up to ~$20 a share. Additionally, the company had installed a new management team that was focused on improving margins and reducing leverage through sale-lease back transactions.

In January the stock appreciated to $16 based on the sale of some of its real estate and strong quarterly results. In March the company announced the all-cash acquisition of privately held Cedar Creek in a highly accretive transaction. While we benefited from being in the right place at the right time when this was announced, I decided to hold the majority of our position as the new entity appeared to be significantly undervalued. With the stock now at $28 I calculated that the combined company would generate ~$7/sh in free cash flow and was therefore at just a 4x multiple. The decision to hold most of our stock proved correct as the stock subsequently increased to $45. Given the dramatic fall in lumber prices and increased uncertainty on the housing sector, the stock has recently pulled back. We no longer own as large of a position but continue to feel that the company is undervalued.

On the loss side of things Tribune Publishing ("TPCO") has seemingly moved against us ever since I bought it. TPCO is a newspaper publisher whose marquis asset is the Chicago Tribune. Headwinds to the industry are not new and TPCO rightly trades at a very low multiple, both from an earnings perspective and price per circulation. What attracted us to the company, however, was its strong balance sheet (the result of having recently sold the Los Angeles Times) and an increase in rumors regarding the sale of the entire company. With a dysfunctional management team and several potential suitors, it seems logical that something will happen. The question remains, what price will it go for. Michael Ferro, the former chairman and current 25% shareholder, has reportedly been pushing for $20.00 per share and has opposed a rumored offer of $16.50 by McClatchy. The stock has sold off recently, perhaps due to tax loss harvesting, selling pressure by other merger arbitrageurs fed up with the process, or simply market weakness. I cannot say exactly if or when the company will get sold, but at the current level I like the risk-return.

Sincerely,

Aaron Sallen

General Disclaimer

This document has been prepared and issued by MRCM. Performance metrics may include internally established valuations of non-traded securities, which are subjective by nature. All figures are unaudited. The enclosed material is confidential and not to be reproduced or redistributed in whole or in part without the prior written consent of MRCM.

Past performance is not indicative of future results. There can be no assurance that MRCM will generate a return on capital similar to these historical returns because, among other reasons, there may be differences in economic conditions, regulatory climate, portfolio size, leverage use, as well as investment policies and techniques. Any information provided with respect to how MRCM manages its accounts is merely a guideline, which may be subject to change.

The information contained herein is only current as of the date indicated, and may be superseded by subsequent market events or for other reasons. These materials may contain historical market data; however, historical market trends are not reliable indicators of future market behavior. Any statements of opinion constitute only current opinions of MRCM, which are subject to change and which MRCM does not undertake to update. Nothing herein constitutes an offer to sell, or solicitation of an offer to purchase, any securities, nor does it constitute an endorsement with respect to any investment strategy or vehicle. Due to, among other things, the volatile nature of the markets and the investment strategies discussed herein, the investment strategies may only be suitable for certain investors.