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Oct. 29th, 2018

Friends of Long Lake,

We would like to take this opportunity to offer our current thoughts on the market, and provide an overview of one new equity holding: Tracon Pharmaceuticals (TCON). A brief summary of the letter is as follows:

- The S&P 500 has been under immense pressure, falling >10% from recent highs, due to rising interest rates, continuing Chinese trade war rhetoric, globally tightening monetary conditions, and developing concerns over a slowing global economy. This is the largest monthly decline since the Financial Crisis of 2008.
- Many of the positive drivers from the first half of 2018, such as the one-time benefit of tax reform, may make 2019 tougher from a comparable standpoint.
- The average S&P 500 stock is down >20% from its 52 week high, only ~20 stocks are within 1% of their 52 week high, and >200 stocks are down over 30% from their 52 week highs.
- Small-cap stocks have fared worse, with the Russell 2000 index dropping over 15% from its recent high.
- Equity price movements tend to dictate near-term sentiment, and sentiment has gotten extremely negative.
- There are still reasons to be optimistic: mid-term elections tend to be positive for the market regardless of outcome, a resolution to the trade situation with China would likely be well received, the US economy is currently healthy, monetary conditions are still accommodative by historical standards, corporate results are strong, and the market is reasonably valued by historic standards.

3Q 2018 Update

Recapping the Past Four Weeks

The US stock market has been under significant pressure over the past few weeks. The selloff began with rising US interest rates, which were not well received by the market, and continued as Federal Reserve commentary indicated they are willing to stay the course despite increased volatility in the stock market. Investors experienced a similar selloff in February, which proved to be fairly short lived as yields declined, and subsequently saw the market rise to an all-time high. However, this October, the selling intensified despite bond yields stabilizing and then declining modestly.

To us, this indicates the market is probably worried about lower economic growth coupled with rising interest rates and lower corporate profitability. We have highlighted this risk

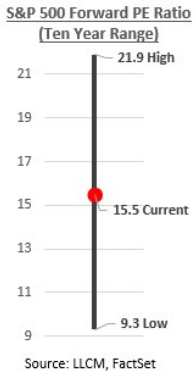
throughout the year, but were very surprised by the voracity of the market's reaction, which has erased all of 2018's year-to-date gains. Of note, this has been the worst month for the S&P 500 since the financial crisis of 2008. In regards to client portfolios, we raised some cash, albeit not enough to fully insulate them from the decline.

4Q 2018 Outlook

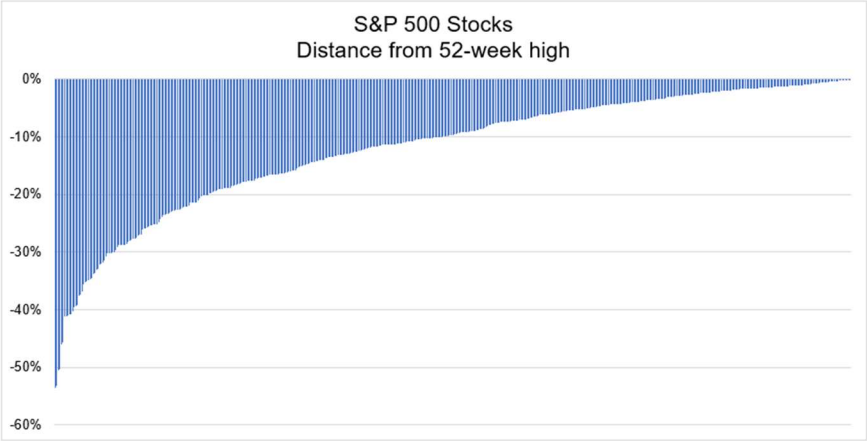
Reasons to be Optimistic	Reasons for Caution
• Corporate earnings are still strong (up ~25% thus far in 2Q18)	• We may have seen the cycle's peak in corporate earnings and economic growth
• Sentiment is terrible, with only 9% of investors currently "positive" on the stock market	• The Fed appears dead set on raising interest rates despite decelerating economic data
• At 15.5x earnings, the S&P's 2019 multiple appears quite reasonable	• Chinese and Eurozone economic growth appears to be decelerating
• Mid-term elections tend to be positive for the market, regardless of outcome (as it removes uncertainty)	• Across the globe, central banks are becoming less accommodative
• Employment is very strong, wages are healthy, and the consumer is flush with cash	• Trade/tariff disputes are taking a toll on corporate profits and economic growth
• Resolving the Chinese trade situation would likely be positive for equities	• 2018 benefitted from tax reform, a one-time event that will not repeat in 2019
• Although rising, interest rates are still near historic lows and financial conditions are not "tight"	• Economically sensitive sectors like automotive, housing, and industrials have been very weak

Source: Long Lake Capital Management, LLC

The preceding table provides an overview of what we believe to be the primary reasons for optimism and caution in the market. At present, the market is largely fixated on the cautious side of the table, which can be summarized as: Slowing global economic growth, coupled with higher interest rates and less accommodative central banks, resulting in declining corporate profits and therefore lower stock prices. So far, in 3Q18, corporate earnings have actually been fairly healthy, with roughly 75% of companies beating EPS estimates and 64% beating revenue estimates. Both of these results are above their respective five-year averages and aggregate guidance for 4Q18 points to mid-double digit earnings growth. However, full year guidance for 2019 implies just high single digit growth, a deceleration from 2018's results. This dynamic is likely somewhat reflected in the S&P 500's valuation, as it trades at 15.5x next year's earnings, which is below the index's five-year average multiple.

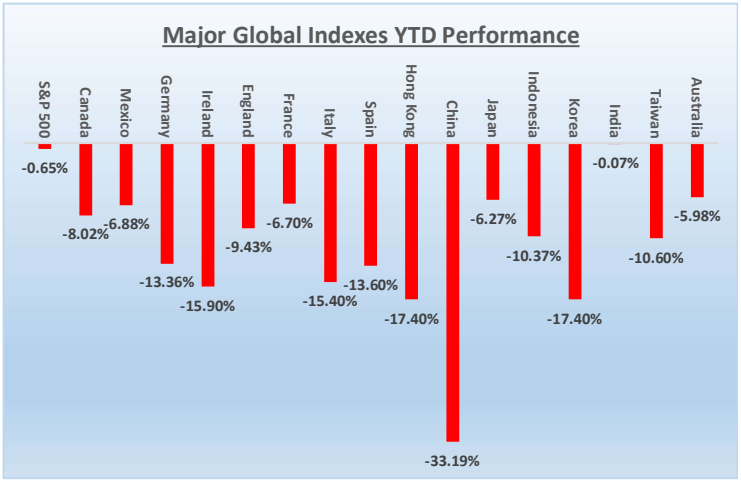


The adjacent chart displays the number of stocks in the S&P 500 and their respective declines from their 52 week highs. The main takeaway is that despite the market being down slightly year-to-date, there are a significant



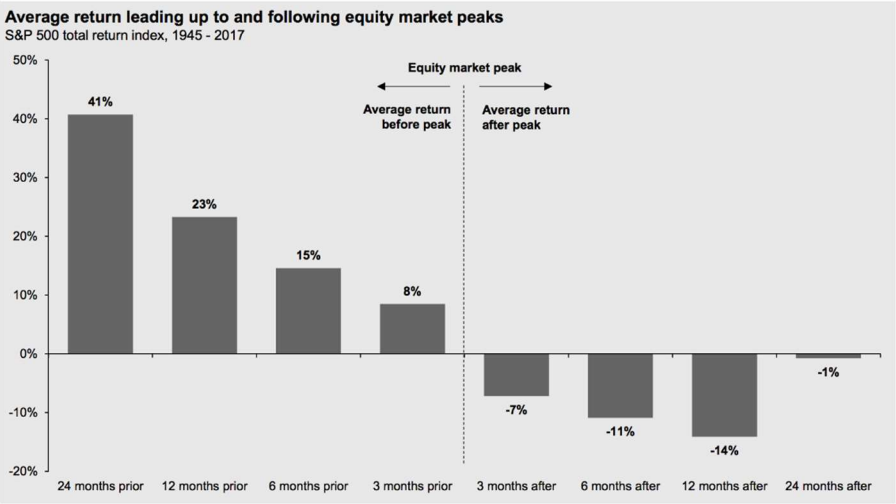
number of stocks that have seen much more meaningful declines. The average S&P 500 stock is down >20% from its 52 week high, only ~20 stocks are within 1% of their 52 week high, and >200 stocks are down over 30% from their 52 week highs. A whopping 407 stocks in the S&P 500 made a 52 week low on 10/24/2018.

Perhaps more concerning than the recent decline is what could come next. As the chart below shows, the US and India are significant outliers in terms of their year-to-date equity market performances (as of 10/25/18).



Source: LLCM, FactSet

While each country has esoteric issues impacting its stock exchange, most share one primary characteristic: slowing economic growth. This is not to say their economies are contracting (for instance, China's most recent GDP reading was +6.5%), they are simply growing at a lower rate than the prior quarter or year. If the same dynamic holds true for the US into 2019, it is conceivable the S&P 500 will perform in a similar manner.



What might that scenario look like in terms of the S&P 500's performance? As the chart above, from JPMorgan Asset Management attempts to display, it would not be particularly pleasant given the average decline from a market's peak is 14% one year after the market peaked. Currently, the S&P 500 is ~10% off the peak, which was achieved one month ago.

If the historic pattern holds true, it means there is likely more downside ahead. It could also mean that after the decline occurs, substantial upside (41% on average) is potentially in store before whenever the next peak occurs. If nothing else, this should serve as a reminder that long-term investors have generally been rewarded for eschewing panic selling and missing out on the subsequent rebound. As a brief aside, charts such as this should be taken with a grain of salt as no two market peaks/declines are created under the same set of economic and macro circumstances, but it is an interesting exercise nonetheless.

As previously mentioned, slowing down a country's economic growth rate can be enough to send a stock market lower. In the US, we are likely to see a slowdown in GDP growth in 2019 as the economy laps the one-time tax benefit passed by the Trump administration in 2018. Additionally, many corporations are facing higher input costs from raw materials, tariffs, wages, and shipping, which when coupled with potentially slowing revenue growth, should lead to lower profitability and therefore declining earnings. If that situation comes to fruition in 2019, or 4Q18, it is difficult to envision a scenario in which equity prices will show upside. Additionally, if the Fed continues to raise interest rates, it is likely to put further pressure on stocks as higher interest rates generally act as a headwind to equity values.

So far, we have spent the entirety of this letter highlighting the growing number of risks facing investors and have painted what appears to be a fairly grim picture. However, there are still many reasons for optimism and ways the market can move higher.

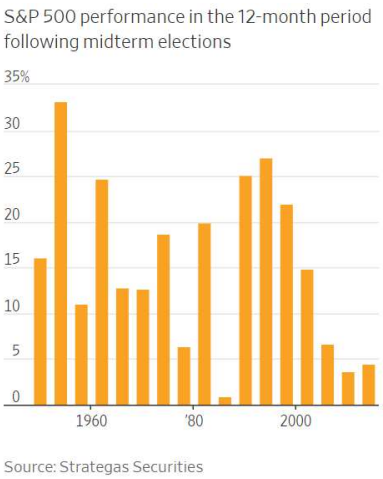
A resolution of the ongoing trade dispute with China would almost certainly be well received by the market. Not only is the current impasse having a negative effect on growth and sentiment, it is also showing up in corporate results as the currently imposed tariffs are hurting profitability. Removing this impediment to profitability would likely help increase future earnings and alleviate some of the concern over moderating growth in 2019.

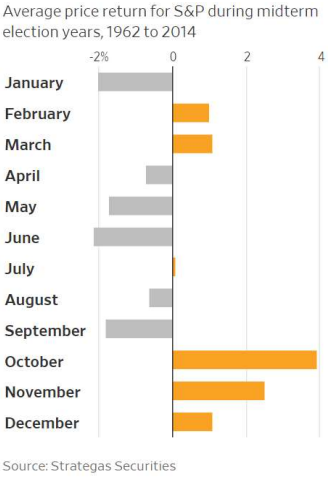
In June, we had the opportunity to attend an investment conference in New York City that included a presentation by former Trump campaign advisor Dan DiMicco. Mr. DiMicco spent decades in the steel industry and most recently served as CEO of Nucor (NUE, $18B market cap). During the presentation, Mr. DiMicco summed up the situation like this:

> *"Wall Street is underestimating the lengths to which Trump will go to get his way with China. Tax reform was done before trade reform in an effort to bring cash on to corporate and individual balance sheets and strengthen the economy to the point that it would be able to weather the storm with China. Trump wants to make trade reform his signature initiative, just like healthcare reform was for Obama."*

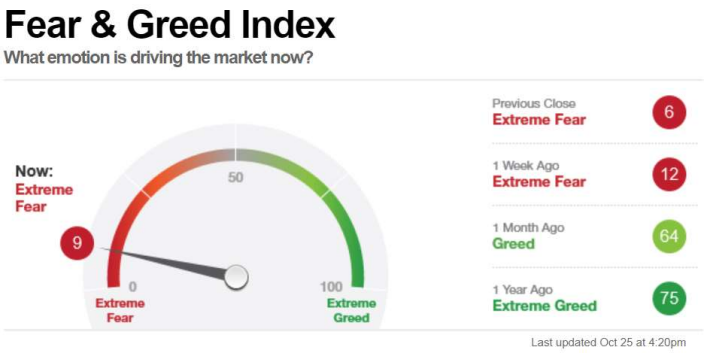
If Mr. DiMicco is accurate, Trump will go to great lengths to get trade reform done at some point during his presidency. When that will occur is anyone's guess, but given that Trump likes to use the stock market as a scoreboard for his Administration, he may have an eye on the recent declines and perhaps be more motivated to strike a deal. While rhetoric remains tough from both Chinese President Xi and Trump, the two are tentatively scheduled to meet at the G20 Summit in Buenos Aires at the end of November.

On the topic of elections, the midterms tend to be positive for stocks and are potentially another upside catalyst. The S&P 500 has not declined in the year following midterm elections since 1946, and has gained 15% on average, regardless of which party won or lost control of Congress, according to an analysis from Strategas Securities. For comparison, the S&P 500's average annual gain per year going back to 1946 is 8.8%, and it has declined in 20 of those years. On a month-by-month basis, October and November tend to be the two strongest months. Obviously, October of 2018 will not be a positive month, but there is some reason to be optimistic about November and December.





A less quantitative measure to consider is general market sentiment, which has become extremely negative. Many media outlets are running stories questioning whether or not this is the start of a bear market and CNBC held a "Markets in Turmoil" special earlier in the week. The following graphic from CNN Money uses seven factors (**Appendix Figure 1**) to calculate a Fear vs. Greed reading on the market, which is currently in "Extreme Fear" territory. While this could get worse, when sentiment is already extremly negative that can lead to opportunities for investors as the the fear works its way out of the market.



A Brief Note on Market Structure

We have written about the market's structure in prior notes, but feel it bears repeating. Two of the largest factors contributing to the rapidness of declines are likely the number of similar algorithmic trading programs and the vast usage of ETFs and index funds.

On the algorithmic side, it appears most programs are designed to sell when various levels of the stock market are breached. For instance, if the S&P 500 declines below its 50-day moving average, the programs automatically sell more. Therefore, lower prices beget lower prices.

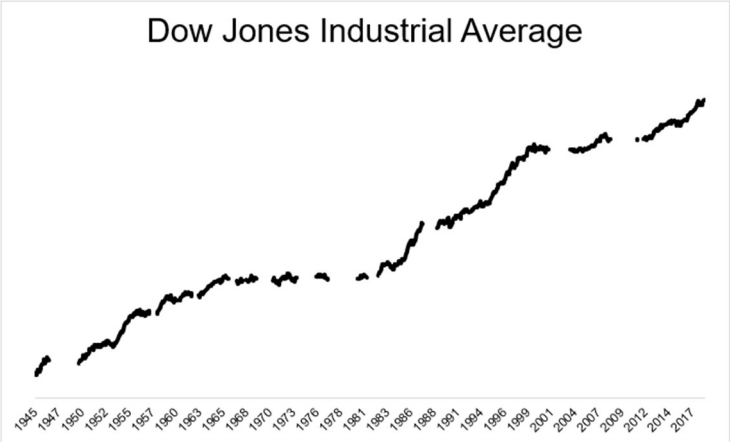
On the ETF and index fund side, there are so many of these products that a given stock is likely to be included in hundreds. For instance, Fluor (FLR), with a market cap ~$6B, is defined as a mid-cap stock and is a fairly niched focused engineering and construction company that primarily does work in the energy markets. Fluor is included in 163 ETFs and 102 index funds (**Appendix Figure 2**). For comparison, mega-cap Amazon (AMZN) is in >400 ETFs and 100 index funds.

Why does any of this matter? From our standpoint, it is difficult to envision a situation where an individual stock does not get dragged down by overall selling of the various ETFs and index funds. It is something for us, and clients, to keep in mind when dealing with heightened volatility.

Days With 2% Drops					
2004	0	2009	28	2014	4
2005	0	2010	10	2015	6
2006	0	2011	21	2016	5
2007	11	2012	3	2017	0
2008	41	2013	2	2018 YTD	11

Portfolio Positioning in 2019

The following chart removes the major declines from the Dow Jones Industrial Average going back to 1945. It serves as a reminder to investors that riding out declines has been, and probably continues to be, the correct long-term choice. We feel it is of great importance not to panic in times of decline and believe one of the biggest mistakes investors can make is to allow near-term price action to drive decision making. We feel having confidence in long-term outlooks and valuation, which are the fundamentals of the stocks in client's portfolios, allow us to tolerate more volatility than many investors.



That being said, we have raised a good deal of cash in attempt to blunt the current decline, which we can foresee becoming worse. The tricky part becomes that if the Fed shifts its stance, or Trump and Xi work out a resolution to the trade situation, the market will likely move sharply higher as growth expectations increase. We will probably miss some of this move, should it materialize, but feel the trade-off of being more conservative during the current correction is worth it for clients. As the old saying goes: Gains are easier to make up than losses.

We hope our readers have enjoyed the market outlook portion of the letter. The following section contains an overview of one new equity holding.

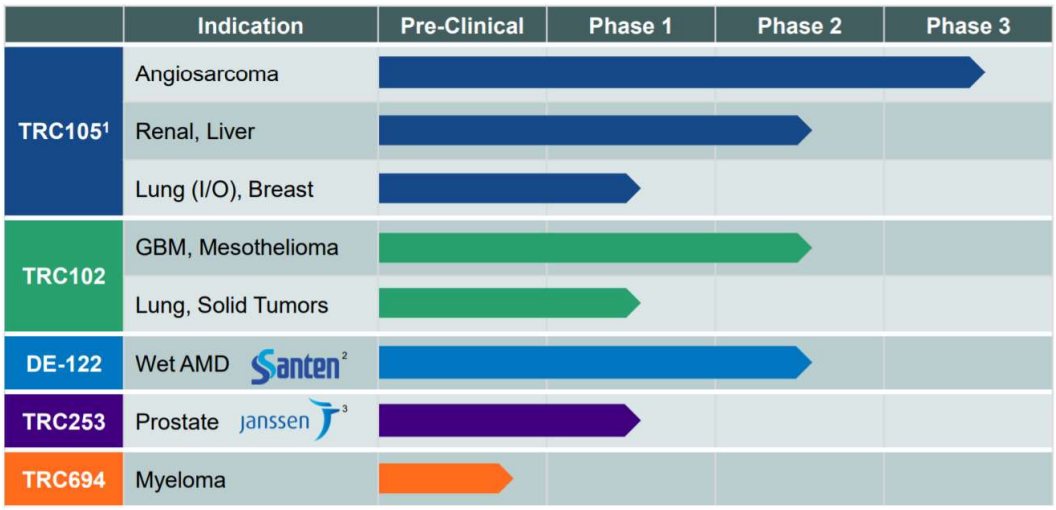
All the best,
Long Lake Capital Management, LLC

Select Equity Holdings Update

For first time readers of this letter, we aim to make the equity update readily understandable for clients that may not have a background in finance. For each long-term investment idea, Long Lake constructs an in-depth report, which we do not distribute due to compliance reasons.

Tracon Pharmaceuticals (TCON, ~$1.45/share, $43M market cap)

Tracon is a development stage pharmaceutical company focusing on treatments for solid state tumors, angiosarcomas (cancers of the inner linings of blood vessels that can occur anywhere in the body), Wet AMD (age related macular degeneration), and a host of other cancers including prostate and myelomas (bone marrow tumors). The following graphic provides a look at TCON's pipeline and the various phases of each drug's trial. Many of TCON's drugs are being used in combination with existing, approved, treatments from major pharmaceutical companies such as Johnson & Johnson (JNJ, $369B market cap) and Bristol-Myers Squibb (BMY, $81B market cap).



As the following table displays in the far right column, there are a number of near-to-medium term potential catalysts as each drug reports more data.

Product	Event	Timeline
TRC105	Top-line data from RCC ph.II TRAXAR (TRC105+Inlyta)	YE18
	Top-line data from NSCLC ph.Ib combining TRC105 w/ Opdivo	YE18
	Full response data from phase II in HCC	Jan'19 (ASCO GI)
	Full data from RCC ph.II TRAXAR (TRC105+Inlyta)	Feb'19 (ASCO GU)
	Angiosarcoma ph.III TAPPAS interim results (120 enrolled)	1Q19
	Full data from NSCLC ph.Ib combining TRC105 w/ Opdivo	1H19
	Angiosarcoma TAPPAS phase III full data (if favorable, N=170)	2H19
	Angiosarcoma TAPPAS phase III full data (if promising/enrichment, N=340/220)	Mid-2020
	Explore options for dosing additional pts with neurofibromatosis and perhaps GTN	ongoing
TRC102	Expansion cohort data in ovarian, lung, and KRAS+ CRC	2019
	GBM and mesothelioma data from NCI and Case Western trials	2019
TRC253	Ph.II portion of the study	ongoing
	Potential JNJ opt-in post ph.I/II completion	2H19
DE-122	Wet AMD (Santen) AVANTE phase II study w/ Lucentis readout	Mid-2019
TRC694	File IND and initiate ph.I	1H19

The most important of these events are data from the phase 3 TAPPAS study. It is also worth pointing out that, for a company of TCON's size, having a development pipeline

with multiple drug candidates is somewhat unique and gives investors numerous "shots on goal". Each drug under development has its own unique study and set of data. If clients would like to see more in-depth research on a certain study, it is available upon request.

Another point of interest regarding TCON is their product development platform, which is essentially a way for other companies with drugs under development to use TCON's existing infrastructure and data to facilitate the trail with the FDA. This is a key differentiator to the TCON investment thesis. FDA trials are lengthy, extremely complex, cost hundreds of millions on average, and have high failure rates (~80-85% fail) moving from preclinical trials into Phase 1, 2 and 3. However, if a drug passes through all three phases, and is submitted to the FDA for final approval, roughly 80% are given the green light.

TCON aims to provide a platform for companies without in-depth knowledge, infrastructure, and experience in exchange for a portion of the drug's economics (TCON may also share in the development costs) if approved. On the surface, it appears to be a win-win, as the drug company is able to offload a significant burden and TCON is able to secure a potentially lucrative profit stream further down the line.

A final item of note for investors occurred in April of 2018 when Puissance Capital invested $38.7M (at $2.70/share) into TCON. Puissance is a healthcare-focused fund managed by Theodore "Ted" Wang, a former Goldman Sachs Managing Director with deep ties to the Chinese. Mr. Wang's background with the Chinese is particularly notable in this case, as TCON's development platform would be a logical fit for a Chinese biotech company seeking to gain FDA approval.

Valuing a development stage biotech is difficult given the binary nature of their drug programs. However it is worth noting that at the end of 2Q18, TCON carried $47M in net cash relative to an equity market cap of $43M. One could argue that the cash will be used to further their drug development programs, which is probably true, but it still appears as if the platform development portion of their business is being valued at basically $0 (assuming all their pipeline drugs fail and all of the cash is spent). We find that to be noteworthy and attractive from a longer-term basis.

Taken all together, it appears to us, that TCON gives investors the opportunity to see significant upside should their drugs under development gain FDA approval while the platform development business should also offer longer-term growth optionality.

Appendix

Figure 1

- **Stock Price Momentum:** The S&P 500 (**SPX**) versus its 125-day moving average
- **Stock Price Strength:** The number of stocks hitting 52-week highs and lows on the New York Stock Exchange
- **Stock Price Breadth:** The volume of shares trading in stocks on the rise versus those declining.
- **Put and Call Options:** The put/call ratio, which compares the trading volume of bullish call options relative to the trading volume of bearish put options
- **Junk Bond Demand:** The spread between yields on investment grade bonds and junk bonds
- **Market Volatility:** The VIX (**VIX**), which measures volatility
- **Safe Haven Demand:** The difference in returns for stocks versus Treasuries

Figure 2

Related Securities

PRIMARY EXCHANGE	PRIMARY TICKER	PRIMARY ID
NYSE	FLR-US	34341210

	Number of Securities
Equities	38
Debt	8
Preferreds	0

	Number of Securities
Warrants	0
Rights	0
Options	876

ETF Membership

ETF Family	Number of ETFs
BlackRock	41
Charles Schwab	6
FirstTrust	2
Guggenheim	0
Invesco PowerShares	0
ProShares	10
SSgA	0
Vanguard	16
WisdomTree	5
Other	83

Index Membership

Index Family	Number of Indices
AMEX	0
Dow Jones	1
FTSE	9
MSCI	46
NASDAQ	3
NYSE	1
Other	0
Russell	28
S&P	14

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