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2018 Fourth Quarter Investor Letter

January 3, 2019

Dear Investors;

Firstly, I want to take a moment and say thank you to all of you for being part of the launch of Pelican Bay Capital Management, without your confidence in me as an Investor, none of this would be possible. It is an honor and a privilege to have you as investors. I take this responsibility very seriously, and I pledge to you all of my intellect, common sense, composure, and most importantly integrity as I manage your capital.

Second, as this is my first investor letter, I thought it would be appropriate to provide a general layout for this letter, which I will repeat each quarter moving forward. I will first provide a general market commentary, followed by individual reviews and analysis of each of our portfolios including Concentrated Value, Dynamic Income Allocation, and the Phoenix Fund.

Lastly, if after finishing this letter you have any questions or believe I failed to address any topics in a depth that you believe it deserves, please don't hesitate to call me at 239-738-0384 or send me an e-mail at tyler@pelicanbaycap.com. I promise you a timely response and look forward to your correspondence.

Market Commentary

In the Fourth Quarter the bear market that was inevitable to arrive, as sure as all cycles must come to an end, finally appears to be upon us. While there have been several corrections during this bull market, this latest indigestion feels to be the real deal. I can point to three hallmarks that signal to me that this deep correction is different than the others.

First, it appears investors are no longer buying the dip which has been recently confirmed by evidence that November and December had the largest equity mutual fund and ETF withdrawals since the Great Recession.

Second, up until this summer there was no good alternative to equities, so investors saw corrections as an opportunity to redeploy cash at slightly better prices than their last purchase. But as of this autumn, cash and short-term treasury yields have evolved into a real alternative for investors. Money Market Funds have finally breached 2% and the yields on ultra-safe 2-year treasuries were as high as 2.96% in early October, finishing the quarter at 2.5%. For the first time since before the financial crises of 2008 these returns finally offer investors a nominal return above inflation with little risk.

Thirdly, sticking with treasury yields, the 2-10 yield curve has flattened to just 12 basis points in the quarter. The 3-year and 5-year notes fell below the 2-year treasury at points in December. A fully inverted yield curve has rarely missed the opportunity to be the harbinger of an impending recession and there is only a thin margin separating us from a full inversion. Combined with the elongated length of the current expansion, recession odds form economic teams across Wall Street Banks are increasing to the highest levels in a decade. And given the scaring memories of the last recession many investors are heeding the warning and moving to cash, whether it ultimately proves to be premature or not.

Interestingly the financial markets are anticipating to a recession well before any of the economic indicators have turned negative signaling that an actual recession is realistically just around the corner. Looking at the leading economic indicators, they are mostly green with only two red flags being the stock market itself and a slowing housing market. Jobs continue to grow. Both employee hours-worked and hourly earnings continue to rise; neither of which occur in the face of an impending recession. Households finances are in good order and business inventories appear to be anything but stretched. Banks continue to loosen lending practices and are fighting aggressively to place new commercial loans. Credit is available and still cheap, despite the Fed's antics. Inflation remains in check. Some Commentators point to a dysfunctional federal government, but if we are honest with ourselves how is that any different than the last 8 years of the Obama administration? There is always fighting and uncertainty on Capitol Hill; we should all expect that to continue.

But none the less, there are areas of the stock market that are pricing in a recession as if it had already arrived. More than half of the S&P 500 has fallen more than 25%. Some entire industries such as Homebuilders, Semiconductors, Financial firms, and Chemical companies are all experiencing steep stock declines with valuations that are historically associated with recessionary environments.

Frankly, for investors it creates a fabulous opportunity as if either no recession materializes, these stocks should bounce back quickly; or if a recession does actually rear its ugly head, the returns after waiting for the next economic recovery to materialize in 3-4 years will still leave investors with healthy long-term returns from their current depressed valuations. Could there be even cheaper prices if a recession does come to pass? Absolutely, but I believe you will do well over the medium-term when buying at current prices too.

Looking at a more granular level into securities prices of individual companies, most of those already experiencing declines heading into Autumn accelerated their losses as we progressed through the quarter. The number of S&P stocks that fell 50% from their 52-week high is the largest since 2008. The biggest losers appear to be almost liquidating as their losses turned parabolic to the downside in December, with many experiencing zero price-up days in the first four weeks of the month.

Why is this happing? With mutual funds losing assets at an accelerating rate to passive ETFs, and other investors selling winners after several years of gains (the S&P 500 is up 250% from the bottom and the ever popular FAANG stocks booming to an unprecedented $4 trillion in combined market value), there is an unusually large tax-loss selling effect that is impacting equity markets this quarter. Stocks that were down 30 or 40% from their 52-week highs coming into the fourth quarter fell victim to investors' tax losses harvesting schemes as they were trying to offset gains realized elsewhere after trimming their equity exposure for the first time in years. The downward pressure became unrelenting in December.

I believe this factor had large negative ramifications for value investors that attempt to buy out-of-favor securities, as stocks that had fallen to points that I thought were attractively valued, these companies quickly became the ideal candidates for tax-loss harvesting when the downturn finally arrived. The firm's Concentrated Value and Phoenix funds were severely negatively impacted by this effect; in fact, it is the overarching theme of their returns.

But every dark night ultimately gives way to dawn; and even tax-loses must be recognized by December 31st at the latest. In the final 3 days of December and into the first 2 days thus far in January (obviously too short a time period to draw any real conclusions), the unrelenting sales pressure of downtrodden names appears to be reversing as the impact of tax-loss harvesting could be abating. Stocks that had fallen 50% or more are starting to outpace the market to the upside. Our portfolios have widely outpaced the market in the last few days. If this positive trend continues it will be validation that we indeed did just experience a massive tax-loss harvesting effect that should quickly correct itself. Our beaten-up portfolios are positioned well for this outcome.

As Investors start looking around for bargains, and tax-loss sellers buy back their stocks on the cheap I suspect the rebound in these companies could be quite compelling in the first quarter and beyond. The last time I experienced a similar tax-loss selling impact was in the 2011 tax year. Stocks fell precipitously in December of 2011 after a long stretch of gains since early 2009. This sell-off ultimately led to a sharp rebound in the first quarter of 2012. Hopefully we have a similar outcome in 2019.

Concentrated Value

It was a difficult inception for the Concentrated Value Portfolio. The fund was down 14.6% for the quarter primarily led by a sharp decline in energy stocks and consumer cyclicals as oil prices suffered a spectacular 40% fall (in my opinion far beyond any level justified by fundamentals) and investors increased their odd of a recession in 2019. Energy Stocks contributed to 6% of the loss and Consumer Cyclicals represented another 3.4% of the decline (9.4% cumulatively).

Additionally, as we initiated all of positions this quarter, we were buying shares that were already trading at discounts to our estimates of their true intrinsic values, that in many cases meant that these stocks were already down substantially for the year prior to the beginning of Q4. As money came out of the market for the first time in a few years, the minority of names that were already down for the year saw heaving than normal selling as they became candidates for tax-loss selling. Excluding our Energy names, Air Lease; Floor & Décor; and Invesco seemed to be impacted the most by this tax-selling effect.

If tax-loss selling was indeed a factor in the broad sell-off in our stocks I would expect to see a rebound in Q1 of 2019, and while we are just a couple of days in to the new year, these stocks are rebounding nicely.

Despite the horrible start to the fund, I like our portfolio very much and we have acquired some fantastic companies at very attractive valuation multiples. Our companies are also throwing off nice dividends while we wait for their valuation to be recognized by other investors. Ironically heading into the quarter, I was thrilled with the opportunity set of high-quality names selling at discounts.   I am even more excited today as the discounts have only widened, but I didn't see any actual impact to fundamentals or the underlying intrinsic values at any of our companies this quarter.

Top 5 Contributors

Name	Absolute Return	Contribution to Portfolio
Gold Corp	4.65%	0.40%
Toll Brothers	2.99%	0.28%
Cash	3.96%	0.04%
Verizon	-3.13%	-0.10%
Apple	-9.07%	-0.32%

Bottom 5 Contributors

Name	Absolute Return	Contribution to Portfolio
Devon Energy	-33.88%	-2.88%
Hess Corp	-32.59%	-1.76%
Floor N Décor	-19.75%	-1.22%
Ford	-20.73%	-1.14%
LyondellBasel	-12.45%	-1.12%

Looking at the details, we only had two absolute gainers in the quarter; Gold Corp was up 4.7% and Toll Brothers was up 3%. By the way, it's never a positive sign for the mood of the markets when your leading stock is a gold miner. Toll Brother's gain was surprising given that it had sold off substantially during the first 3 quarters of 2018. I would have thought that Toll would have been impacted by tax-loss selling too. However, with valuation discounts this wide enough new contrarians are attracted to a name. At $28 Toll Brothers was trading at just 0.9x book value; a valuation level that homebuilders typically don't experience until the depths of a recession. Since we aren't in a recession and Toll Brothers is the highest quality home builder, this valuation made no sense to me either, and apparently others are starting to agree.

Turning to the losers, Devon and Hess were the biggest negative contributors to our performance. Both are premier high-quality energy companies which are both currently pricing in oil prices near $50-$55 in perpetuity. While this is certainly a potential outcome for oil prices, I think it is unlikely to play out this way. By my analysis the medium-term global oil supply vs demand outlook is bullishly tilted to an undersupplied market as years of underinvestment in conventional oil fields is coming home to roost. The growth of US shale oil has been fantastic, but it is pushing the limits of geology and is not nearly enough to offset the decline of traditional oil fields which still account for 93% of global oil supply.

The other two big losers were Floor & Decor and Ford. Floor & Décor fell in sympathy with the weakening housing market and Ford was hampered over fears of a sharp pullback in the auto sector. Both names were also impacted by the threat of Chinese Trade war as Ford's sales to China fell off a cliff as higher tariffs in the mainland scared away buyers (anti-American sentiment in China Media likely hurt too).

Floor & Décor is conversely a large importer of Chinese manufactured flooring products, representing around 25% of their product lines. The impact to Floor & Décor seems overblown as even if 25% tariffs did go into effect and FND management couldn't make Chinese Suppliers eat any of the tariff increase, it would only cause the average renovation project cost to rise by 2%, not nearly enough to defer a project from higher prices. Nonetheless building product companies still took it on the chin this quarter across the board as tariff threats and weak homebuilders caused too many investors to take cover and just sell.

Dynamic Income Allocation

The bright spot at Pelican Bay Capital Management this quarter was certainly the Dynamic Income Allocation Portfolio (DIAP). The fund is designed to minimize volatility and it did its job as expected. Frankly, the 4th quarter represented an excellent stress test of the investment strategy and I am very happy to report that the fund was down just 4.8% this quarter, handily beating the S&P 500, Russell 2000, and the standard 60-40 Advisor Portfolio.

The portfolio is intentionally constructed of higher-yielding asset classes that can often act as safe havens for investors in times of market stress. The portfolio also strives to minimize asset correlation that creates a secondary buffer as some assets such as fixed income and preferred shares can offset weakness in equities when bad markets inevitably materialize like they did last quarter.

Turning to income, the current yield on the DIAP as of January 3, 2019 is 6.2% annualized. The current investments have dividend yields ranging from 3.48% to 8.88%, compared to the S&P 500 dividend yield of 2.2% and 10-Year US treasury of 2.6%.

Ticker	Curent yield	Portfolio Yield
AMLP	8.25%	2.06%
PFF	8.88%	1.78%
VCIT	3.98%	0.60%
VYM	3.77%	0.57%
VNQ	5.09%	0.51%
VPU	3.48%	0.35%
SJNK	5.74%	0.29%
Total Portfolio		**6.16%**

There were no changes in the target weightings of the DIAP this quarter. The largest position continues to be Energy MLPs. Energy MLP's are substantially undervalued and were also the worse performer this quarter representing more than half of the portfolio's loss at -2.7% contribution to our return.

MLP's shares fell off in concert with oil prices despite their economic fortunes being more linked to crude oil and refined products *volumes* rather than the *prices* of the underlying commodities. Given the shale explosion in Texas and increase need for Natural Gas infrastructure to supply ever-increasing demands, the underlying value of the MLP's should be increasing, regardless of the volatility of oil prices.

Ticker	Name	Target Weight	Absolute Return	Contribution to Portfolio
AMLP	ALERIAN MLP ETF	25.0%	-9.84%	-2.66%
PFF	ISHARES US PREFERRED STOCK	20.0%	-3.84%	-0.77%
VCIT	VANGUARD INT-TERM CORPORATE	15.0%	1.26%	0.20%
VYM	VANGUARD HIGH DVD YIELD ETF	15.0%	-5.74%	-0.94%
VNQ	VANGUARD REAL ESTATE ETF	10.0%	-3.52%	-0.42%
VPU	VANGUARD UTILITIES ETF	10.0%	-0.50%	-0.14%
SJNK	SPDR BBG BARC ST HIGH YIELD	5.0%	-2.81%	-0.11%
MUB	ISHARES NATIONAL MUNI BOND	0.0%	-0.32%	-0.01%
	CASH	0.0%	4.37%	0.05%

High paying dividend equities were the second worst performer down 5.7% in the quarter. The equity sell-off was very broad based with most stocks registering absolute declines. Stocks with higher-dividend yields did benefit from smaller relative loses as investors flocked to yield in a safety trade. This limited our downside compared to the overall market for our equity basket. This dividend preference factor becomes more evident when we isolate REIT and Utility equities that were down just 3.5% and 0.5% respectively. Utilities were the best performing sector in the S&P 500.

The only absolute winner this quarter was intermediate term bonds which returned 1.3%, primarily as a result of declining interest rates outpacing the widening of credit spreads. As a reminder declining interest rates equal higher bond price, and visa-versa. However, in the junk bond category, the widening of credit spreads was much higher than the general fall in interest rates causing our high-yield bonds to fall 2.8% in aggregate. Before the drop, I thought High-yield bonds were relatively expensive as credit spreads vs investment grade were far too skimpy heading into the quarter. The current spread has widened to 5.4% vs 10-Year Treasuries from just 3.2% in the beginning of the quarter.

If Junk bond spreads remain elevated and utilities continue to outperform, our next allocation change will likely be adding to our SJNK position and lessening our VPU exposure as utilities are starting to look more fairly valued relative to other equities. Alternatively, if the high-yield spread continues to widen and reaches a 6% premium to 10-year treasures and no other asset classes see their valuations change markedly, I may also increase our position in SNJK; drawing funds equally from REITs, Utilities, and Intermediate-term Corporate Bonds.

The other potential portfolio change may be adding emerging market sovereign debt to the fund in a small 5% opening position. Emerging market bonds had a rough year falling 5.2% in the last 12 months as some countries have experienced turmoil and emerging-market currencies fell against the dollar. The asset class currently yields 4.9%, a wider spread to developed market sovereign yields than normal. Emerging economies could also benefit from China stimulus and faster than expected growth in developed markets such as the US and Europe. This would cause spreads to tighten and values to increase.

Simultaneously, I think emerging market sovereign debt could also benefit from a reversal of the strengthening dollar. While I'm not a currency specialist, the market is now pricing in no more Federal Reserve interest rate hikes that had been a primary cause of driving the dollar higher this year. Also moves in currencies are very cyclical and any 3 or 4 quarter length period of strength or weakness is often followed by a reversal, as currency markets are mean reverting. The US dollar has been particularly strong this year increasing 9% from the lows in early February through the end of 2018. A pull back in 2019 wouldn't be out of the ordinary.

Overall, I feel satisfied with our current allocation if we elect to make no changes in our portfolio. The quarterly rebalance back to target rates should prove beneficial as we add to MLP's which have been weak. We will continue to also re-invest our dividends received in the quarter, enjoying the compounded return they should provide.

Phoenix Fund

Please note: The Phoenix Portfolio is only available to "Qualified Clients" pursuant to section 205(e) of the Investment Advisors Act of 1940 and section 418 of the Dodd-Frank Act.

Given the sharp risk-off attitude of investors and added pressure from tax-loss harvesting, a distressed investment strategy had little chance of performing well and the Phoenix Fund was no exception. The fund endured a sharp selloff and we finished the quarter down 21.5%.
The decline is very frustrating as our holdings were already selling at significant discounts as most of these stocks had already been purged by institutional investors as they were already carrying stock prices in the mid-single digits after experiencing 50% or greater sell-offs before we became involved.

Around the first week in December it became clear to me that the fourth quarter was likely ending with a strong tax-loss effect and I halted adding to our positions as I thought the likelihood that they would continue falling was very high. I contemplated selling some positions like Cloud Peak, Hovnanian and Francesca that were seeing magnified impacts from this effect. But I ultimately decided I may not be able to buy them back at a better price before the tax-loss selling would abate and recover; ultimately resulting from either a tax-wash sale or a gap move up to higher prices then where we sold.

In hindsight this was a mistake that probably cost the portfolio 4-7% of incremental loses that wouldn't have materialized if I sold shares with the idea to buy them back when tax-loss selling abated, as the declines were greater than I anticipated. In the long-run I don't suspect it will matter as these names will rebound and our entry prices will likely prove to be advantageous.

If the market shows signs in early January that the selloff was driven by tax-loss selling as I suspect, and our stocks only see a small rebound from their year-end lows, I will deploy more capital in these names to lower our cost basis. The portfolio has 25% cash at present. If the market continues to sell off and our names fall further, we will have to consider I am wrong and close some of our positions.

On a positive note, the final liquidation of our securities was so brutal in December, I think the probability that the worst is over is very high. As Institutional Investors report their holdings in mid-February, I think we will see that there was significant institutional turnover of these securities, and the new owner base will be looking for a rebound.

This rebound could be very sharp. By my estimation approximately three quarters of the holdings in our portfolio would see gains of more than 100% if they traded up to the low end of what I calculate to be their intrinsic values.

Top 5 Contributors

Name	Absolute Return	Contribution to Portfolio
Kinross Gold	16.91%	1.05%
3X Long Nat Gas	-46.68%	0.76%
Turkcell ADR	5.87%	0.18%
Gold Corp	1.96%	0.10%
Cash	0.29%	0.09%

Bottom 5 Contributors

Name	Absolute Return	Contribution to Portfolio
Cloud Peak	-79.58%	-5.29%
Hovnanian	-52.94%	-3.12%
Denbury Resources	-50.11%	-2.37%
Diebold Nixdorf	-42.40%	-2.08%
Gran Tierra Energy	-29.60%	-2.07%

Looking at individual contributors to the quarter, we were hurt by falling energy prices as Denbury and Gran Tierra rounded up the list of top five negative contributors. Denbury compounded the impact of falling oil price as they have engaged in a large acquisition using dilutive equity to fund the transaction. It was a self-inflicted wound that is not acceptable. Despite this error we are holding our position as there is still substantial upside despite the dilution we'll experience if the deal is consummated (which isn't a forgone conclusion as the selling shareholders may nix the deal given Denbury's crashing share price).

The biggest loser in the quarter was Cloud Peak. They are one of the four coal miners operating in the Powder River Basin in Wyoming. They have debt that matures in 2021 which the market is worried they won't be able to refinance. However, the company has announced that they are putting themselves up for sale and have cancelled their undrawn revolver to prove they are serious. Cloud Peak's assets are attractive to other buyers in the basin as they can help lower fixed costs and Cloud Peak is the only player with Asian export optionality which drives tremendous cash flow when Asian seaborne coal prices are elevated. There were rumors of a possible transaction for $4 per share earlier in the year from a competitor. If we even saw half that amount it would represent a 600% increase from the current share price. The odds of either a deal being consummated or rebound in Asian Coal Prices will cause the stock to rebound sharply in the near future. Think odds of a positive outcome are in our favor.

On the bright side our gold companies were strong performers as miners typically do well when gold bounces during periods of market stress. Kinross Gold was our largest winner.

Turkcell also did well this quarter as fears of a total collapse of the economy in Turkey were proven to be overblown. Turkcell was liquidated by investors fleeing the country with shares falling from $11 down to $4. The economy is on the mend in Turkey, and Turkcell has proven to be a deft operator passing on most of the currency depreciation impacts to customers while taking share from competitors. The company is performing very nicely given all the headwinds in Turkey, and investors looking to bottom fish will want higher quality firms like Turkcell.

We also had success in our small trading ideas. We generated 71 basis points trading natural gas futures benefiting from the spike in late November as the forecast for winter was very cold and natural gas storage was at multi-year lows, although we gave back some of those gains in December when the winter proved warmer than expected. We have excited our position.

Our other trade is betting on GameStop to be acquired in the next few months. The company has put itself up for sale, but the stock market doesn't seem to care. I believe the odds are very high that GameStop will find a private equity buyer as the company still throws off tons of cash and has the wherewithal to add leverage in a deal. I suspect a buyout would happen at $18-$24 per share giving us a nice pop from our $13 purchase price. If a transaction isn't announced by March, we will move on.

As a reminder we keep each of our trading positions at just 2% of the portfolio as they are typically more binary short-term events.