CHARLOTTE LANE

To Charlotte Lane partners,

Our master account return for March was +0.6% vs. +0.1% for the S&P 500. We were 12% net short for the month.

For Q1 2017, our master account return was +1.5% vs. +6.1% for the S&P 500 while Charlotte Lane was 4% net long for the period[1].

As of the end of Q1, we were 12% net short, at 70% long by (82%) short.

	Charlotte Lane	S&P 500	CL vs. SPX	Alpha	Beta	Net Long / Short	Capture
Q1	(2.7%)	1.3%	(4.0%)	(2.2%)	(0.55)	(38%)	(197%)
Q2	1.2%	2.5%	(1.3%)	1.6%	(0.26)	(54%)	48%
Q3	(2.4%)	3.9%	(6.2%)	(1.7%)	(0.25)	(25%)	(62%)
Q4	5.9%	3.8%	2.1%	5.3%	0.11	9%	156%
2016	1.84%	11.95%	(10.1%)	4.8%	(0.34)	(27%)	15%
Jan	(1.4%)	1.9%	(3.3%)	(1.4%)	(0.05)	8%	(72%)
Feb	2.3%	4.0%	(1.7%)	(0.8%)	0.78	20%	58%
Mar	0.6%	0.1%	0.5%	0.5%	(0.19)	(12%)	
Q1	1.5%	6.1%	(4.5%)	0.8%	0.07	4%	25%
2017	1.53%	6.07%	(4.5%)	0.8%	0.07	4%	25%
ITD	3.39%	18.74%	(15.3%)	7.8%	(0.31)	(21%)	18%

After fees, expenses

Net long/short exposure is daily average for period

I am pleased to report positive alpha and upside capture well in excess of our net exposure for the quarter. Equity markets stalled out in March after four months of the post-election run. During that time, the market advanced 10.1% and Charlotte Lane was up 7.4% while being 7% net long, on average. Inter- and intra-sector volatility have been helpful for our strategy. I'll explain why that is and what I try to do in harvesting that.

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[1] All return information contained herein for information purposes only. All return data unaudited. Return data not represented as GIPS-compliant. Returns are net of management fees and expenses. Long/short are daily averages for respective periods. Alpha calculated using weekly covariance vs. S&P 500 and 2-year treasury bill yield.

First, we will always be a high active share strategy and stick out against the index. At present, our long active share is 76%, short active share is 88%, and total active share is 114%[2]. Second, the best risk-adjusted returns for high active share strategies come from those strategies with both selective single name exposure and broad sector exposures, according to Antti Petajisto in this update (pdf file) to the paper that codified "active share." I have always maintained this sort of exposure in Charlotte Lane, not by dint of aiming to check boxes, but by dint of approaching 20 years as a generalist operating with a broad canvas of opportunities. If one spends 20 years covering one sector, low inter-sector dispersion probably works well. For broad generalists like myself, high dispersion works far better. Let's look at what that meant for us in Q1.

What follows is the rundown of returns and exposures by sector for Q1 2017:

	Net Exposure		Charlotte Lane Gross Exposure		Net Return Contribution	
	Charlotte Lane	S&P 500	Long	Short	Charlotte Lane	S&P 500
Consumer Staples	14%	9%	14%	0%	1.4%	0.6%
Consumer Discretionary	(2%)	12%	17%	(19%)	(2.0%)	1.0%
Energy	(0%)	7%	3%	(3%)	(0.1%)	(0.4%)
Financials	4%	14%	17%	(13%)	0.9%	0.4%
Health Care	8%	14%	9%	(2%)	2.4%	1.2%
Industrials	(21%)	10%	7%	(28%)	(0.5%)	0.5%
Materials	1%	3%	1%	0%	(0.0%)	0.2%
Information Technology	(0%)	22%	0%	(0%)	(0.0%)	2.8%
Utilities	0%	3%	0%	0%	0.0%	0.2%
Telecommunication Services	0%	3%	0%	0%	(0.0%)	(0.1%)
Real Estate	(0%)	2%	0%	(0%)	0.0%	0.1%
Total	2%		67%	(66%)	1.5%	6.1%

After fees, expenses
Charlotte Lane exposures, monthly average, measured at end of month
SPX measured at end of Q1 2017

	Charlotte Lane ROA by Sector		Charlotte Lane Contribution to Net Return		S&P 500 Return by Sector
	Long	Short	Long	Short	
Consumer Staples	9.8%		1.3%		6.4%
Consumer Discretionary	8.5%	(18.0%)	1.4%	(3.5%)	8.5%
Energy	(8.1%)	3.5%	(0.2%)	0.1%	(6.7%)
Financials	6.9%	(2.1%)	1.2%	(0.3%)	2.5%
Health Care	23.9%	14.2%	2.2%	0.2%	8.4%
Industrials	7.4%	(3.9%)	0.5%	(1.1%)	4.6%
Materials	(5.2%)		(0.0%)	0.0%	5.9%
Information Technology		(3.6%)		(0.0%)	12.6%
Utilities				0.0%	6.4%
Telecommunication Services				(0.0%)	(4.0%)
Real Estate		0.0%			3.5%
Total	9.3%	(7.0%)	6.4%	(4.6%)	6.1%

Charlotte Lane ROA before fees, expenses

[2] Assuming each side of the ledger were 100% long or short, long active share would be 97% and short would be 96%. Active share calculations do not calculate cash as a position. Total active share exceeds 100% due to gross exposure exceeding 100%.

In **Financial Services**, Q1 long ROA was 6.9% and short ROA was (2.1%) vs. the sector's 2.5% return. We added to our short positions in the regional banks that have expanded in reckless ways and that are trading at very high valuations with low quality asset bases. I don't think the yield curve will save the sector and I believe investors focusing on just one variable, to the exclusion of all other key drivers for banks, are way off-track.

We added a new position to the sector on March 20 with a 3% long position in **BlackRock (BLK)**. I don't know if I should feel a bit guilty as a traitor to my class with long positions in **S&P Global (SPGI)** and BlackRock, two handmaidens in the devastation of active management. We closed out our long **Charles Schwab (SCHW)** position in early January after it had moved well through fair value. BlackRock trades at a sizeable discount to Schwab despite having similar, in my opinion, growth outlooks and incremental return characteristics.

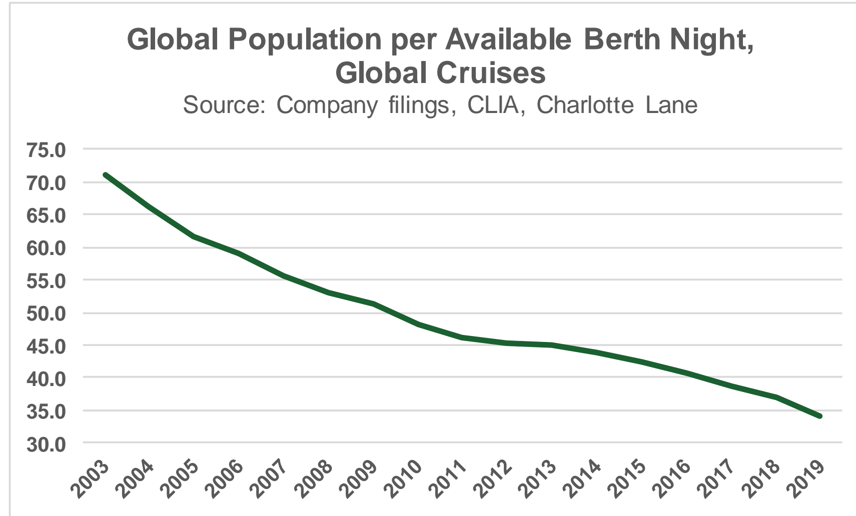
BlackRock's acquisition of Merrill Lynch's asset management division a decade ago encumbered the balance sheet with stranded, unproductive equity, but the Barclays deal in 2009 made up for that. As such, an 11% ROE doesn't look all that enticing, but the return on incremental capital for the company over the last four years has averaged 43% (and 24% last year). This is a $5 trillion+ asset manager, in a scale returns business, with net flows of $202B last year augmenting the $325B increase in AUM from market appreciation. At 18x 2017E EPS with ~10-12% IRR potential over a 3-5 year analytical horizon, this was an attractive addition to the portfolio.

Consumer Discretionary was the miserable outlier in Q1, as our short in the **bubbly auto OEM / clean energy / autonomous transport / Mars Mission** company ran, our **Under Armour (UA)** long slumped badly, and our shorts in cruise lines and a soup/salad/sandwich restaurant stock all had torrid runs. As you know, I think long and hard about averaging positions when they're down. First, a short that is in drawdown is by its very nature being averaged down, which is sometimes a good thing and sometimes bad. I covered the bubbly auto OEM and the restaurant early in Q2 (not before they got in their final licks[3]) and added to the cruise line shorts. Let's look at those.

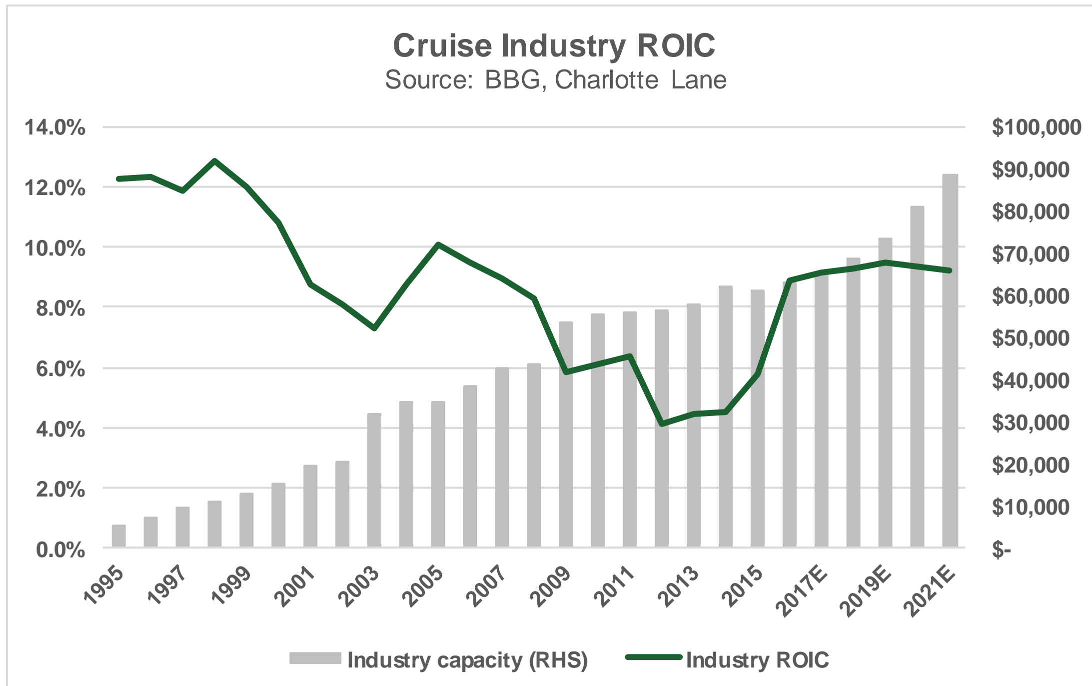
In the last four years, the cruise industry has experienced a nice bump in returns based on capacity growth having slowed after the Global Financial Crisis, with declining fuel providing a nice fillip to earnings growth in the most recent two years. As we buy businesses and short businesses looking out over a multi-year analytical horizon, of particular importance to the investment case here is the wave of capacity that is on the horizon:

[3] The soup/salad/sandwich restaurant received a bid from JAB Holdings, a European private equity entity that is snapping up US companies left and right. The bid values our former short at 41x earnings. Such a bid is helped in part due to the European Central Bank buying corporate bonds, which puts a bid under such credit. JAB's long-dated credit trades at 105 bps over benchmark rates. To summarize: ECB policy promotes corporations buying other corporations on other continents so the buyer can fire lots of employees at the acquired corporation, buy back stock, and squeeze suppliers of the consolidated entity, which then has greater pricing power over consumers. This wealth effect is supposed to help economic growth, in the thinking of central bank economist staffs.

	2011	2012	2013	2014	2015	2016	2017E	2018E	2019E
Market Size (000)									
Supply, Global (Berths, 000)	412	425	432	448	469	493	523	552	604
YoY growth	5.4%	3.2%	1.6%	3.7%	4.7%	5.1%	6.1%	5.6%	9.4%
YoY change	21	13	7	16	21	24	30	29	52
Berth Nights (000)	150,380	155,125	157,680	163,520	171,185	179,945	190,897	201,646	220,561



Capacity is growing much faster than global population and real income per capita, with accelerating capacity growth. Because the lead time on building a new ship is 5+ years, it's almost impossible to slow capacity growth if there's an unforeseen demand growth problem. The berths that are no longer economic in developed markets go to emerging markets and haunt the global supply picture afterward, since those consumers no longer have to fly to points of embarkation in developed markets. Supply growth exceeding real per capita GDP growth has historically been the industry's Achilles heel.



I don't model the companies falling into a consumer recession; the shorts are predicated on returns on capital plateauing with global capacity growth offsetting positive contributions from organic demand growth. With the industry trading at 157% of invested capital and returns on capital equal to WACC or below historically (these are not taxpayers, so there's no interest shield), that premium shouldn't be there and will likely melt. With a fair bit of financial leverage, that will sting for equity.

A note on framing addressable market and framing investment opportunities is warranted here. Bulls will say this is an oligopoly, which is technically correct, given **Carnival Cruise Lines (CCL)** has 44% market share, **Royal Caribbean (RCL)** has 20%, and **Norwegian Cruise Line Holdings (NCLH)** has 9%. The "consolidated" and "oligopoly" framing is often mounted in investment hypotheses to support pricing power assertions. Outside of the fact industry average ROIC since 1995 has not met its cost of capital, which should speak to the lack of pricing power, the addressable market here doesn't consist solely of cruise spending. This industry competes with a vastly greater leisure market consisting of a rich universe of substitutes.

In the US, the leisure market is about $885B, not including airfare. Cruise line industry revenue for US-sourced passengers ran at about $15B last year[4], or 1.7% of the addressable market for all leisure spending. In its 2015 slide deck, industry trade group Cruise Line Industry Association crowed, "Demand for cruising has increased 62% in the last ten years." Lo and behold, so has supply! Yet the industry just met its cost of capital in 2016 for the first time since 2007. If an industry needs 5-8 years of economic expansion to meet its cost of capital, it's an empty oligopoly. More on framing next month as I discuss our short positions in airlines.

Energy. Within energy, we have small exposures that yielded a poor result for the quarter. We have a long position in **Centennial Resource Development (CDEV)**, a smaller company brought public via a SPAC by legendary former **EOG (EOG)** CEO Mark Papa. CDEV is an oily Permian basin E&P company that is debt-free. It's expensive on the basis of acreage and flowing barrels, but this is a junior company, where that's often the case as reserve development ramps. Papa's signature in driving a 19.5% IRR at EOG from 1997 through 2013 (850 bps excess annual return) was technical excellence in drilling and geology. This is where E&Ps differentiate themselves, which you can see in finding & development (F&D) costs per BOE. I have found no correlation between excess equity returns in the sector and operating costs per BOE. Certainly no excess sector return correlation exists on pricing; they produce commodities.

The factor to pay attention to is recycle ratio, which is cash flow per barrel produced divided by capex per barrel discovered & developed. There is very little deviation from the mean in this industry in terms of cash flow per barrel of production at the same hydrocarbon mix, but F&D costs for one E&P can be half that of another. So, for each dollar coming out of the ground, a company with half the F&D cost can find and develop twice the amount of incremental reserves per dollar of cash flow as the average company.

That all may sound overly technical, so to translate: a higher recycle ratio translates to higher sustainable growth rate, steady state free cash flow, and ROIC. This is why EOG was so successful and why we own CDEV.

Consumer Staples. Finally, staples performance was driven by our positions in **Hostess (TWNK, TWNKW)**, which we've exited, **Lamb Weston (LW)**, **Altria (MO)**, **Costco (COST)**, and a small supermarket short. Altria is perhaps one of the only large staples companies that is really innovating with its partner, **Phillip Morris International (PM)**. PMI's reduced risk products are flying off the shelves outside the US and Altria will benefit from these products in the US. Longer-term, there are applications for this technology to substances that are not yet legal widely in the US. Altria sits at the pole position to benefit from a liberalization in laws around these substances, as it is the scale producer, marketer, and (importantly) the trusted government partner in the collection and reporting of excise taxes. The concept companies running around in this space sound like fun moonshots, but they just won't in almost all cases have the scale, reach, and excise tax mechanism trust accorded to Altria by government agencies. These will determine the economics of success as the addressable market grows.

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[4] This includes airfare in many cruise packages.

Conclusion

We remain net short in Charlotte Lane for all the reasons cited over the last couple years. I am gratified to have delivered positive returns in the first five quarters as a standalone strategy and am pleased to continue to build alpha. With return dispersion returning to the market in a halting way, I believe the strategy is well positioned to continue to compound and protect your wealth. I appreciate your trust in me.

I leave you with this picture of Charlotte Lane, looking very springy near Easter, 2012. Char and I have a squash + sushi date lined up for her 8th birthday weekend, which I look forward to this week.

Dale Wettlaufer
April 14, 2017