

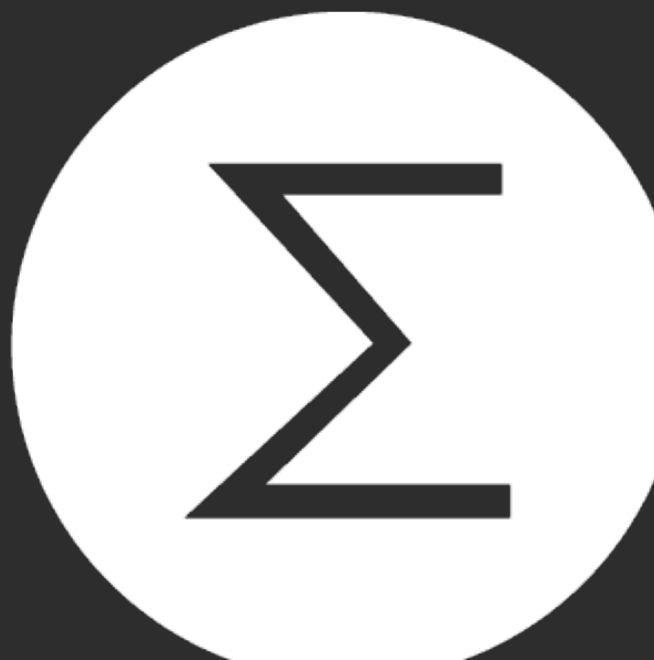


*INSIDE A HISTORIC MARKET BUBBLE:
SPAC'S, RETAIL INVESTORS, AND
THE SPECULATIVE PYRAMID*

FEAT. RYAN BALLENTINE, BIREME CAPITAL

MODERATED BY AVERY PAGAN

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ABOUT RYAN BALLENTINE



Ryan is the Co-founder and Chief Executive Officer of Bireme Capital. He is responsible for algorithm development, automated trading, and software infrastructure for all of Bireme's strategies and operations. He also assists with asset allocation decisions.

Ryan worked for 7 years at Ballentine Capital, where he developed and deployed algorithmic trading strategies.

He graduated in 2009 with a BS in Finance from MIT, where also captained the hockey and lacrosse teams.

ABOUT BIREME CAPITAL



Bireme Capital is a boutique, value-oriented investment firm founded by MIT classmates who have a combined two decades of buy-side experience.

Drawing on our PM's experience as a former professional poker player, we identify and exploit common investor behavioral biases that we believe engender a gap between intrinsic value and market price in public equities. The ability to articulate reasons for mispricing gives us conviction in our variant perceptions.

This repeatable process has allowed us to avoid value traps and generate material net outperformance since inception in 2016, despite inferior results for most value investing strategies over that time period.



AVERY PAGAN, SUMZERO: *Ryan, thanks for joining us to pop some of the speculative bubbles we are seeing in the markets today. Before we get into it, can you give us a bit of background on yourself and your investing career?*

RYAN BALLENTINE, BIREME CAPITAL: Thanks for having me, Avery. I'm excited for this opportunity to get our message out to SumZero readers. I also hope we can bring some attention to the speculative excesses in the market so readers can avoid the fallout – or even profit from it.

I graduated MIT in 2009 with a degree in finance from Sloan and went to work for my dad. He'd been running a hedge fund, Ballentine Capital Management, since the late '80s. I recruited my current business partner Evan Tindell to work at Ballentine as well. He'd been playing poker professionally since graduating from MIT a few years prior. There's tremendous overlap between the skills and mindset required to be a successful poker player and a successful public equities investor. This is especially true with our approach, as I'm sure we'll get into shortly.

We were fortunate enough to train under my dad until he retired and shut the fund down at the end of 2015. Evan and I struck out on our own and cofounded our current firm, Bireme Capital, in mid-2016.

SZ: *How would you describe the strategy you are currently running with Bireme Capital?*

RB: Fundamental Value is a US-focused long-biased value strategy. We run a concentrated portfolio, typically 10-15 names on the long side and 0-10 on the short side.

The goal of any value investor is to find value stocks and avoid value traps obviously, but the question is: how do you do that in a systematic way? With FV, we've come up with a unique framework that gives us confidence in our process.

We've identified a set of common investor behavioral biases that we believe can create a gap between intrinsic value and market price, such as availability bias, extrapolation bias, and familiarity bias. We do in-depth writeups and DCFs – you can find them on SumZero and on our blog – but in the end, when we underwrite a position we need to be able to boil our thesis down to one or two key levers, and point to the cognitive bias that's causing other investors to misunderstand those key levers and hence misprice the stock.

This framework allows us to draw parallels between lessons we've learned in the past and the situations we see in the market today; it allows us to find valuable commonality between companies and opportunities where other investors may not connect the dots. It's a source of both discipline and ideas. For example, social conformity bias is the tendency for investors to make investment decisions for external validation or some other non-economic reason. We might use our social conformity bias lens to search for undervalued companies in the tobacco or oil industries, or overvalued ones in the EV or solar industries.

Like being a poker player, being an active manager is fundamentally an act of hubris. It relies on a belief that you know more than whoever is on the other side of

your table, or on the other side of your trade. To generate alpha, you can't just play your cards – you have to exploit the mistakes of others. We try to always be cognizant of that.

SZ: *In your recent letter titled “The Anatomy of a Bubble” you touch on the extreme value spreads which created an ideal environment for value investors toward the end of 2020 and heading into this year. Have you seen this hypothesis play out in the early months of 2021 and where do valuations stand today compared to previous bubbles?*

RB: It's been a wild ride. By the middle of 2020, the value spread – the difference in valuation between the cheapest and most expensive stocks in the market – approached the all-time highs it reached at the height of the tech bubble in 2000. In addition to this quantitative data, our bottom-up analysis indicated a phenomenal opportunity set. Anecdotally, the astonishing frenzy in retail trading, concentrated in the most speculative issues in the market, indicated to us that value's decade-long run of underperformance was on the cusp of its end.

To some extent, we were right, and value did come roaring back but the value spread has barely ticked down! Though value came roaring back – with valuations going from the 11th percentile to the 65th in six months – growth valuations have persisted near tech-bubble levels.

So we think the “easiest” absolute returns for value investors are in the past. Value as a class is no longer outrageously cheap. But pockets of opportunity remain, and we are nearly as constructive as ever on the prospects for value's relative returns.

SZ: *You talk about the positive feedback loop which breeds a market bubble - rising investor expectations, inflated valuations, rinse, and repeat. Are there any safeguards in place to regulate sentiment-driven valuation cycles?*

RB: That's a great question Avery. You know, in the end, there's nothing that can stop bubbles from forming. Humans are humans. Cognitive biases are structural features of our brains. Cycles of irrational exuberance are unavoidable. But I think what we as a society can aspire to do is to try to minimize the size of bubbles. If we can pop them a little earlier than they would've otherwise popped on their own, we can attempt to minimize the misallocation of resources and the damage from the eventual fallout. To do that requires responsible stewardship and guidance from both public institutions and private citizens.

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Congress and the Fed have both added substantial fuel to the fire with totally unprecedented fiscal and monetary stimulus. While some fiscal support was necessary, untargeted stimulus was a mistake. Stimulus should have gone to those who suffered economic loss from the pandemic. Surveys indicate that a significant portion of stimulus checks went to people who didn't have immediate spending needs, and much of that stimulus went right into stock market speculation.

I just hope Congress and the Fed prove willing to take away the twin punchbowls when they are no longer absolutely necessary to support the economy – a date I believe is rapidly approaching, if not already here. While that will

undoubtedly cause fits in the market, it's better than continuing to exacerbate the current bubble.

Regarding private citizens, short sellers could serve as a countercyclical force, but unfortunately, they are much diminished in number, size, and credibility. And I've been dismayed to see people like Mark Cuban and Elon Musk serving as procyclical forces, encouraging Dogecoin speculation and pumping up the retail frenzy in Gamestop. That's a dereliction of duty, in my opinion. For better or worse, a significant portion of the public looks to folks like them for financial advice. And these people are experienced investors who should know better.

“Short sellers don't make bubbles stop bubbling. In fact, they encourage the opposite.”

SZ: *What do current short interest levels tell us about the health of the markets and investor perception?*

RB: Short sellers have gotten burned in the financial markets and in the court of popular opinion. Jim Chanos' Kynikos Associates AUM is under \$500M after peaking at \$7B due to losses and redemptions. Citron Research has stopped publishing short-selling opinions due to the vitriol that has been directed toward Citron and other short sellers. We've seen the first, but surely not the last, crowdsourced short squeezes. All this in the face of a perpetually rising market has resulted in the total capitulation of short sellers; short interest levels are near tech-bubble lows. A healthy market is one with disagreement, where the free exchange of ideas – both long and short – improve

price discovery. Brow-beating short sellers don't make fraudsters stop defrauding or bubbles stop bubbling. In fact, they encourage the opposite. Short sellers are a positive force in the markets, serving as a restraining force on bubbles, exposing fraud, and increasing liquidity.

But everyone today hates short sellers. And that's because they fear what they have to say. Fundamentally sound companies don't have anything to fear from short sellers. I'm reminded of Reed Hastings's 2010 response to Whitney Tilson after Tilson came out with a short report on Netflix. Hastings addressed Tilson's concerns point by point with a respectful and friendly tone. And in fact his response changed Tilson's mind. If your company is a house of cards, you don't have that option.

As a corollary, in our view, all of the above makes it the perfect time to be a short seller. Our short book is bigger than it has ever been.

SZ: *Any other key indicators that you find helpful in gauging the bullishness of this market?*

RB: Virtually every indicator is off the charts. The S&P 500 and Nasdaq 100 are both trading at higher valuations than any time other than the tech bubble. The average first-day IPO pop was the highest since the tech bubble. US companies sold 54% more stock last year than the prior annual high. Stock funds saw the largest week of equity inflows ever. Yet corporate insiders aren't buying it; in fact, they are selling at a record pace. Retail activity has exploded. Trading of short-term call options is exploding off the charts. Margin debt as a percentage of GDP is well above all-time highs. Money is pouring into leveraged long ETFs. The most speculative issues are soaring: the Goldman Sachs Non-Profitable Technology Index quadrupled in less than a year.

We are at the top of one of history's biggest bubbles. To be blunt, I'm not sure

how you could look at the weight of the evidence dispassionately and come to any other conclusion.

SZ: *Help us understand the four categories of the speculative pyramid before we look at a few specific examples. Please briefly characterize the transcenders, the contenders, the pretenders, and the pump-and-dumpers.*

RB: In search of fortune, investors have reached higher and higher up the speculative pyramid, each level more rickety than the last.

At the base are **the transcenders**: Apple, Amazon, Microsoft, Facebook and Alphabet. The five megacap tech companies are truly transcendent businesses. They dominate huge markets and earn enormous – and growing – profits. They constitute about 20% of the market cap of S&P 500, an unprecedented total for five companies. But this is not due to outsize valuations: four of the five trade at lower earnings multiples than the Nasdaq 100, with Amazon the lone exception. If anything, there's a bubble in their profits, not their stock prices.

Investors who climb to the next level of the speculative pyramid will find **the contenders**, companies like Shopify, Zoom and Teladoc. Here every investor hopes to find the next Apple or the next Facebook. These firms build promising technology and deliver compelling products but have market caps in the hundreds of billions despite negligible profits. But there's a difference between a great company and a great investment. A few contenders will have the transcendent business success necessary to justify their market caps, but many will not.

Those who dare venture further up the speculative pyramid find **the pretenders**. At this level, companies are devoid of solid business models, meaningful proprietary technology, or even working products. However, these companies are

skilled at mimicking the signals of other more successful companies. They absorb the zeitgeist and learn the relevant buzzwords -- electric vehicles, blockchain, disruption -- and spend more energy marketing their stock than building a business.

Recently, we received two voicemails from an employee in the investor relations department of Electrameccanica Vehicles Corp. He told us that they were an electric vehicle company, that the ticker was SOLO, and that he had sent us some materials and would be happy to talk about it.

To receive a solicitous cold call from a publicly listed company with a market cap of \$750m is scarcely credible – but we have the voicemails to prove it. If anything in the history of the world has ever screamed “stock promotion,” it is this. SOLO has assembled a cold calling team not to sell its \$18,500 single-seat EV, but to sell its stock.

Similar pretenders are everywhere in today's overly credulous marketplace. We discuss Nikola, Vaxart, Kodak and MicroStrategy at length in our letter. Such companies exist in every phase of the economic cycle, but today, their ubiquity and their share price performance are indicative of late-cycle behavior.

At the apex of the speculative pyramid are **the pump-and-dumpers**. In your typical pump-and-dump scam, one informed party attempts to get rich quick by cynically duping others into buying stock off them at inflated prices.

Today's pump-and-dumps are far more collegial. Very few people are duped. Instead, traders on Robinhood, Reddit and Twitter coalesce around a stock. The company has virtually no role in the scheme; it is merely an abstract vehicle for gambling. The stock serves as a Schelling point for an informed and cooperative Ponzi scheme – a Ponzi game, or a Ponzi party, if you will. Those who get in early are hoping to get rich quick off those who get in later. And

those who get in later are hoping to get rich quick off others who get in even later, and so on. Nobody is buying these stocks for their future cash flows. It makes a sad mockery of our capital markets.

SZ: *What do you think about the rise of super-apps and the lofty precedent set by companies like Apple, Amazon, and Facebook?*

RB: The size, quality, and relatively reasonable valuations of these companies has obfuscated the true extent of the bubble in more speculative securities. When you believe that every company that calls itself a “tech disruptor” will one day rake in hundreds of billions of dollars in revenue at >50% gross margins like Google, it is easy to justify nearly any multiple on today’s figures. But we think investors have wildly unrealistic expectations for the success of the average growth stock. We believe truly transcendent companies are few and far between.

The transcendents seem neither especially cheap nor outrageously expensive to us today. They have at times traded at lower valuations, valuations more appropriate for troubled companies than transcendent ones.

SZ: *In your letter, you are vocally anti-SPAC and you place these vehicles at the apex of the speculative pyramid. How are SPACs designed to capitalize on the naivete of retail investors?*

RB: I’d like to be a little more nuanced here. I’m not necessarily anti-SPAC. I like that SPACs allow an alternative method for companies to go public. There’s been an increasing propensity of large and valuable startups to stay private for longer. To my mind, that’s very unfortunate. It’s unfortunate for the companies and their employees, it’s unfortunate for market efficiency, and it’s unfortunate for the average investor who can’t invest in these private companies and will miss out on gains.

And part of the reason companies stay private longer is due to the problems with the traditional IPO process. So I’m in favor of additional avenues for companies to come public.

"The way the average SPAC is structured today virtually guarantees terrible long-term returns for common stockholders."

With that said, the way the average SPAC is structured today virtually guarantees terrible long-term returns for common stockholders. The economics behind the median SPAC looks something like this: IPO fees run about 5%. Then sponsors get an allocation amounting to 25% of the IPO funds.

Then a search commences. Remember that there are about 500 SPACs competing to find a target company to merge with. So in order to get a target to agree to merge with it, our hypothetical SPAC has to outbid 500 other SPACs, with an offer that’s more attractive than just staying private or pursuing an IPO or direct listing. And the SPAC sponsor gets paid nothing if they don’t consummate a merger within two years, so the incentive for the sponsor is to merge with a company no matter the price. Sponsors do want the stock to do well, but their overriding financial concern is that a merger gets consummated. So at best the sponsor will be indifferent to overpaying.

The target knows that a large percentage of shares will be redeemed, reducing the amount of cash the target will receive upon merger consummation. So the target will require a committed PIPE in conjunction with the merger. The PIPE is

generally done at terms preferential to the public equity, adding yet more dilution.

This is a comically bad process for the common shareholders who choose not to redeem. They are bearing an enormous expected cost. There's a reason that hedge funds, sponsors, investment banks, and targets all love these things. They view it as a free lunch, and guess who is paying? The common shareholders who don't redeem. The median return of a SPAC twelve months post-merger is -65%. A lot of sponsors are going to get fabulously wealthy while begging their investors. That's a travesty.

**“As they say, the market
can stay irrational longer
than you can stay solvent.”**

SZ: *Do you think the rise of SPACs will inflict long-term damage on the capital markets? If so, how and why?*

RB: There's a world in which the excesses slowly go away, and in five years we still have lots of SPACs, they just have much more sensible terms. There are obvious ways to improve the structure to more closely align sponsors and investors; Bill Ackman for one has criticized the typical structure and created his own version.

But these things tend to be cyclical, and they tend to over-correct. The pendulum has clearly swung too far one way, and I'd guess the pendulum will swing too far the other way. Investors who got burned by this round will be much less likely to subsidize the next round. And regulators, who have stood by, will come out with harsh new regulations.

In fact, this isn't the first time this has happened. There was a wave of blank check companies in the 1980s. After they imploded, Congress passed legislation to ban them. Today's SPACs are specifically

designed to get around those regulations from 1990. So I wouldn't be surprised if something like that happens that shuts down the blank check market for a generation.

SZ: *Who really wins in a swooning market like this and how should professional and retail investors align interests?*

RB: This market has been good for a lot of people. Soaring valuations are good for PE. Soaring retail volume is good for retail brokers and HFTs. Soaring M&A is good for investment banks.

It's been very bad for active managers. If the S&P goes up 20% every year, it's hard to add value to justify your fees. If there are no bear markets, it's hard to add value via risk control. If pretenders persist at obscene valuations, it's hard to add value on the short side.

Of course, the S&P is not going to go up 20% every year indefinitely. There will be another bear market. Pretenders will be unmasked. And value will have its day again.

The trick for a value manager like us is to survive to see that day. As they say, the market can stay irrational longer than you can stay solvent. At Bireme, we've been fortunate enough to outperform since inception despite the strong headwinds for value investors. So I think the future is bright for us.

Professional and retail investors have one primary shared interest: efficient markets. Efficient markets encourage capital formation, foster productive investment, and allow for predictable returns over time. The wild swings and speculative excesses we've seen lately have made some folks very rich, but in the end many more individuals – and society as a whole – will be worse off because of it.



ABOUT SUMZERO

SumZero is the world's largest community of investment professionals working with the industry's most prominent hedge funds, mutual funds and private equity funds. With more than 16,000 pre-screened professionals collaborating on a fully transparent platform, SumZero provides direct access to thousands of proprietary investment reports every year and fosters on-going communication within the network.

The research on SumZero cuts through the noise that pervades the industry and provides its community with in-depth, actionable investment research and data. SumZero offers several ancillary services in support of our research platform. These services include capital introduction, buy-side career placement, media placement and more.

ABOUT CAP INTRO

Cap Intro is a passive, reverse-solicitation platform that offers firms direct exposure to a fast-growing group of pre-vetted, institutional allocators for the purpose of raising capital.

Cap Intro is a matchmaking forum built on the premise of idea exchange and transparency. For managers, it is a place to socialize your fund, enhance your marketing efforts, and gain the recurring, high-quality exposure needed to scale AUM. For allocators, Cap Intro is a place to uncover talented managers.

Since 2016, Cap Intro has catalyzed hundreds of inbound inquiries to funds from accredited institutional investors. These inbound inquiries have led to the placement of over half a billion dollars in allocations. SumZero is not a broker-dealer and collects no success-based fees in the event of an allocation. SumZero will, on occasion, highlight successful transactions catalyzed through the platform as a demonstration of efficacy. The following is one example.

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