

April 21, 2020

Dear Partners and Friends,

I hope this letter finds you and your loved ones safe and healthy. As Lenin is reported to have said, “There are decades where nothing happens; and there are weeks where decades happen.” I think we’ve just lived through a few of those weeks. It is difficult to find the words to do justice to the transformative events of the last quarter. The economy went from a position of strength to a severe recession in just a few months. Stocks declined precipitously, and small stocks were hit harder than large.<sup>1</sup> Maran Partners Fund returned -17.5% net of all fees and expenses in the first quarter.

I’m not going to attempt to provide an in-depth analysis of the pandemic in this letter. Even as some worst-case scenarios seem to have been taken off the table, the situation remains very fluid. I am trying to be thoughtful and levelheaded in my analysis of the situation — with a focus on facts and data rather than conjecture, hope, or fear.

It doesn’t pay to bet against human ingenuity. Problems are soluble, and this one will be solved, too. That said, I believe now is the time for intellectual humility. The range of outcomes across a huge number of factors over the next few years is extremely wide, with numerous second-, third-, and higher-order effects to be considered.

During this period of extreme change and volatility, I am sticking to our fundamental guiding principles: margin of safety, conservative underwriting, alignment of interests, a long time horizon, and investment as ownership in a piece of a business (rather than a line that wiggles around on a screen). It is critical to maintain integrity — that is, having principles and sticking to them — when the world gets rocky. I believe that our structural advantages (such as our small size; single decision maker; and aligned, long-term capital base), philosophy, and approach have given us a firm bedrock on which to stand during times like these.

I rarely hold a view as to what the broader market is going to do in the short term. That said, I am surprised that the broader market (as measured by the S&P 500) is higher than it was last summer. Even with fiscal and monetary stimulus in place and hopes that treatments or cures will facilitate the reopening of the economy, the global economic outlook is certainly much worse than it was last summer.

Luckily, we don’t have to decide whether to invest in *the market*. More companies than ever are currently in our “too-hard” pile. But there have been enough proverbial babies thrown out with the bathwater to keep me excited. There are still many stocks down 30%, 50%, or even 80% that I think are now undervalued, especially in my favored hunting ground of smaller capitalization companies. We are seeing extreme inefficiency in small- and micro-cap companies right now. On the flip side, some stocks seemingly haven’t noticed that there is a global pandemic underway. I believe more companies are mispriced now than in, say, January, which provides us with opportunities in both directions.

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<sup>1</sup> Q1 2020 was the worst quarter for smaller stocks in over three decades (yes, including the worst quarters in each of the dot-com bust and the great financial crisis). The S&P 400 (mid-cap) index declined 30%; the Russell 2000 (small-cap) index declined 31%; and the equal-weighted S&P 500 index (which is more representative of the average stock in that index, rather than just the largest handful) declined 27%. (The equal-weighted small-cap index was down 37%.) The S&P 500 declined 20% (note while the S&P 500 is comprised, as the name suggests, of 500 companies, over 20% of it is held in just five stocks: Microsoft, Apple, Amazon, Google, and Facebook).

## Portfolio Update

At quarter's end, our top five positions (in alphabetical order) were Clarus Corp (CLAR), Scott's Liquid Gold (SLGD), Standard Diversified (SDI), and two undisclosed positions (which we are still buying).

The fact that we had such limited turnover in our core positions through Q1 is indicative of the business quality and balance-sheet strength that I demand in our core positions. That's not to say that I sat idly as the virus started to spread around the world. Our small size and advantaged structure allowed me to quickly reposition our fund as facts on the ground changed. I re-underwrote all of our positions during the quarter (utilizing a wide range of scenarios for each) and took action where I felt it was warranted.

By February 29<sup>th</sup>, I had taken our net exposure to approximately 50%. I added small hedges in retail, restaurants, foodservice distribution, industrials, aerospace, casinos, and high-yield bonds. I also exited several economically sensitive positions that we held such as a hospitality company and an industrial-equipment rental company.

These actions helped blunt the pain of the pandemic compared to the various small and micro-cap indices, but our stocks were not immune to the indiscriminate selling in March.<sup>2</sup> Hindsight is 20/20; in retrospect, we should have gone to 0% net exposure, or even net short. But we are long-term investors and I liked (and still like!) our core positions.

In our three disclosed core positions alone, we own numerous brands that survived the 1957 global pandemic (and several that survived the Spanish Flu, the Great Depression, both World Wars, and every other bump in the road that the economy has thrown their way over the past century-plus), including Black Diamond Equipment (whose roots trace back to Chouinard Equipment Ltd. in the 1950s), Sierra Bullets, Prell, Scott's Liquid Gold, Beech Nut, Stoker's, and Zig Zag (which was founded in 1855). I believe they will each survive this one, too.

In March, I covered most of the portfolio hedges that I put on in late February and began adding to longs in what I think are great businesses at great prices. But as I mentioned, the dispersion in the market is as wide as ever, which continues to create opportunities on both sides of our book as well as in special situations, which are generally highly asymmetric risk/reward situations with firm catalysts in place that should be uncorrelated to the broader market.

## Special Situations

I wrote at length about our long Standard Diversified / short Turning Point Brands parent-daughter arbitrage trade last quarter. On April 7th, the companies announced the final exchange ratio of their "downstream reorganization": 97% of the value of the TPB shares that SDI holds (net of all SDI liabilities) — slightly worse than our base case of parity (i.e., 100%), but still well within the margin of safety at which I underwrote the trade. (The net proceeds from the sale of SDI's billboard assets were also below my

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<sup>2</sup> Just over half of the drawdown that occurred in our portfolio in the first quarter was driven by two positions: Scott's Liquid Gold and another micro-cap, less liquid company. Sometimes all it takes is one seller in companies such as these to move the prices dramatically.

estimate but within our margin of safety.) We fully exited the SDI / TPB arbitrage following the announcement of the final exchange ratio.<sup>3</sup>

This was an archetypal special-situation trade for us. When the proposed transaction was announced on November 18<sup>th</sup>, 2019, the timeframe to completion was uncertain (I estimated six months from that point), as was the exact exchange ratio (I believed it would be within a few percent of parity). There were several hurdles that had to be overcome, including the disposition of SDI's small operating businesses (at uncertain valuations). That said, I believed there was no regulatory risk and a high likelihood that the deal would be consummated (it was in the interest of both companies to do so; there was no financing contingency; the large hedge fund that controlled both entities was behind the transaction, etc.). This was not a typical "risk arb." Most importantly, I believed the spread at which the securities traded at various times provided a very large margin of safety. This was a classic high uncertainty / low risk trade setup (likely available in part because it was illiquid, off the beaten path, and required a certain amount of intrepid wading through SDI's inscrutable financials). The trade involved de minimis net exposure and was uncorrelated to the market.

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In addition to the Standard Diversified / Turning Point Brands reorganization, I have been busy on the special-situation front.

During the first quarter, we exited a liquidation and entered and exited two other special situations that each quickly resolved (a fraudulent tender announcement and an arbitrage between two listed securities of one company). We are currently involved in or evaluating several announced merger situations (both on the long and short sides) and a holdco "stub" trade with an announced timeline to unwinding.

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## Operational Matters

Operationally, we have not missed a beat during this crisis; all our systems and processes are working well. Our fund administration and tax/audit partners at SS&C ALPS and Spicer Jefferies seamlessly implemented their contingency plans, and we completed all our audit and tax work on schedule with no hiccups. K-1s were distributed electronically and via postal mail in mid-March.

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<sup>3</sup> This has been the special situation that keeps on giving. Rather than wait for the deal to close this summer, we were able to unwind our entire SDI arbitrage at what I believe was a *premium* to the consideration that it will receive in the merger with Turning Point. *The sure thing of slightly more than one bird in the hand right now is better than the chance to get at most one bird out of a bush in a few months.* I even put on a small position of the inverse arbitrage (short SDI / long TPB) because I believe there is no fundamental reason for this deal to trade at a premium to the announced terms (as can sometimes happen when investors are hoping for a higher competing bid); I just think the announced terms are complicated and the market is sometimes inefficient (perhaps some have forgotten about SDI's \$25mm (million!) term loan and the closing condition that SDI must have less than \$25k (thousand!) of net liabilities at close).

**Conclusion**

Despite the stormy backdrop, I remain confident. There are some good companies on sale; attractive hedges are available; and uncorrelated special situations worthy of consideration are plentiful. I believe this is a good recipe for favorable long-term results. I continue to have the majority of my net worth invested in the partnership alongside yours. Please don't hesitate to reach out if you have questions or concerns.

Stay safe and well.

Sincerely,



Dan Roller

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