Postmortems Part 1

April 24, 2023

We want to take this opportunity to look back at the last few years and analyze our investments and decision-making to see what has worked and what hasn't and to see what lessons can be learned. We are doing this postmortem exercise in two parts, with Part 1 focusing on investments that lost money and the upcoming Part 2 to focus on winners. Hopefully, we can analyze both the winners and the losers with an objective eye, learn some important lessons, and adjust going forward.

COVID

A lot of investment funds benefited from COVID, not so much through prescience, but by virtue of being in the right place at the right time. Those investors who happened to be invested in internet growth stocks and similar COVID beneficiaries did extremely well, but I've seen very few people who actually actively positioned themselves to profit from the COVID dynamics. Indeed, many of these same investors (but not all) gave back a substantial part of their gains when the world began reopening, as the same stocks that soared and gave them such great outperformance in 2020 and the beginning of 2021 came back down to earth over 2022. One manager whom we respect was actually down more than 66% (ouch!) from the second half of 2021 through 2022, through the same sort of positions that gave him such outperformance in the year-and-a-half before (where he returned about 150%).

As an ultra-concentrated fund, the specific stocks and industries that we held when COVID struck had an outsized impact on our performance. And although the entire market dropped in March 2020, we were very much in the wrong place at the wrong time, with investments in a cruise company (Lindblad Expeditions) and a financial (Lending Club). Both of those companies were particularly vulnerable to the threat of a huge economic disruption, especially one which shut down all cruise travel for more than a year, bringing Lindblad's business to a standstill. Other positions of ours were affected to a lesser degree, and some even benefited in some ways, while being hurt in other ways. Overall, we were down about 45% for the year in mid-March 2020, substantially worse than the market's decline of 15%.

Our reaction to COVID was threefold. One, analyze our positions and choose which to jettison and which to keep. Two, seek new opportunities in the fire sale that was affecting all assets. And three, reach out to our investors to encourage reinvestment.

In our analysis of our positions, we focused on worst-case scenarios (which we very emphatically did *not* end up experiencing, but which were definitely a possibility) and weighed each of our portfolio companies on resilience and the ability to weather this cataclysmic economic disruption. The results of our analysis were to jettison Lending Club, but keep Lindblad Expeditions, decisions that we believe were the correct ones to make. We discuss each of these decisions in their respective sections.

As for seeking new opportunities, we took advantage of the unwarranted COVID lows to enter Burford in a major way, more than quintupling our starter investment in Burford. We believe events since then have borne out our confidence in Burford and the attractiveness of its valuation at the time, and we expect continued strong performance from Burford in the future.

Finally, we sent a letter to our investors in mid-March (at what turned out to be one week before the market bottomed, although there was no way to know this at the time) encouraging a long-term outlook and calling for reinvestment at the amazing prices available in the market. We emphasized in our letter that we have no special foreknowledge of the future (not then and not now) and do not seek to engage in market timing. Nevertheless, COVID and its ensuing disruptions, however long they would last, would eventually

end, and many companies that would survive and thrive were available at deep discounts. Below is an excerpt from the letter we wrote then (emphasis in original).

> I do not believe that we should attempt to time the market, as pretty much everyone who attempts to do so fails miserably. What I would like to stress is that **whatever happens in the short term, in two years time, this will be in the past**.
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> …
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> **I see many spots in the market that are down to fire sale levels. I firmly believe that now is the time to double down on the market, with some very attractive businesses temporarily available at extremely depressed prices.** I have even seen a number of companies that are down 30-60% despite having absolutely zero possible exposure to either coronavirus, oil prices, interest rates, or even a general economic malaise. **Now is the time to take advantage of the gift the markets are offering.**

We are happy to say that our message resonated with our investors, with about half choosing to invest additional money at the time.

Overall, we believe our response to COVID was on target. Perhaps we could have foreseen the coming crisis a little sooner and reacted quicker, but very, very few people were successful at that. Perhaps a case could be made that we should have rebalanced our positions somewhat and re-invested more in Lindblad when it hit its lows. But although we judged Lindblad to be resilient enough to last through the crisis (as it indeed proved itself to be), we are not sure that adding more money into it was the right move to make under the circumstances, taking into account the risks. All in all, we are happy with our handling of COVID.

Grade: A−

Lending Club

We sold Lending Club in March 2020 for a loss of −64% (IRR of −31.5%). Although Lending Club had a lot of cash piled on the balance sheet, we still judged it to be lacking in resilience. We considered it to be at risk of collapse in face of a possible deep recession and seizing of credit markets, especially since it was as-yet unprofitable. This worst-case scenario did not actually materialize as the government pumped liquidity everywhere (apparently more than they should have, as evidenced by the spike in inflation the government actions caused, and the knock-on effects the economy is still suffering from now).

Despite the worst-case scenario not actually occurring, we believe we made the right call to prepare for the real possibility of such a scenario. Lending Club proceeded to rise in 2020 and spike sharply in 2021 before plummeting sharply over 2022 until it has again returned to its March 2020 level recently. We have no regrets in selling it, and we would do the same again under the same or similar circumstances.

Grade: A+

Marketwise

Marketwise was an ill-fated investment that we entered in July 2021 and exited in November 2022 at approximately a −75% loss (IRR of −65%), the worst investment for us ever at that time.

Marketwise is an investment advisory service directed at retail investors, with many different sub-brands aimed at different market segments. They have free newsletters which then try to upsell subscribers to

pay for premium content, with the highest cohorts paying thousands of dollars for access to ultra-premium content. The investment advice offered is poor to fair, the company is very promotional and aggressive in their advertising, and overall, the product is something we would advise everyone to stay far away from. Similar to The Motley Fool, but with worse investing advice and sleazier advertising.

Nevertheless, despite the general ick factor, Marketwise was (and is) good at this sort of business, is profitable, and was profitable every year since inception, including during the 2008 crash. It is a capital-light business, which from the $50,000 used to launch the business in 1999 grew organically and through acquisitions to become a $500 million business by 2021, without any need for more injected capital. In fact, it grew its revenue every year over those twenty years except for two.

Marketwise came to market vis a SPAC (Special Purpose Acquisition Company, which is a backdoor method of coming to market by merging with a blank-check company rather than going through the traditional IPO process), which generally (but not always) are bad deals. In our paper *Idea Generation* (2018 Q1), we specifically call out the risk of searching for investments in bad hunting grounds, areas where the majority of offerings are bad or worse. SPACs are one hundred percent such an area that requires tremendous care, and although we thought we took the requisite care, we were burned. (Lindblad Expeditions was also a SPAC, one which we ultimately made money on, despite major unforeseen COVID disruptions. So not all SPACs must be bad, but they do deserve extra skepticism.)

Another yellow flag surrounding Marketwise was actually the fact that it was so capital light. Being that they had no conceivable need for money to expand, one must ask oneself why the owners are selling part of such a good business. Often, the answer is that they know something you don't, and they're selling at the top.

Ultimately though, the main issue with our investment in Marketwise was that we paid up way, way too much for continued growth that not only did not materialize, but actually reversed, beginning immediately after the SPAC came to market. SPACs always come with rosy projections. Indeed, one of the attractive "features" of SPACs, for sponsors, is the ability to give whatever projections they want, whether grounded in reality or not, while being subject to safe harbor protection from lawsuits. Of course, we sharply discounted their projections, but in truth we needed to discount them even more.

In the final analysis, Marketwise was an atypical investment for us, based as it was on paying up for future growth instead of value already inherent. When you pay high multiples, this comes back to bite you when the growth doesn't appear (and many times, even if it does). We should have stuck to our regular playbook and taken a hard pass on this one.

We also took too long to reverse course on Marketwise. Unfortunately, we sold it after a little more than a year for a loss of −75%, which made it the worst investment for us ever at that time.

Grade: C+

Silvergate

At the end of 2022, we invested in Silvergate. Shortly afterwards, in the beginning of 2023, we doubled down. And less than two months later, Silvergate entered voluntary liquidation. Never before has there been a disconnect between our enthusiasm for a stock and the reality so massive and demonstrated so quickly. First, let us discuss what attracted us to Silvergate and what our thesis was, and then we will discuss what happened and what we should have done differently.

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Silvergate was a bank that serviced the crypto industry. Crypto likes to see itself as a separate financial system from the traditional banks and gatekeepers. However, at some point, money (US dollars and other fiat currency) has to enter the crypto system, and at some point it has to be able to exit. Hence the need for banks. Most US banks refuse to do business with crypto and crypto-adjacent businesses, due to concerns of fraud, money laundering and the like. Two banks that did welcome crypto business deposits were Silvergate, which focused 100% on banking crypto businesses, and Signature Bank, which although mainly specializing in New York real estate businesses, also had about 25% of its deposits from crypto businesses.

To be absolutely clear, Silvergate did not ever hold Bitcoin or any other crypto, not for themselves and not for their customers; they simply held dollar deposits for crypto businesses. Nor did they do much lending to crypto businesses (except for a tiny portion of loan over-collateralized by 2x-4x worth of Bitcoin). The business was essentially a very simple one. They took deposits from crypto businesses (who had few other options to choose from), paid no interest on the deposits, and invested the money in ultra-safe Treasuries, agency securities, and municipal bonds. With no branches, very low operating expenses, and a relatively small number of employees, this was a highly profitable line of business, one that was growing rapidly as crypto boomed. By Q3 2022, deposits had grown to more than $12 billion. As interest rates rose from historic lows, Silvergate stood to become even more profitable, as they continued to pay no interest on deposits, but made more money from their investments in bonds and securities.

Then came the FTX collapse in November 2022. FTX was one of the world's largest crypto exchanges, and it collapsed in a matter of days, revealing an $8 billion hole of missing customer money due to fraud, incompetence, and self-dealing. Sam Bankman-Fried, the founder and CEO of FTX as well as founder and owner of sister company, Alameda Research, is currently facing multiple federal charges for fraud, etc. The FTX disaster shook the foundations of the crypto economy and precipitated numerous other bankruptcies and failures as intertwined companies fell like dominos. Bitcoin and other crypto coins also dropped sharply in the tumult, on top of the steep declines they had already experienced throughout 2022.

Silvergate was the main banking partner for FTX. Silvergate's stock, which had already dropped close to 80% from its 2021 highs, dropped another 50% in response to the FTX scandal. Yet in theory, they had no major exposure to FTX's collapse. They were in no way a creditor of FTX or any related entity, nor were they a creditor of any company that FTX's collapse pushed into bankruptcy. The only relationship between FTX and Silvergate was that FTX and related entities deposited US dollars in Silvergate bank accounts. In theory, Silvergate had nothing to lose here other than a sizable amount of lucrative deposits (about $1 billion, <10% of their deposit base).

Nevertheless, rumors regarding Silvergate's financial position and legal liability started to swirl. Short sellers piled in and pounded on the thesis that Silvergate would be found liable for money laundering and KYC deficiencies and be shut down by regulators. We analyzed the evidence and found no evidence of wrongdoing by Silvergate. Furthermore, any regulatory fine or liability would take years to establish through the regular process. Most importantly, anyone familiar with bank regulation and past fines for such activity and indeed for far more egregious activity involving much worse, purposeful violations of money laundering regulations, would know that any fines Silvergate would receive would not be anywhere *near* extinction level for the company. A fine, even if incurred, would be the equivalent of a slap on the wrist at most. We continue to believe we were and are correct on this issue.

The more concerning issue was possible loss of confidence in the bank and customers pulling deposits and precipitating a bank run. We considered this to be highly unlikely due to the unique structure of Silvergate's balance sheet. Most banks borrow short-term, via on demand deposits, and lend long-term, via mortgages and the like. This creates a balance sheet with ultra-liquid liabilities, yet assets that are relatively illiquid, leaving them vulnerable to a bank run. Most banks would have difficulty surviving if even 20% of their deposits departed at once, and certainly if more. Silvergate, in contrast, invested virtually all of their assets in highly liquid government securities. Indeed, their cash and government securities exceeded all of their deposits. In theory, Silvergate was able to return *all* their customer's deposits at once, if required, a feat unheard of in the banking world. In theory, Silvergate could withstand a bank run without breaking a sweat, although obviously if all their depositors withdrew their deposits that would not leave Silvergate with much of a business going forward. Taking into account Silvergate's fortress-like and highly liquid balance sheet and other indications that seemed to point to the pressure on Silvergate abating, we judged the risk of a bank run to be quite remote.

When their primary competitor in the crypto space, Signature Bank, announced that they were going to scale back their banking of crypto businesses (essentially firing customers), we took this as a further bullish sign for Silvergate's business going forward. If Signature Bank was turning away customers, where would they go if not Silvergate? In short, we looked at the ongoing crisis and believed Silvergate to be a profitable, growing franchise serving an industry (crypto) which was undergoing troubles but would not disappear into the night. We strongly believed that Silvergate would emerge with a stronger position as basically the only remaining bank focusing on this profitable niche business. And we were being offered the business at a substantial discount to net equity and low single digit multiples of net income. When we first invested in November, we split our investment between common and preferred stock, which we believed would act as a sort of hedge in many downside scenarios. But when we doubled down in December and again in January, we actually grew *more* confident and no longer saw the hedge as a necessity. We thought we were getting the buy of the decade.

We were right in our analysis of their balance sheet, but *more importantly, we were very, very wrong on the investment*. Silvergate did undergo a bank run, with about 70% of their deposits being pulled. To meet these massive withdrawals, they were forced to sell underwater securities and realize $1 billion of losses. Upon announcement of the size of withdrawals and losses they faced, and more importantly when they announced that their auditor had concerns about signing off that they could still be deemed a going concern, the remaining deposits fled. In all this, banking regulators did not have to step in because Silvergate was indeed fully liquid and was able to meet all withdrawals. We were correct in our assessment of Silvergate as the one bank that could fully withstand a bank run, *but that did not help us*. All the deposits were withdrawn, there was no business left, and Silvergate is undergoing a voluntary liquidation.

Silvergate was the first of the banks to collapse in the recent banking mini-crisis, and its failure precipitated lack of confidence in and bank runs on Silicon Valley Bank, Signature Bank, and First Republic (which so far has been holding on by the skin of its teeth). Someone pointed out recently that bank runs often end up spreading from bad banks to good banks, as generally no bank, no matter how good, can withstand a sustained bank run. In our opinion, however, this crisis was uniquely backwards. The crisis started with Silvergate, a very good bank, a bank so solvent and so highly liquid that all deposits were pulled and still no intervention was deemed necessary by banking regulators. From there, the crisis spread to Silicon Valley Bank, which like virtually all banks was not super liquid, but was actually basically solvent before suffering the bank

run. From there, the crisis then spread to First Republic, which is neither liquid nor really solvent, as its liabilities and deposits greatly outnumber its assets at fair value. The final chapter here has yet to be written.

Ultimately, Silvergate's situation was exacerbated greatly by their having invested their assets in medium to long term securities. Although these were ultra-safe securities in terms of credit risk (and most were backed by the full faith and credit of the US government), they remained very susceptible to drops in value as interest rates rose. And interest rates rose very rapidly in 2022, with the Fed funds rate rising from essentially zero at the start of the year to 4.5% at year end. By Q3 2022, this had already caused massive paper losses of over $900 million on a tangible net equity of $1.4 billion. If the bank would continue to conduct business as usual, these losses would never materialize, as the securities would mature and roll over at higher interest rates within the next few years. But business did not continue as usual and the unthinkable happened, a bank run. Never before has there been a disconnect between our enthusiasm for a stock and the reality so massive and demonstrated so quickly.

As a rule, we have always avoided bank stocks, as we've always found their outstanding loan books to be inscrutable and it is difficult, if not impossible, to adequately judge asset quality. We thought that with Silvergate having invested almost exclusively in ultra-safe government securities, we had a bank that sidestepped these issues and could be analyzed. But that was only looking at asset quality, but ignored liability quality, whether deposits would stick around or run. We were wrong to substitute own analysis of the bank's liquidity and strength for what was the real issue, the overall market's and Silvergate's customers' fear and panic, which does not necessarily have to care whether the balance sheet was liquid and strong (which it indeed was). Perhaps it *shouldn't* have suffered a bank run, but it *did*, and we should have been more alive to that possibility. And with an existential risk like that, Silvergate had no place in an ultra-concentrated portfolio.

Worse still, we were *way* too slow to update as events unfolded. Even after the size of withdrawals became apparent, there were times that we could have exited at close to breakeven and had a very different story to tell today. But instead of reanalyzing with fresh eyes, we were biased to inaction and we waited for further information to make a final decision. This was inexcusable.

Grade: C−

Lessons Learned

We walk away from this half of the postmortem with two main lessons. One, stick to our knitting. Paying up too much for growth is dangerous. If you invest at low multiples and your thesis is incorrect, your downside can be somewhat limited by not having paid too much for it to begin with. At times, lots of things can go wrong and you still make money because you bought it at such an undervalued price to begin with. But if you pay up for growth and the growth does not materialize, watch out below.

Two, update, update, update. If new information undermining the thesis emerges, look at the situation again anew and ask yourself if you would invest here to begin with in the situation as it stands now. If the answer is no, you have no business still being there. We were biased too much to inaction and were too slow to take corrective action, and our results suffered for it. This was not the first time this occurred to us, but we will strive to make it the last. The lesson was painful, but we hope we have learned it well.

Part 2 of Postmortems will focus on our winners over the past few years and any lessons we can glean from our handling of them.