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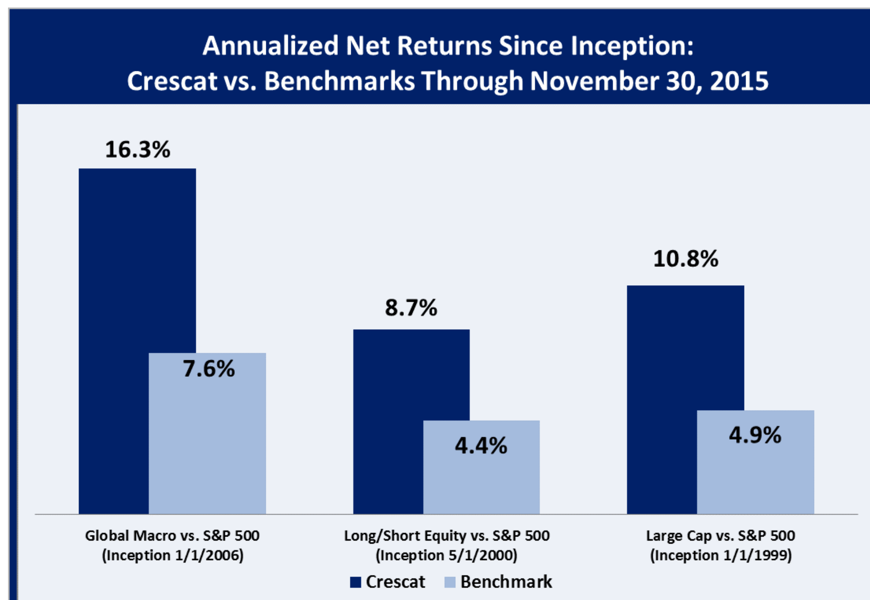
December 16, 2015

Crescat Capital Quarterly Investor Letter, Q4 2015

Dear Investors,

With pockets of weakness being exposed in the financial markets, Crescat's three strategies have delivered strong performance year to date. Through 11/30/15, our Global Macro Fund was up 15.3% net, Long/Short Fund was up 8.3% net, and Large Cap was up 3.3% net. Emerging market dislocations, including a currency devaluation in China, plunging oil and gas prices, poor stock market breadth, and trouble in the high yield credit market have each contributed to losses for money managers this year. Fortunately, Crescat has been on the right side of these and other trades in 2015. In addition to having several prescient macro themes and solid positioning around them, we have managed risk well in these choppy markets through a combination of hedging, diversification, and exposure constraints within our conditional value-at-risk model.

Net Returns through 11/30/2015						
			Annualized			Cumulative Since Inception
Crescat Strategy	Last Month	Year to Date	1 Year	3 year	Since Inception	
Global Macro Hedge Fund	2.0%	15.3%	19.0%	14.6%	16.3%	364.4%
Long/Short Hedge Fund	0.7%	8.3%	12.4%	12.5%	8.7%	266.6%
Large Cap SMA	-0.5%	3.3%	3.4%	12.1%	10.8%	463.8%



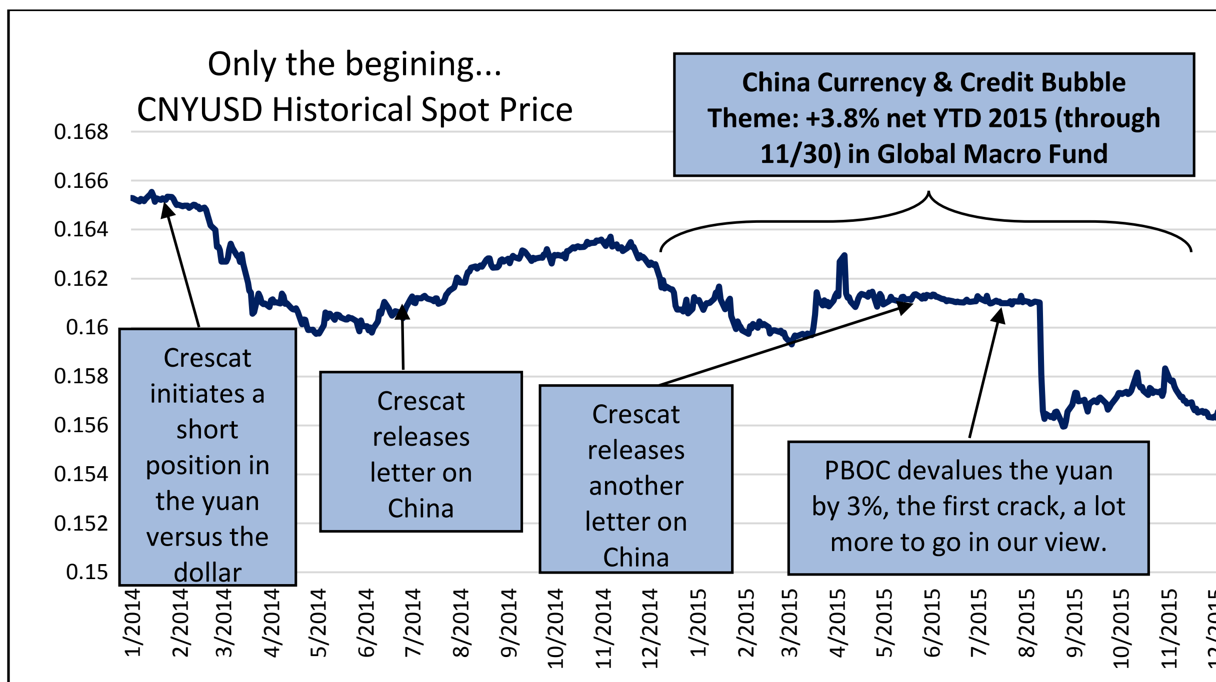
Unlike many money managers and hedge funds that make large concentrated bets, we spread our exposure across a diverse set of well-developed macro themes and positions in all our strategies. In our global macro hedge fund,

we held an average of 127 different securities—long and short—at any point in time during 2015, and we had exposure to 16 macro themes in total (14 of which are still active as of this writing). We made money in 12 out of 16 of these themes so far this year, a high 75% hit ratio as shown in the table below:

Crescat Global Macro Fund Net Profit Attribution by Theme YTD through 11/30/2015			
Aging Population	2.1%	Domestic Banking Resurgence	0.2%
Aussie Debt Crisis	0.5%	Eurozone Recovery	-0.9%
Biotech Bubble	0.6%	Fed Moderation	0.6%
Broadcast Auction	0.8%	Global Fiat Currency Debasement	-1.7%
China Currency & Credit Bubble	3.8%	India Policy Shift	-0.3%
Consumer Comeback	1.2%	Nanoscale	0.8%
Debt-to-GDP Resolution	2.2%	New Oil & Gas Resources	4.8%
Digital Evolution	1.2%	Security & Defense	-0.5%
CGMF YTD Net Return			15.3%

China Currency and Credit Bubble

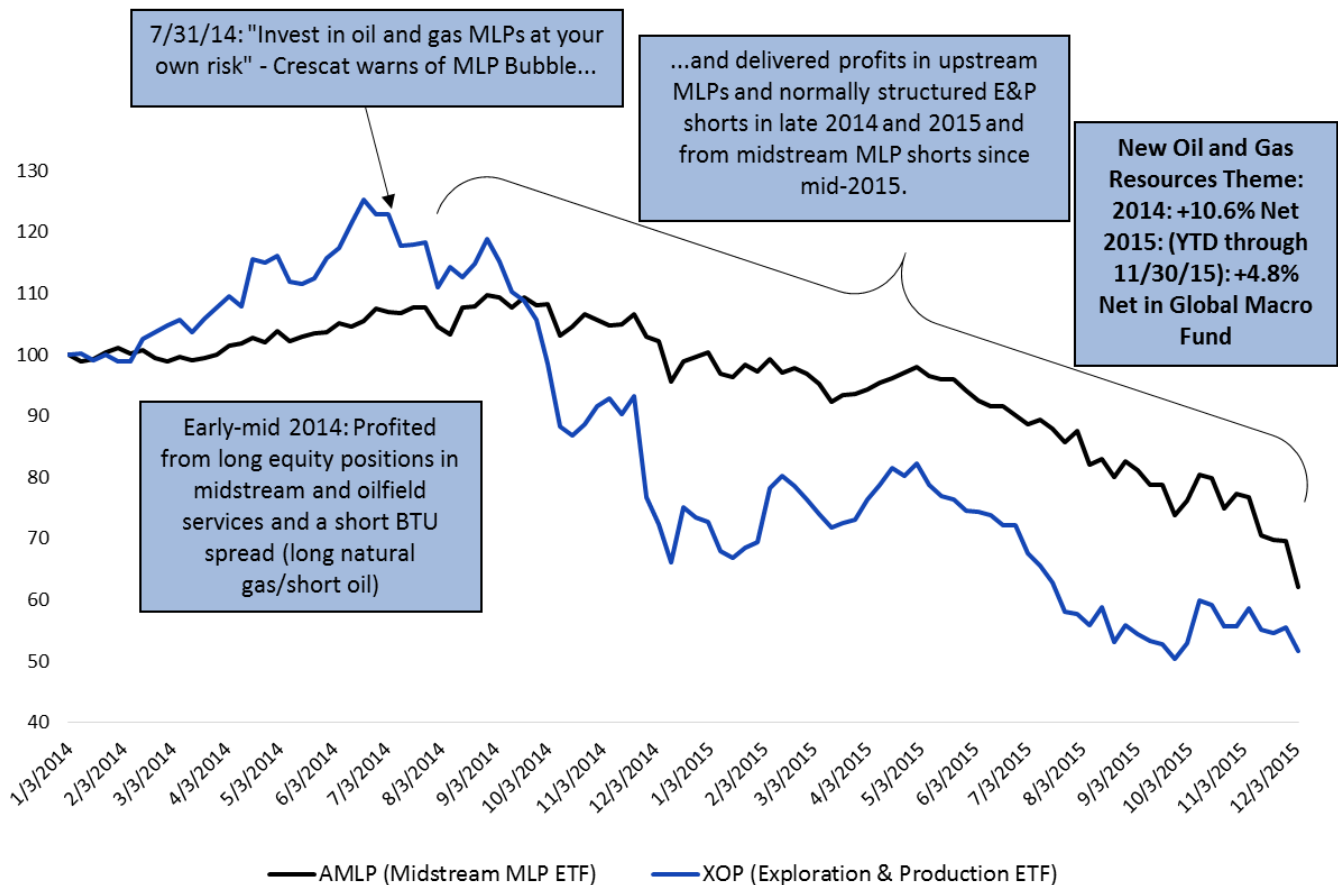
Since we have written extensively about the overvaluation of China's currency and its suspect totalitarian economic model in our prior quarterly letters, we will provide just a brief summary here. China Currency and Credit Bubble remains one of our highest conviction macro themes. What we believe will be the inevitable bursting of the China economic bubble has significant ramifications for the global financial markets. A mere 3% devaluation of the yuan in August this year took the markets by surprise and led to a 6% down month for the S&P 500. Thanks to our yuan put options, other China-related shorts, and other positions that served as S&P 500 hedges, Crescat Global Macro Fund was up 4.8% net that month. We believe China's currency remains extraordinarily overvalued. We think the August devaluation was only the beginning of a much further decline. After years of world record money printing, inefficient centrally planned capital allocation, extreme currency overvaluation, and ongoing capital flight, we believe China is in the beginning phases of a hard landing. In our Global Macro Fund, we have significant exposure to a yuan devaluation with minimal risk through put options. In both of our hedge funds, we remain short China equities.



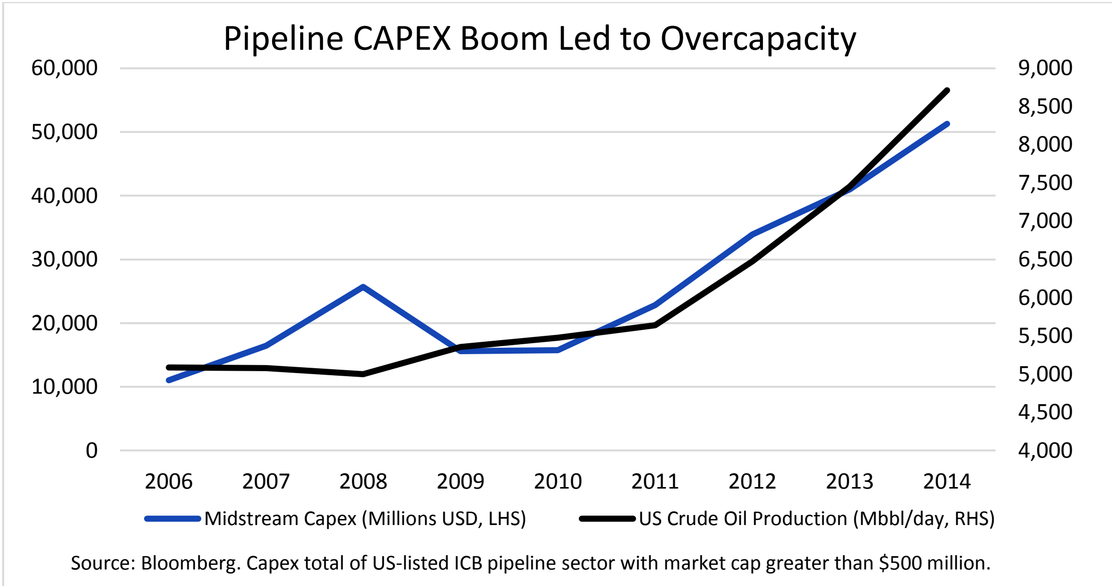
New Oil and Gas Resources

New Oil and Gas Resources has been the strongest performing theme for Crescat's hedge funds for the past two years. The theme relates to increased production of oil and gas in the U.S. from the shale basins. As part of this theme, we profited from a spread trade (long natural gas and short crude oil futures) in our Global Macro Fund from 2012 to 2014 as a record energy-equivalent differential (the BTU spread) between oil and natural gas prices narrowed. We also profited in the early days of this theme from long positions in pipeline and oil service companies. However, as the price of oil began collapsing in 2014, we seized the opportunity to short oil and gas exploration and production (E&P or upstream) companies in both of our hedge funds. Our fundamental equity model helped us identify these shorts based on excessive debt, negative free cash flow, and high valuations. We correctly predicted dividend cuts and capitalized on short positions in E&P master limited partnerships (MLPs): Breitburn Energy (BBEP), Linn Energy (LINE), Atlas (ATLS), Legacy Reserves (LGCY), and Memorial Products (MEMP). We capitalized on many other upstream short positions over the last 18 months, including Carrizo Oil and Gas (CRZO), Gulfport Energy (GPOR), Laredo Petroleum (LPI), Oasis Petroleum (OAS), Petrobras (PBR), Penn Virginia (PVA), Whiting Petroleum (WLL), Pioneer Natural Resources (PXD), Continental Resources (CLR), Concho Resources (CXO), and the SPDR Oil & Gas ETF (XOP).

This year, in addition to maintaining the E&P shorts at reduced exposure levels, we began shorting midstream (pipeline) MLPs. Short positions in Plains All-American (PAA), Energy Transfer Equity (ETE), Kinder Morgan (KMI), SemGroup (SEMG), Genesis (GEL), Enbridge (ENB), and Markwest (MWE), and MPLX LP (MPLX) have all been highly successful midstream short positions for our hedge funds year to date. The graph below illustrates our positioning in the energy space over the past two years.



Crescat warned of the energy MLP bubble in our July 2014 quarterly letter. At that point, oil and gas MLPs had been bid up for years by unseasoned investors hungry for yield and tax advantages. Wall Street investment bankers were happy to oblige and greatly expanded the formerly small MLP corner of the energy market. The problem is that the oil and gas sector operates in classic boom and bust fashion. Even the pipeline companies that were touted as "toll roads" are susceptible to the swings of the industry. As production increases during boom times and spreads out from core areas, midstream companies respond by providing expanded infrastructure. The past several years of $90+ per barrel oil saw billions invested in oil and gas pipelines to facilitate the rapid increase in production. These investments were justified by assuming continued high levels of oil and gas output growth, often in regions far from existing infrastructure. As recently as late-2014, very optimistic 5-year US production growth scenarios were commonly seen in midstream company presentations. For example, in December 2014, Plains All-American projected 40% oil production growth in the US and Canada from year end 2013 through year end 2018. With the collapse in the price of oil and gas, these production growth scenarios are no longer realistic for the pipeline operators.



Source: Bloomberg. Capex total of US-listed ICB pipeline sector with market cap greater than $500 million.

When production slows compared to pipeline capacity, less product needs to get to market, and pipeline utilization decreases. Declines in crude pipeline utilization have already been seen in many regions. The graph below shows total Permian Basin takeaway capacity already exceeding production this year as Plains All-American's (PAA) Cactus Pipeline came online. The Enterprise Products (EPD) Midland Sealy pipeline is slated to begin flowing in 2017, creating more excess capacity. The Permian is arguably the healthiest shale basin in the country. Other areas have seen similar overbuilding.

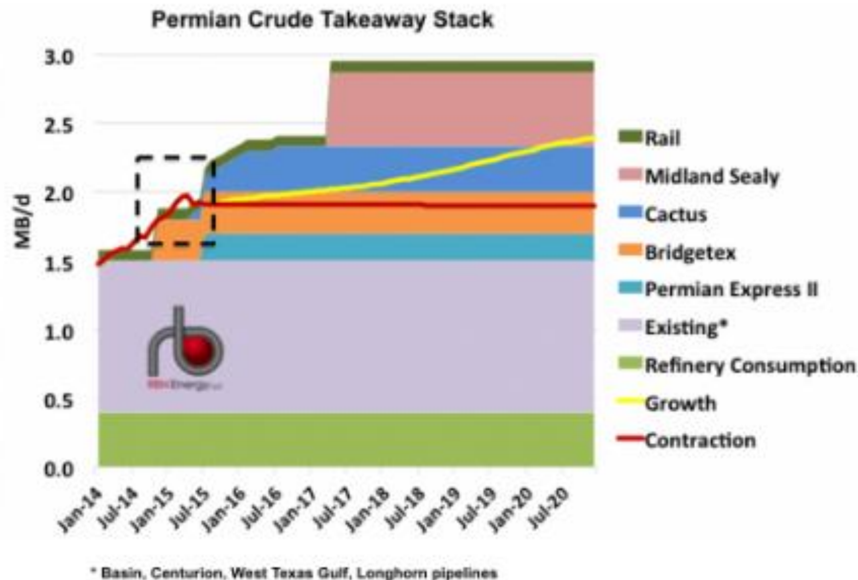


Figure #1: Source: RBN Energy (Click to Enlarge)

Plains All-American Pipeline (PAA) CEO, Greg Armstrong, admitted on the company's Q3 conference call "We've got a lot of excess capacity …we've got capital spend and not revenue, so it's dragging on the aggregate results." Also on the call, PAA executives noted that 3/4ths of their volume decline could be attributed to declining production, and 1/4th due to losing volume to lower-priced competitors.

The Alerian MLP Index, which contains many of our midstream short positions, has seen significant revenue and EBITDA declines over the past year. Searching through quarterly 10-Q reports reveals that these revenue and EBITDA declines were frequently attributed to lower volumes as well as to lower commodity prices. Despite significant revenue and EBITDA declines, CAPEX has remained historically high, and income distribution growth had been continuing, even as oil prices were collapsing. The math was not adding up for us and still does not to justify most midstream MLP valuations. Since EBITDA is the starting point for calculating the distributable cash flow that MLP investors covet, midstream MLP investors should be wary of the data in the following table:

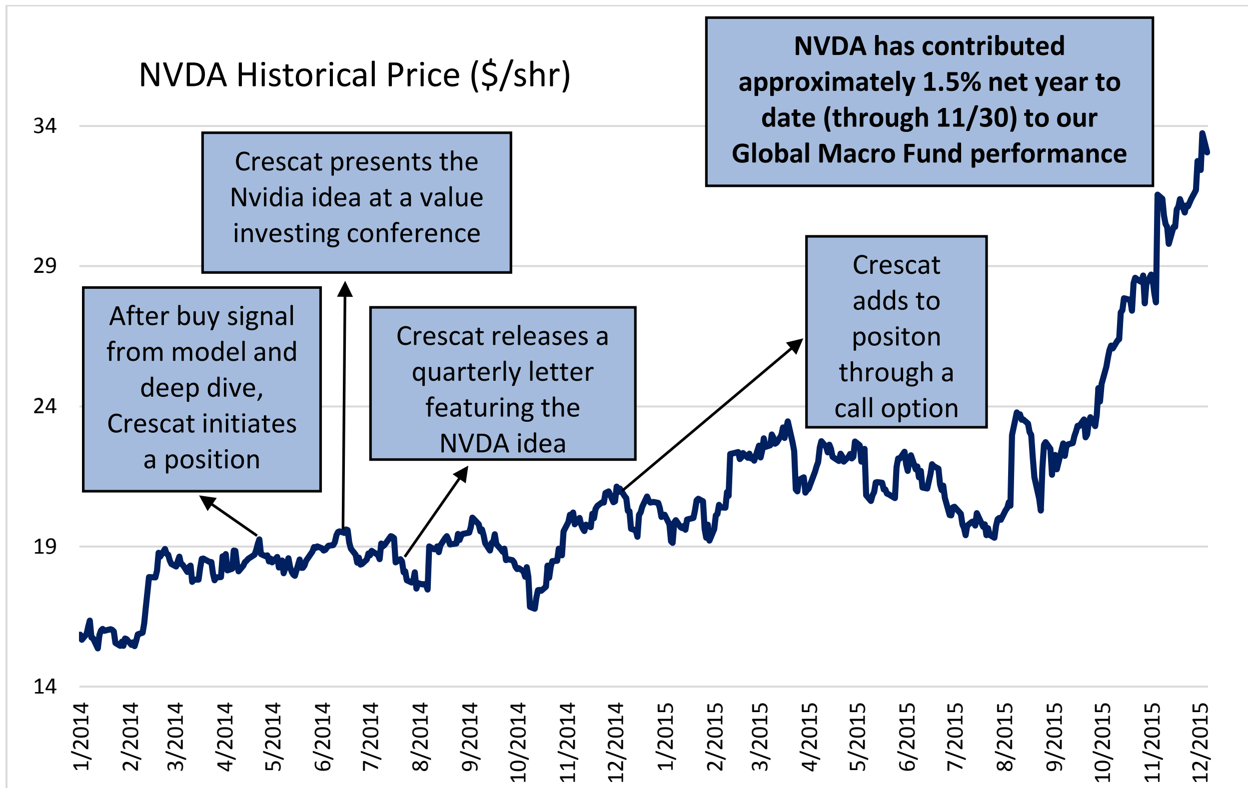
Alerian MLP Index	Q3 2015	Q2 2015	Q1 2015	Q4 2014
Revenue Growth (YoY)	-39.5%	-21.5%	-30.3%	-1.8%
EBITDA Growth (YoY)	-40.5%	-21.8%	-33.2%	-35.7%
Distribution Growth (YoY)	+5.5%	+5.3%	+5.2%	+5.5%

Although it is already down 37% year to date, and it has already been a fruitful short area for Crescat's hedge funds, the Alerian MLP Index remains far too expensive for prudent investors to buy today with an excessive enterprise value of 14 times EBITDA, high debt, a high CAPEX requirement, and negative free cash flow. Kinder Morgan (KMI), one of our shorts, was the first midstream behemoth to cut its dividend. Just recently on December 8, the dividend was slashed by 74%! This move should have been expected given the deteriorating fundamentals. More dividend cuts across the entire midstream MLP space are likely. With energy debt and equity financing drying up, just as we had predicted, and our model signals still flashing "sell", we remain short U.S. energy midstream stocks for now.

Digital Evolution

Our Digital Evolution theme is focused on identifying winners and losers in the dynamic and highly competitive information technology sector. One particularly strong winner over the past year and a half has been NVIDIA

(NVDA). Crescat's Chief Investment Officer, Kevin C. Smith, presented the NVIDIA investment thesis at a value investing conference during the summer of 2014, and the stock has performed well since, really taking off over the past several months. It is the number 4 best performing stock in the S&P 500 year to date. The company invented the GPU (graphical processing unit) and dominates the market for high-end gaming. It has developed over 10,000 patents for visual processing chips and technologies that are increasingly being used in automotive, data center, cloud, and machine learning applications. NVDIA's valuation is still very reasonable with a 6.6% yield based on trailing 12-month free cash flow to enterprise value and a Crescat-projected 20% 3-year forward growth rate. The stock still scores in the 99th percentile of our 2000-stock universe based on our fundamental equity model.



Other successful Digital Evolution positions this year have included long positions in Akamai (AKAM), AOL (AOL), Facebook (FB), Google (GOOGL) and Qorvo (QRVO, formerly RF Micro Devices), as well as a short positions in Hertz (HTZ) and Avis Budget Group (CAR).

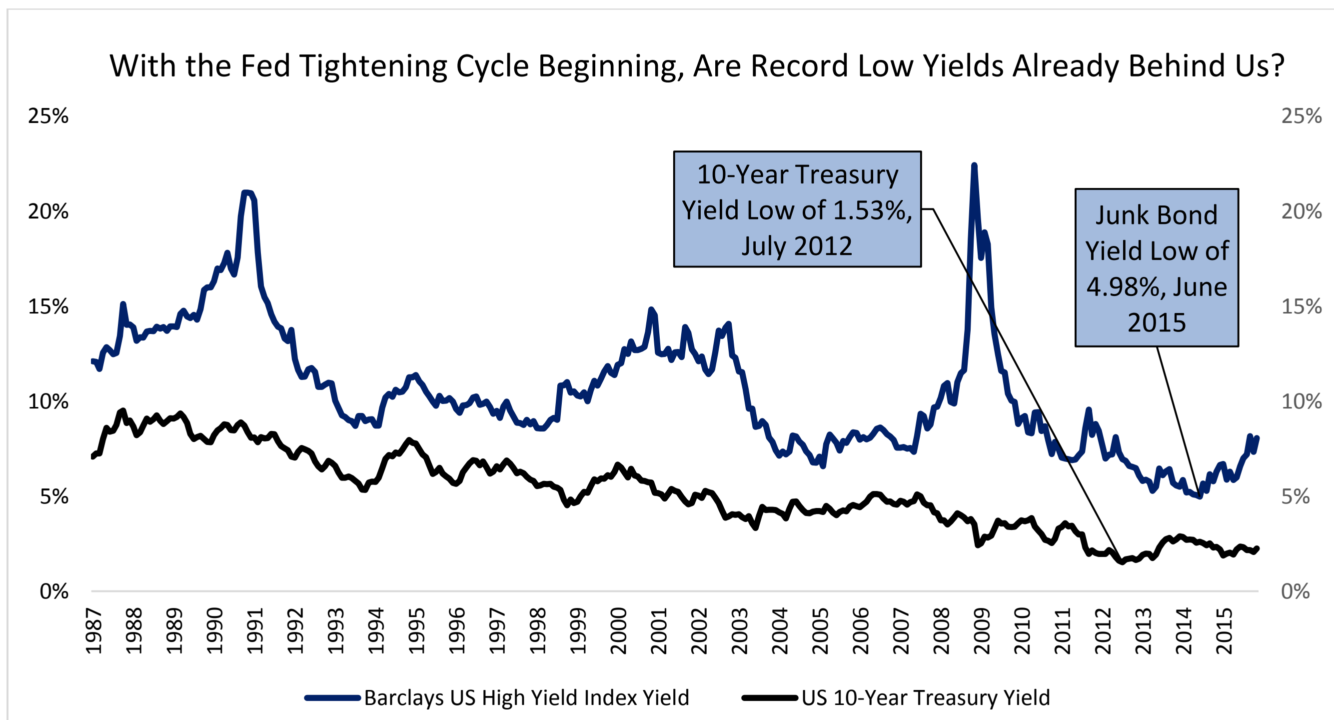
A new Digital Evolution positon for us in both of our hedge funds is a long Yahoo (YHOO) and short Alibaba (BABA) spread trade to hedge out BABA's high (15 times sales) valuation and capture what we believe is conservatively $19.50 per share of Yahoo sum-of-the-parts remainder value. Here is the math: Yahoo owns 15% or 384 million shares of Alibaba, worth $31.7 billion at BABA's last closing price of $82.49 per share, which is $33.54 per Yahoo share. The Alibaba valuation can be locked in by buying Yahoo and shorting a dollar equivalent amount of BABA. YHOO's last close was $33.03/share. Therefore the non-BABA part of Yahoo is being valued by the market at -$0.51 per share. But what is the rest of Yahoo really worth? To start, Yahoo owns 35.5% of Yahoo Japan, a free-cash-flow positive, growing, profitable, Japanese public internet company trading at a market cap of 24.2 billion USD equivalent in Tokyo. Yahoo's stake of Yahoo Japan is worth $8.6 billion or $9 per Yahoo share. After subtracting the cash from its market cap, Yahoo Japan is valued at a very reasonable forward P/E of 14. Yahoo itself has net cash of $6 per share. Then there is the core Yahoo U.S. internet businesses which if valued at just 4 times estimated 2016 EBITDA and 8 times 2016 estimated free cash flow is worth $4 per Yahoo share! 4 times EBITDA is conservative. Remember, troubled negative free cash flow, capital-intensive pipeline MLPs still trade at

14 times EBITDA. Compare that to the effective cost of $-0.5 per YHOO share if we hedge out the entire BABA stake by shorting it. We eventually get to a $19.50 per share incremental value and likely gain on a $33 per share Yahoo stock, a 59% low risk arbitrage gain. Here is the short version of the math: -33+33.5+9+6+4=19.5.

The non-BABA parts of Yahoo are worth substantially more than the market is giving them credit and the BABA valuation and risk can be hedged out completely! Many of those who have been long YHOO were in it for the BABA spinoff, not the Yahoo remainder, but they have it backwards. They are creating the opportunity. Management's cancelling of the BABA spinoff due to activist pressure and the potentially high tax effect of a BABA spin is the catalyst that should unlock this value within the next year. To be clear, in our view, going long Yahoo and short Alibaba at roughly equal dollar amounts at today's price levels is an extremely low risk arbitrage to capture a conservative $19.50 incremental value per YHOO share, a 59% gain. As a value investors, we cannot pass this one up.

Fed Moderation

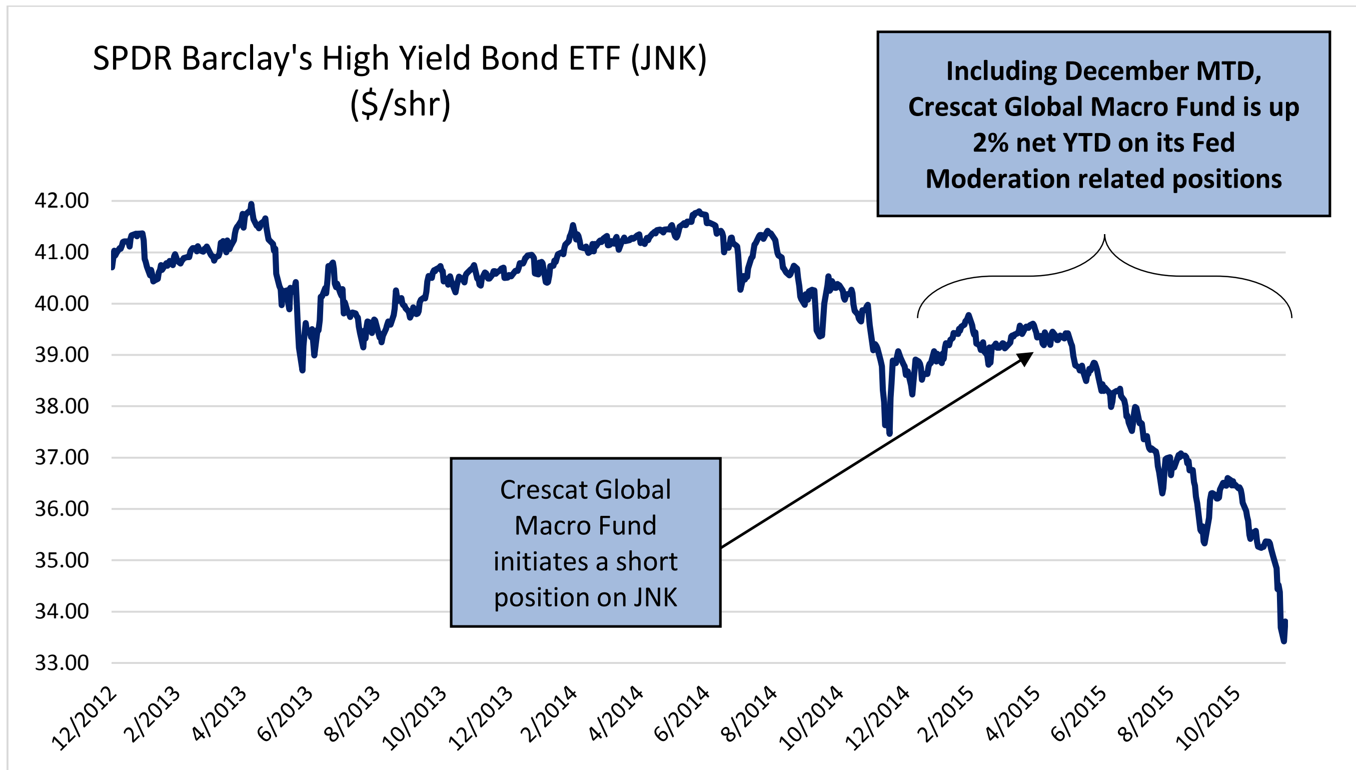
Perhaps one of the biggest risks in the U.S. financial markets today is that we have reached the end of a record 34-year bull market for U.S. Treasury bonds at the same time as we are hitting a cyclical downturn in corporate credit. After seven years of maintaining a zero-percent Fed funds rate and monetizing $4 trillion in U.S. Treasury debt along the way, the Fed finally raised interest rates today and is attempting to begin a credit tightening cycle. There is never a good time to begin a central bank tightening cycle, as they are almost always bad for securities prices, both stocks and bonds. The reasons for tightening are two-fold: 1. Prevent security price bubbles from getting too out of control lest their ultimate bursting and negative effects on the economy be even bigger; and 2. Preventing future inflation from getting too out of control. We have to consider the possibility that the Fed is late to the game on one or both of these counts, especially because both of these are non-consensus views. On the one hand you have a large group of investors still contemplating the deflationary abyss; while on the other you have momentum investors pumping up FANG, Facebook (FB), Amazon (AMZN), Netflix (NFLX), and Google (GOOGL) to nosebleed multiples.



The consequence of the Fed's 7-year stretch of zero percent interest rates is that investors have been reaching for yield and bidding up security prices in places they should not. We already wrote about the disaster unfolding

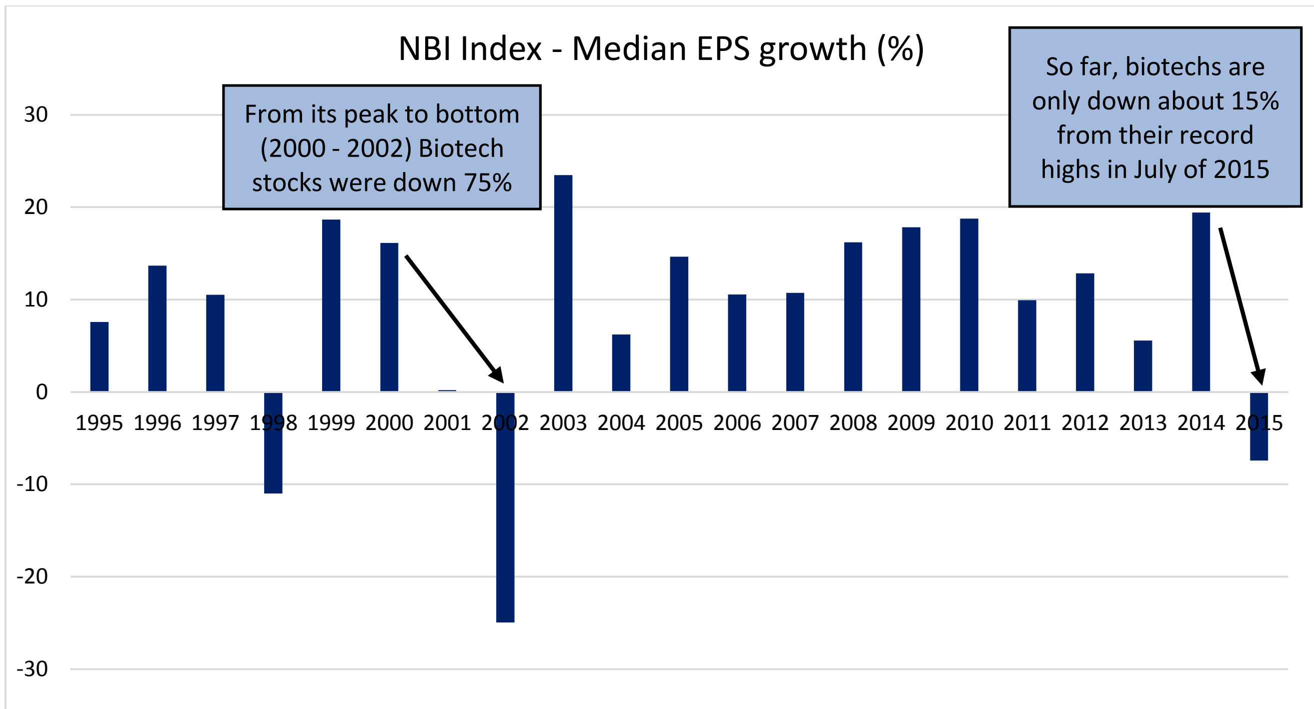
in the energy sector due to the MLP yield grab. The Fed deserves much of the blame. Investors have been reaching for yield in the junk bond market too. Since 2008, non-bank US public companies have added $7.4 trillion in new debt to their balance sheets, 41% of today's US GDP. Despite the new supply, investors drove junk bond yields to a record low 4.98% as recently as June of this year. Meanwhile, the Barclays US Corporate High Yield Total Return Index appreciated 182% from its 2008 low to its recent peak in June.

Crescat Global Macro Fund has profited from the recent dislocations in the credit market – up 2% net year to date through 12/15/2015 on our Fed Moderation related positions. In that fund, we continue to be short high yield bonds through ETF's (JNK and HYG), including through long put options on the same securities. We are also short an investment grade ETF (LQD) and 10- and 30-year U.S. Treasury futures as part of our Fed Moderation theme.

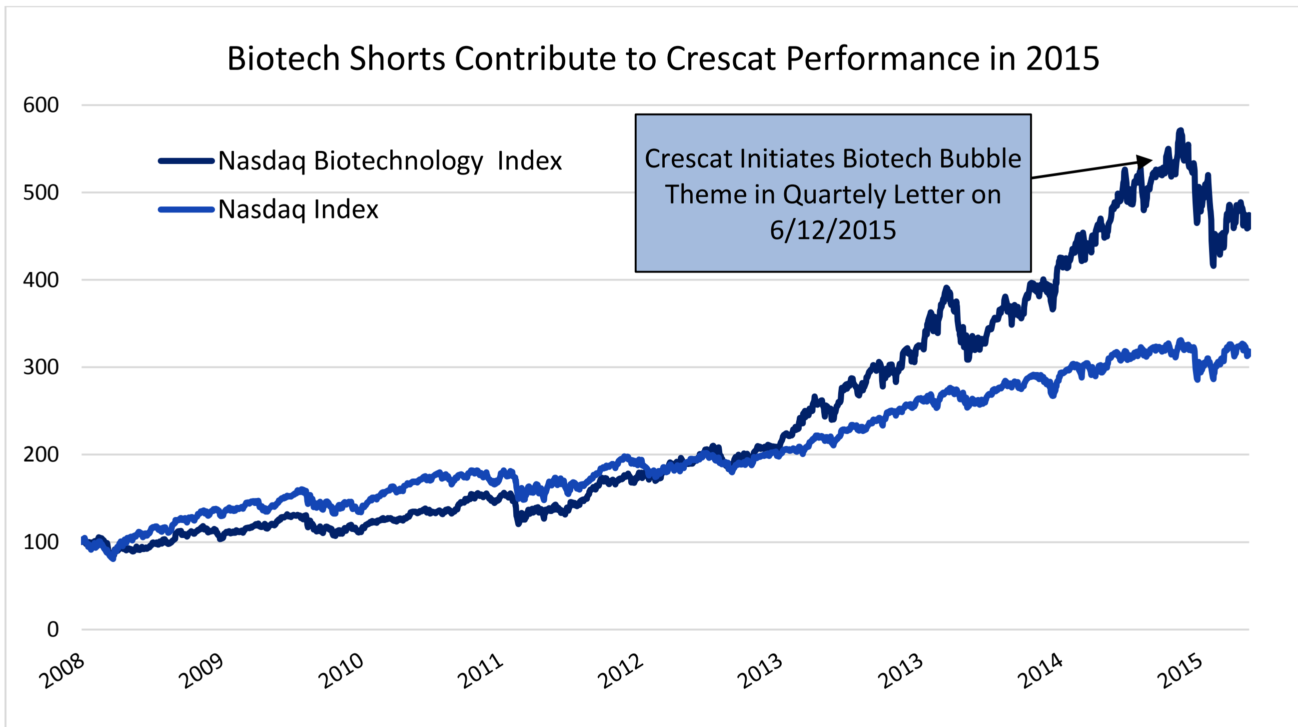


Biotech Bubble

Several years ago, we initiated a Nanoscale theme based primarily on exciting new technologies in the biosciences. These investments successfully drove profits on the long side of biotech for our three strategies from 2013 to mid-2015 as we rode the biotech wave. But by mid-2015, it became clear to us that biotech was getting into bubble territory based on valuations relative to underlying fundamentals – particularly among early stage companies. We reversed course and began shorting them. Most biotech companies are cash burning machines that will never have a blockbuster drug and are extremely overvalued. Of the 153 companies in the Nasdaq Biotechnology Index (NBI), only 27% are profitable and earnings are deteriorating as shown in the chart below.



From its low to highest level, the NBI Index appreciated by 482% --July of 2009 to July of 2015, and was the strongest performing Nasdaq sector over that time. While it had a 29% correction from its peak in the third quarter this year, and a 16% rally since, the Crescat investment team continues to believe that further depreciation is ahead. Our current holdings in this theme include short positions in two ETF's (IBB and XBI), and a basket of small short positions in the worst scoring biotechs in our Crescat Fundamental Model (ACAD, ALNY, BLUE, CMRX, ICPT, SGEN and TSRO). The Biotech Bubble theme has contributed 1.0% to net performance in our hedge funds year to date through 12/15/2015.

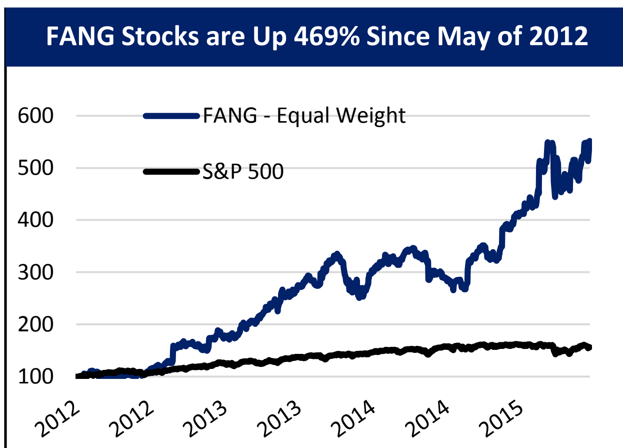


US Equity Bear Market

US Equity Bear Market is not an official Crescat macro theme yet, but it could become one soon. A sage market technician warned in the year 2000, "When the generals lead and the soldiers don't follow, you know you are in a bear market". He was given little respect at the time but was spot on. In 2000, the generals of the S&P 500 were Microsoft (MSFT), Intel (INTC), Cisco (CSCO), General Electric (GE), and Pfizer (PFE). They all hit their all-time highs that year and have not gone above them since, although Microsoft is almost back to its 2000 levels after a very strong 2015. Today's market generals are a new breed of large caps known as FANG – Facebook (FB), Amazon (AMZN), Netflix (NFLX), and Alphabet (GOOG or GOOGL), the company formerly known as Google. FANG comprises four of the top five contributors to the S&P 500's market-cap weighted index performance this year. The four FANG stocks are up an average of 88% each year to date on an equal-weighted basis. These are mature companies with positive earnings that are richly valued at a mean trailing 12-month price-to-earnings ratio of 139. Collectively, much like the generals of Y2K, they are priced for future growth that they almost certainly will not be able to deliver. Interestingly, Microsoft is the fourth best contributor the market-cap driven S&P 500 performance this year, but it only trades with a trailing P/E of 21.

By the way, two of the top four performers in the S&P 500 this year (on an equal-weighted basis) were Crescat longs and model picks, NVIDIA (NVDA) and Activision Blizzard (ATVI). In the S&P 500, only Netflix and Amazon performed better. We would like to see the FANG generals break down – to confirm that we are indeed in a bear market today. They appear ripe for a correction.

FANG Stocks are Up 469% Since May of 2012

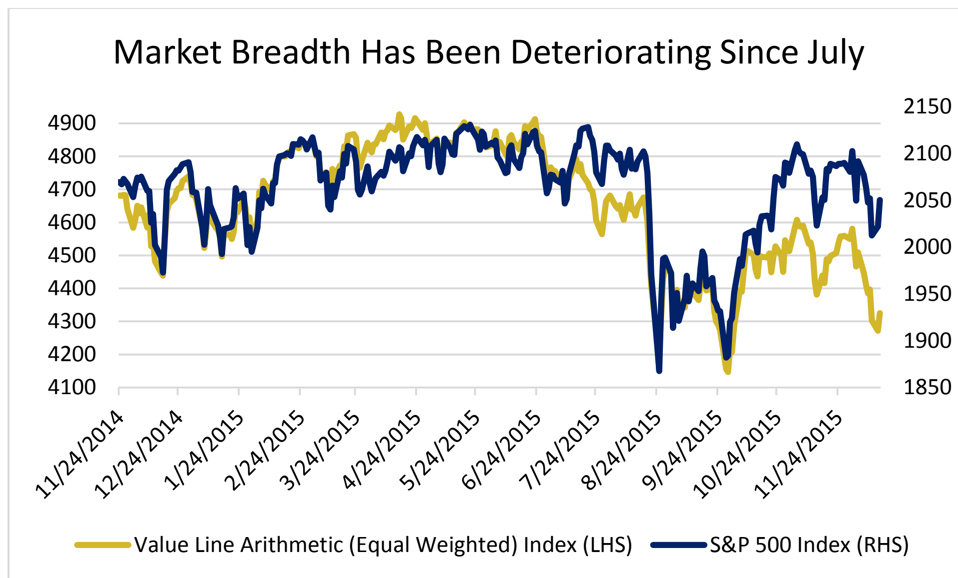


FANG Fundamentals as of 12/11/2015

Tickers	P/E	FCF to EV Yield (%)	P/S	P/B	Crescat Percentile Score	Crescat 3- Year Growth Rate
FB	52	1.8	18.5	7.2	93	29
AMZN	203	1.7	3.1	25.5	51	29
NFLX	274	-1.7	8.1	25.1	3	7
GOOGL	28	3.1	7.3	4.6	65	14
Mean	139	1.2	9.3	15.6	53	20

"The soldiers not following" scenario has already been playing out since July of this year as indicated by the performance of the equal-weighted Value Line Arithmetic Index which is down 7.7% year to date through 12/15/2015. The S&P 500 by contrast is up 1.3% YTD.

The S&P 500 Index performance is being propped up by a narrow group of high valuation large cap momentum names, including FANG, which is a big concern. The broader market as measured by the Value Line Arithmetic is already acting like a bear.



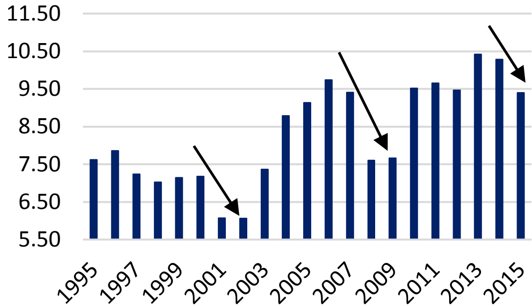
In this letter, we have discussed several developments that are bearish:

- China and emerging markets in turmoil
- Energy in a bear market
- Poor market breadth, with former leading industry groups like biotechs and MLPs breaking down
- FANG stocks leading the market at breathtaking valuations
- Fed raising rates
- High-yield credit market breaking down

As a result of these developments, we have to ask ourselves the question: are we already in a bear market for U.S. stocks and corporate credit? To get further clarity on this possibility, we would like to refer you to the following twelve charts showing 20-year median fundamental data for the companies in the S&P 500. Please see our comments below.

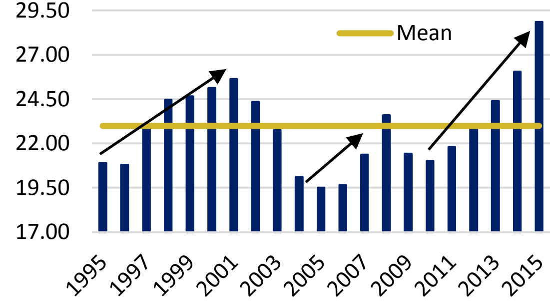
Profit Margin (%)

Net income margins reached record levels in 2013-14 and have started declining.



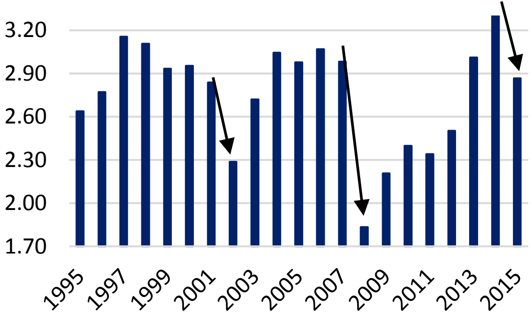
Total Debt to Total Assets (%)

The median S&P 500 company is more leveraged than at any point in last 20 years.



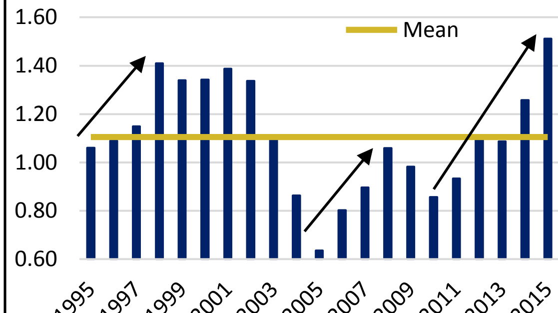
Price to Book

Price-to-book values became historically high in 2014 and may have already peaked.



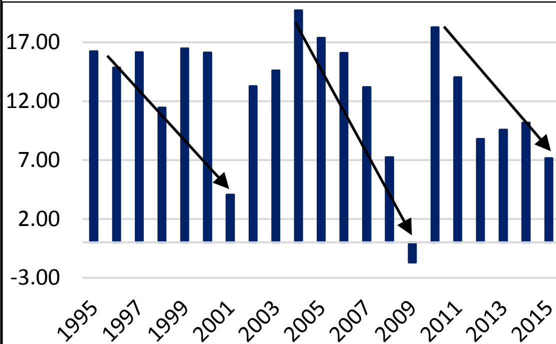
Net Debt to EBITDA

Short & long-term debt, net of cash, relative to operation profit is historically high.



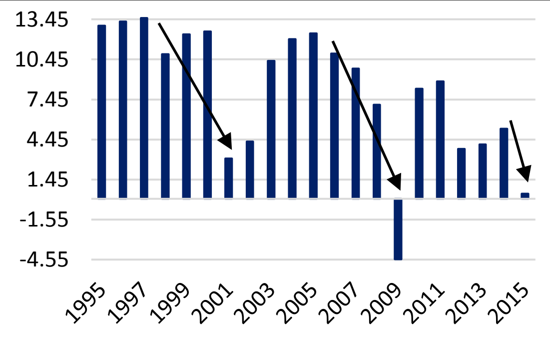
Comparable EPS Growth (%)

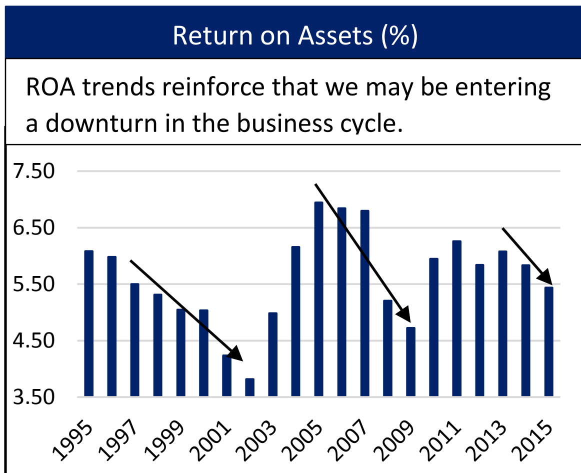
Decelerating EPS growth points to a potential downturn in the economic cycle.

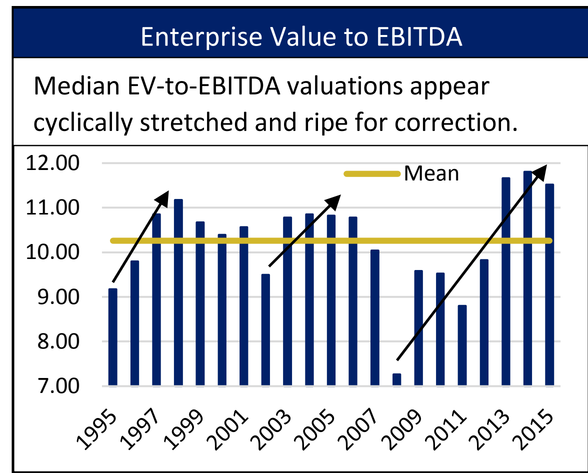


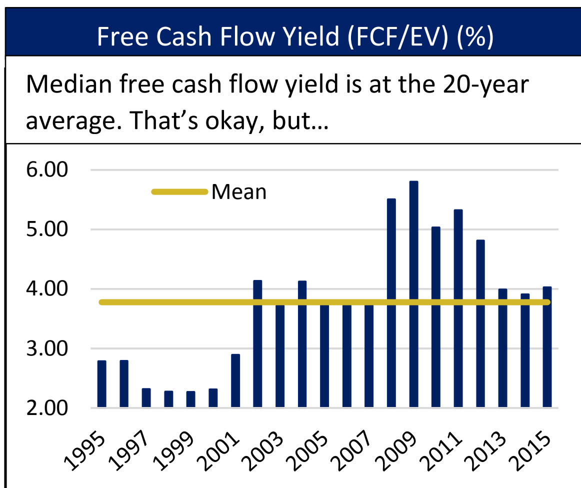
Sales Growth (%)

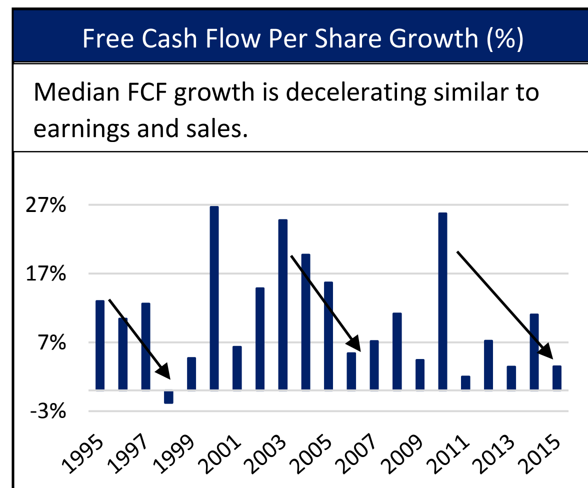
Top-line growth looks even worse than the bottom line.

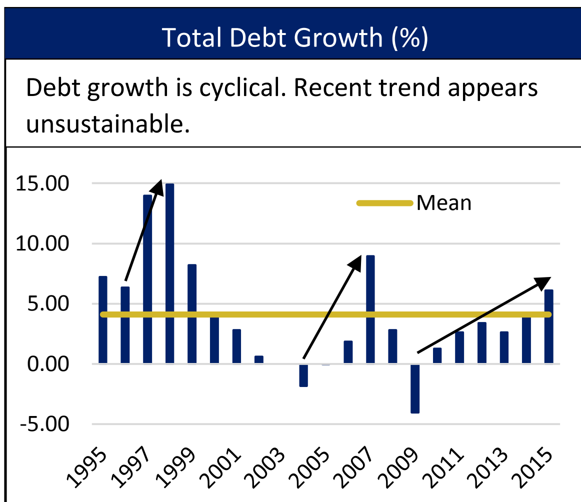


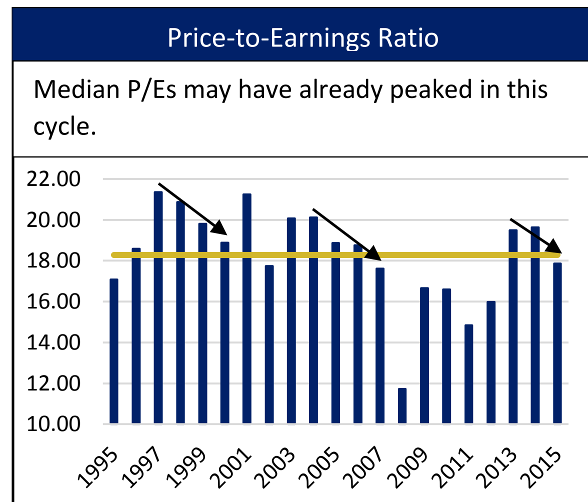

Return on Assets (%)
ROA trends reinforce that we may be entering a downturn in the business cycle.
7.50
6.50
5.50
4.50
3.50
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015


Enterprise Value to EBITDA
Median EV-to-EBITDA valuations appear cyclically stretched and ripe for correction.
Mean
12.00
11.00
10.00
9.00
8.00
7.00
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015


Free Cash Flow Yield (FCF/EV) (%)
Median free cash flow yield is at the 20-year average. That's okay, but…
Mean
6.00
5.00
4.00
3.00
2.00
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015


Free Cash Flow Per Share Growth (%)
Median FCF growth is decelerating similar to earnings and sales.
27%
17%
7%
-3%
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015


Total Debt Growth (%)
Debt growth is cyclical. Recent trend appears unsustainable.
Mean
15.00
10.00
5.00
0.00
-5.00
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015


Price-to-Earnings Ratio
Median P/Es may have already peaked in this cycle.
22.00
20.00
18.00
16.00
14.00
12.00
10.00
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015

At Crescat, we combine diverse global macro themes with a fundamental equity model and a risk model. The process applies to all three strategies: Global Macro, Long/Short Equity, and Large Cap Equity. In the firm's flagship Global Macro fund we own and trade a diversified, hedged portfolio across all asset classes: equities, commodities, currencies, and fixed income securities. The Long/Short hedge fund is the equity-only version of the Global Macro Fund. The Large Cap managed accounts are equity long-only.

Despite choppy market conditions, Crescat has delivered strong returns in 2015. In a year when many hedge funds, including global macro funds, and other managers have struggled, in some cases due to failed concentrated bets, Crescat has continued to grow and protect client assets based on our comprehensive investment process. We believe we are well positioned to succeed in 2016 and beyond.

Sincerely,

The Crescat Investment Team

Kevin C. Smith, CFA

Chief Investment Officer

Case studies are included for informational purposes only and are provided as a general overview of our general investment process, and not as indicative of any investment experience. There is no guarantee that the case studies discussed here are completely representative of our strategies or of the entirety of our investments, and we reserve the right to use or modify some or all of the methodologies mentioned herein. Only accredited investors and qualified clients will be admitted as limited partners to a Crescat fund. For natural persons, investors must meet SEC requirements including minimum annual income or net worth thresholds. Crescat funds are being offered in reliance on an exemption from the registration requirements of the Securities Act of 1933 and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act. The SEC has not passed upon the merits of or given its approval to the Crescat funds, the terms of the offering, or the accuracy or completeness of any offering materials. A registration statement has not been filed for any Crescat fund with the SEC. Limited partner interests in the Crescat funds are subject to legal restrictions on transfer and resale. Investors should not assume they will be able to resell their securities. Investing in securities involves risk. Investors should be able to bear the loss of their investment. Investments in the Crescat funds are not subject to the protections of the Investment Company Act of 1940. Performance data represents past performance, and past performance does not guarantee future results. Performance data is subject to revision following each monthly reconciliation and annual audit. Current performance may be lower or higher than the performance data presented. Crescat is not required by law to follow any standard methodology when calculating and representing performance data. The performance of Crescat funds may not be directly comparable to the performance of other private or registered funds. Investors may obtain the most current performance data and private offering memorandum for a Crescat fund by contacting Linda Smith at (303) 271-9997 or by sending a request via email to lsmith@crescat.net. See the private offering memorandum for each Crescat fund for complete information and risk factors.