OFF WALL STREET

QUARTERLY LETTER

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SHORT SETUPS & VALUE DESTRUCTION – April 11, 2024

Shorting in the Current Market Environment

In short selling, it usually pays to be cautious. In our opinion, now is not one of those times. In this market environment, we want to be aggressive on the short side of the portfolio. The wind is at our back, and 2024 has the potential to be an extraordinary year for generating short alpha.

In 1Q24, OWS's active short ideas (median market cap $4.8B) outperformed a SPX short by 11.7%. That's more alpha in one quarter than we generate in the typical year (our average alpha is 9.2% per year since 2002). Regrettably, our skill level hasn't increased by two standard deviations over the past three months (though we're trying our best). Instead, this statistic reveals the narrowing leadership of the US stock market since Christmas 2023.[1]

Narrowing market breadth means that *most* shorts are working (at least on a relative basis) despite the SPX going up -- which suggests that you can lean on them -- while the breadth underpinnings of the narrow leadership group are shaky -- which suggests that you can look for shorts in the leadership group, without undue fear of getting run over by a sustained bull market.

The junky and speculative stocks that briefly revived in 4Q23 as interest rate expectations dropped (such as active OWS ideas [redacted], [redacted], [redacted], [redacted] are now languishing again. For those clients who prefer to "kick the drunk down the stairs" when shorting stocks, we say - the time to kick is now.

Meanwhile, we see three themes driving market leadership. One of these is a thematic, 1990s style investment frenzy, while the other two reflect macro factors. In our view, all of them present short opportunities in 2Q24.

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[1] Traditional measures suggest that, within the large cap universe, market breadth is narrow but not extremely so. The most severe breadth divergence is between large caps and everything else.

1) **AI-related names** (everything from NVDA, to data center HVAC, to that company run by Sam Altman's brother's nephew's cousin's former roommate);

2**) Rate-sensitive cyclicals** (homebuilders, commercial construction[2], big-ticket consumer durables, big cap financials) that currently reflect expectations for robust 2024-25 demand, spurred by lower borrowing costs -- and apparently didn't get the memo from the bond market that rate expectations and yields bottomed in January;

3) **"Relief rally" consumer stocks**, that now reflect "soft landing" (i.e. strong) demand expectations for the US consumer, while simultaneously enjoying unprecedented margin tailwinds from 2023's collapse in freight and raw materials. This group ranges from big box retail (COST, TGT) to specialty apparel (GPS, ANF) to restaurants (CMG, TXRH, EAT).

We discuss each of these themes below. More broadly, what would cause us to change our mind and get more cautious on the environment again?

As short sellers, our worst nightmare is that US growth and inflation re-accelerate into 2H24 - 2025 without a corresponding recovery in interest rate expectations -- i.e. that we experience a significant decline in real interest rates. The cyclical and consumer names in the market vanguard seem to reflect expectations that this will indeed occur; investors seem to be assuming they can have their cake (strong demand growth) and eat it too (lower interest rates and low input costs). And maybe they can!

Mr. Market seems to doubt it, though. The weathervane to watch closely is the stock price performance of the low-quality, unprofitable and/or speculative growth names that led the market in 2021. As of today, the weak performance of this group gives us confidence that real longer-term interest rate expectations remain higher -- and the fact that bonds and FX both peaked in January supports that notion. This should continue to weigh on risk sentiment and valuations, especially for those companies that require outside capital to fund their operations.

Although OWS does fundamental research, part of our job for clients is to identify, using whatever tools are available, which *type* of fundamental short ideas are most likely to work in a given market environment. Every short needs a psychological catalyst -- and some market environments are better suited to certain psychological catalysts than others.[3]

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[2] CAT, the ultimate cyclical construction bellwether, is up +65% since October and now trades at a hefty 2.8x sales. Over the past 40 years, CAT's stock price has only reached its current overbought levels (as measured by weekly price momentum) on seven occasions: 2021, 2017, 2011, 2003, 1997, 1994, and 1986.

[3] Clients should note our timing in recommending a short of TRUP in Oct 2022. Many other short sellers, focused on TRUP's various accounting issues, had identified this idea and shorted it earlier, only to suffer losses. Part of our value for clients, we think, was not only in analyzing TRUP fundamentally, but in

If breadth starts to expand into smaller caps, and lower-quality names start leading the market again, it could be a sign that a new market regime is starting. In that case, investors could prove more forgiving (again) of revenue and earnings misses, and we would need to re-evaluate and potentially shift our short research emphasis to lower beta or more idiosyncratic shorts. We don't see signs of that, yet - and so we counsel clients to stay aggressive.

Where We See Short Setups and Value Destruction in 2Q24

- ***Note:*** *Definitions of OWS's Short Setups (Structural, etc.) are included in the Appendix, below*

1. AI Technological Disruption - *Structural*

There are two waves of tech disruption coming from generative AI.

The first is direct, and it is already upon us. That is genAI displacing, like-for-like, services that already exist in the marketplace. Today, genAI tools can produce writing, images and logos, they can convert text to (increasingly realistic) speech, and they can help with basic programming work[4]. Businesses that provide these services are already being displaced by genAI. We draw clients' attention to active OWS short ideas [redacted], [redacted] and [redacted], in particular. These ideas are already playing out.

But this is minor in comparison to what's coming in 2025 and beyond. The second wave of genAI disruption promises to be more indirect, more ubiquitous -- and more disruptive to existing players in the tech ecosystem. We would classify this as a *user interface* disruption within computing. In short, rather than manipulate boxes and menus on a screen, the user will increasingly interact with an AI agent as gatekeeper -- by speaking and/or writing. As usual, science fiction provides a glimpse of the future: do you ever see Iron Man click on a mouse? No way, he talks to Jarvis.

This promises to be the biggest change in computing since the GUI was introduced in the early 1980s[5]. As a shortable theme, we think it exceeds in magnitude and impact the e-commerce disruption of retailers and big consumer brands of the early 2010s. While the theme is still too nascent to present shortable targets, we expect this to be a

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recognizing that 2H22 was an environment in which a slowdown in TRUP revenue growth -- which our research suggested was likely -- was more likely to cause a severe multiple compression.

[4] The next generation of genAI tools for programming look to be significantly more capable, creative minded and independent. The early feedback is that these tools act more like low-level engineering employees than mere "copilots."

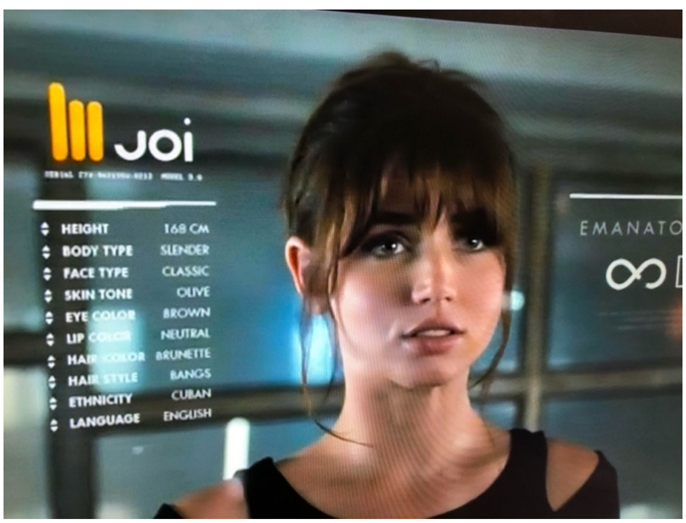
[5] For more technical discussion of LLMs as operating system, we suggest these recent articles:

- Illustrated LLM OS: An Implementational Perspective
- What would an LLM OS look like?
- Andrej Karpathy diagram of potential LLM OS

major area of focus for OWS in the second half of the 2020s, and we want to put this on clients' radar screens now.

Like the e-commerce disruption theme, this, too, is a story about *who owns the customer relationship.* E-commerce was a tool that enabled more nimble and emerging players to dis-intermediate the distribution layer (i.e. brick and mortar retail stores), and to build a direct relationship with customers. The physical store no longer owned the customer -- the competitive landscape was suddenly a free-for-all. The brands that had the strongest emotional connection with consumers, the brands that consumers sought out directly, online, because they *wanted* them, not just because they were there[6], won this competition.

GenAI threatens to similarly dis-intermediate existing gatekeepers within compute. You should not assume that leading, incumbent players like Microsoft will necessarily dominate this market, either - the opportunity to build a direct rapport with the user seems to be an open field for new entrants. Furthermore, do not underestimate how *emotional* and *personal* the selection of an AI agent might prove to be. If you want to see the future of AI as UI, watch Ryan Gosling interact with Ana de Armas in Blade Runner 2049 -- and imagine that, in addition to providing emotional support and love, Armas was also Gosling's personal assistant, his gatekeeper to all Internet and personal computing functions, and the screener for all his communications. Eat your heart out, Clippy.



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[6] Or as George Constanza once described an earlier world of consumer gatekeepers:
"The show is about nothing . . . Nothing happens."
"Well, why am I watching it?"
"Because it's on TV!"

What would this UI disruption mean for stocks?

First, across the software stack, switching costs might decline -- both because genAI agents can now handle the grunt work of switching, but also because you no longer have humans who become accustomed to using a certain software product and don't want to change (their AI agents won't be nearly so intractable). One of the key assumptions behind all software investing -- that existing software contracts are effectively an annuity, due to high switching costs and low churn -- could face a major test in the coming years. We think software valuation multiples could compress dramatically in such a scenario.

More broadly, the grounds of competition across multiple areas, both B2C and B2B, might dramatically change. In many cases, you will no longer be trying to convince a person to buy your product or service*. You will be trying to convince that person's AI agent.* Imagine SEO on steroids, all the time, for nearly everything bought and sold, as players seek to optimize their pitch to the mysterious/emergent and ever-changing vagaries of the AI decision model. Competition short setups will abound as certain players lag in adapting to this change, or find their business models ill-suited to it.

In short, science fiction is becoming reality, and while this structural AI theme remains beyond our investment time horizon, for now, we observed two notable signposts in 1Q24 that we are watching with interest:

1. The launch and subsequent attention paid to Rabbit AI, an innovative, AI-centered personal hardware device (picture a Walkman-sized box that you can talk to, and that interacts with online services on your behalf). Rabbit, Humane, and other early players will probably fail, but we are less interested in the individual players, than we are in the broader emergence of AI-focused hardware gatekeepers as a validation of our OS dis-intermediation thesis.

2. Cutting edge genAI voice agents are quickly starting to demonstrate improved emotional intelligence and naturalism. We encourage clients to check out this demo version of Hume.AI (https://demo.hume.ai), which just launched a week ago. It's no Ana de Armas, but it's getting closer. In terms of naturalism, AI voice agents seem to be ~70% across the "uncanny valley."

2. AI Hardware Boom – *Cyclical/Competition/Misunderstood Business*

To power this sci-fi future, there is an AI hardware boom going on, as everyone knows. We see two types of potential short setups here.

The first is represented by existing OWS short ideas like [redacted] and [redacted]. These are companies whose recent numbers are deteriorating, and who don't really sell anything that's used for AI chips, but that are giving aggressive guidance for 2H24-2025 because . . . well, "AI." We think of these as "gotcha" AI hardware shorts. In our experience, some of the best shorts are cases (like [redacted] and [redacted] where the companies also face competition and/or structural displacement issues that are unrelated to AI per se.

The second category of AI hardware shorts are those companies whose recent results have been extremely strong due to the AI hardware frenzy, and for which investors are extrapolating those results far into the future, even in cases where competitive dynamics are rapidly changing. [redacted], a recent OWS short initiation, is a good example of this. This is a company that rode NVDA's coattails over the past eight quarters, but now faces an increasing threat of competitive displacement. Fired by the idea of AI capacity growth going exponential, investors are extrapolating its numbers forward indefinitely, a classic cyclical short setup. There are surely other companies like this for us to identify and target.

As AI hardware procurement becomes more "rational" (i.e. the frenzy slows), and OEMs like NVDA look to diversify their supplier risk, we think there are potential competitive problems lurking for many companies whose recent results have looked stellar due to booming AI hardware CapEx. Couple this with the potential for a cyclical slowdown[7] as we head into 2025, and you have a double whammy of market growth deceleration and market share loss.

3. Commercial Construction - The "Perfect Storm" Subsides – *Cyclical*

Somewhat related to the data center buildout frenzy, we are finding short ideas in commodity producers or spread-based distributors that sell into non-residential construction markets, including manufacturing, data centers, warehouses, and infrastructure. Clients should refer to existing OWS short ideas [redacted] and [redacted] for examples of this. In both cases, bullish investors are licking their chops over deceptively low multiples and so-called "megatrends" that will drive long-term demand.

There are two sides to these cyclical short setups - supply and demand. On the supply side, many cyclical companies experienced "perfect storm" conditions in 2021-22, as supply chain bottlenecks restricted the availability of competing product, even while demand exploded under the fiscal stimulus of the IRA and CHIPS acts. Companies that normally struggle to earn their cost of capital over a full cycle, were suddenly generating ROIC of 40%-50%.

Since 2022-2023, these returns have been -- slowly -- reverting back toward long-term averages as supply enters the market in response to the high returns on offer. However, in many cases, "street" models are projecting margins and ROIC to level out

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[7] Most recently, *The Information* reports on April 3 that "Startups That Bought Too Many NVIDIA Chips May Have to Rent Them Out." Evidence is growing that the peak of the hardware cycle might be closer than some think.

far above long-term averages, implying a "permanently higher plateau." We doubt such an optimistic scenario will happen.

The demand side is the other shoe to drop. This is now starting to play out. Commercial construction on a SAAR basis has now declined M/M for two months, the first time this economic cycle. The Architecture Billings Index, which leads non-residential construction activity by 9-12 months, has been in severe contractionary territory since last Autumn. Industrial production of cement and aggregates both shifted negative in late 2023. Many of these stocks have ripped to new highs on expectations of impending rate cuts, but the hoped-for decline in rates and bond yields isn't materializing, and the canary in the coal mine for non-residential construction demand might already be dead. We expect, not a rebound, but rather an accelerating decline in profit and ROIC for many of these names throughout the course of 2024.

4. The Big Consumer Reset – *Competition/Cyclical*

An under-recognized fact: retail stocks (XRT) have outperformed tech (XLK) since the market bottomed in November 2023. Indeed, consumer names have enjoyed a kind of perfect storm of their own.

As the holiday 2023 sales data rolled in, investors woke up to the fact that the US consumer is alive and kicking. Top line performance among consumer stocks has remained robust through year-end 2023 (and bulls will likely write off poor January numbers as attributable to abnormally bad weather). At the same time, the collapse in freight and commodity COGS in 2023 has led to blowout gross margins. Naturally, this is a sign of management's "good execution" rather than mere good luck, and the "street" is projecting these strong sales and margin results into the future. In many cases, these optimistic expectations seem bound to be disappointed.

We see opportunities to short consumer stocks where expectations for sales and margin have re-set much higher -- setting an unrealistically high bar for 2H24 -- and that simultaneously face competition or structural problems that are worsening. See existing OWS short ideas [redacted] and [redacted], for example.

Incidentally, despite the 2023 freight bloodbath, truckers and railroads both made new highs in late February, as investors bet that the inventory cycle is turning upward again -- if that is correct, it bodes ill for the fat freight margins of these consumer companies.

In retail specifically, we think the resurgence of the inventory cycle is likely to increase promotional intensity and reveal the competitive losers more clearly in the second half of 2024. It's easy to maintain discipline when everybody is shedding inventories against a strong consumer demand backdrop. With inventory levels now balanced, and with the consumer perhaps showing some cracks (note recent warnings from LULU, NKE, ULTA, etc.), the competitive environment is bound to get tougher again, even as consumer demand softens and the freight providers get back on their feet.

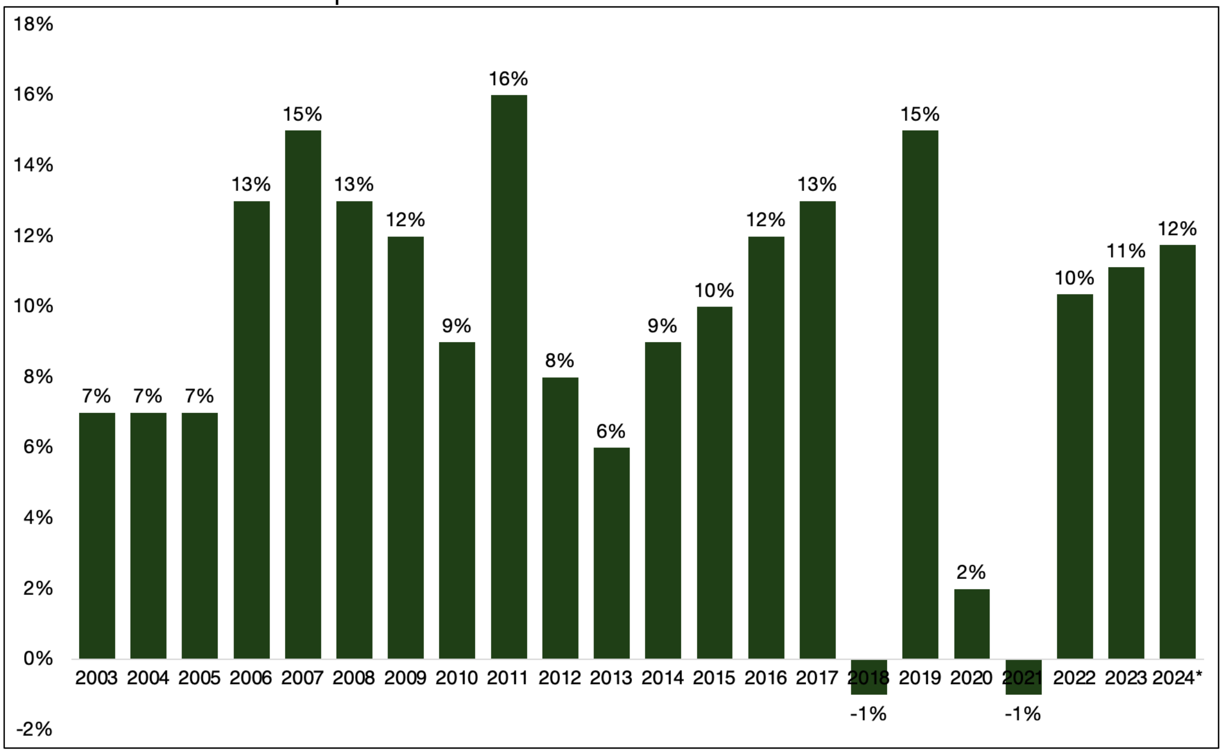
Appendix

OWS Short Setup Definitions

SHORT SETUP	WHY DOES IT RECUR?
1. Structural - The business model faces existential challenges from technical obsolescence or innovation.	**1. Conservatism bias –** investors underestimate the power and speed of "creative destruction."
2. Competition - These businesses face escalating competitive dynamics because of industry structure, including low barriers to entry.	**2. Conservatism bias –** investors over-estimate the durability of a business's excess returns and underestimate the competitors coming to get those returns.
3. Cyclical - Investors extrapolate cyclical strength too far into the future.	**3. Anchoring bias –** investors focus too much on recent strong results and struggle to imagine mean-reversion.
4. Misunderstood Business - The business model is not what the company says: broken roll-ups, fads, etc. These businesses often show evidence of aggressive accounting, fraud, off-balance sheet financial leverage, and eroding cash flow, and may face regulatory challenges.	**4. Availability bias –** investors focus on the story, numbers or (adjusted) metrics that management puts in front of them.

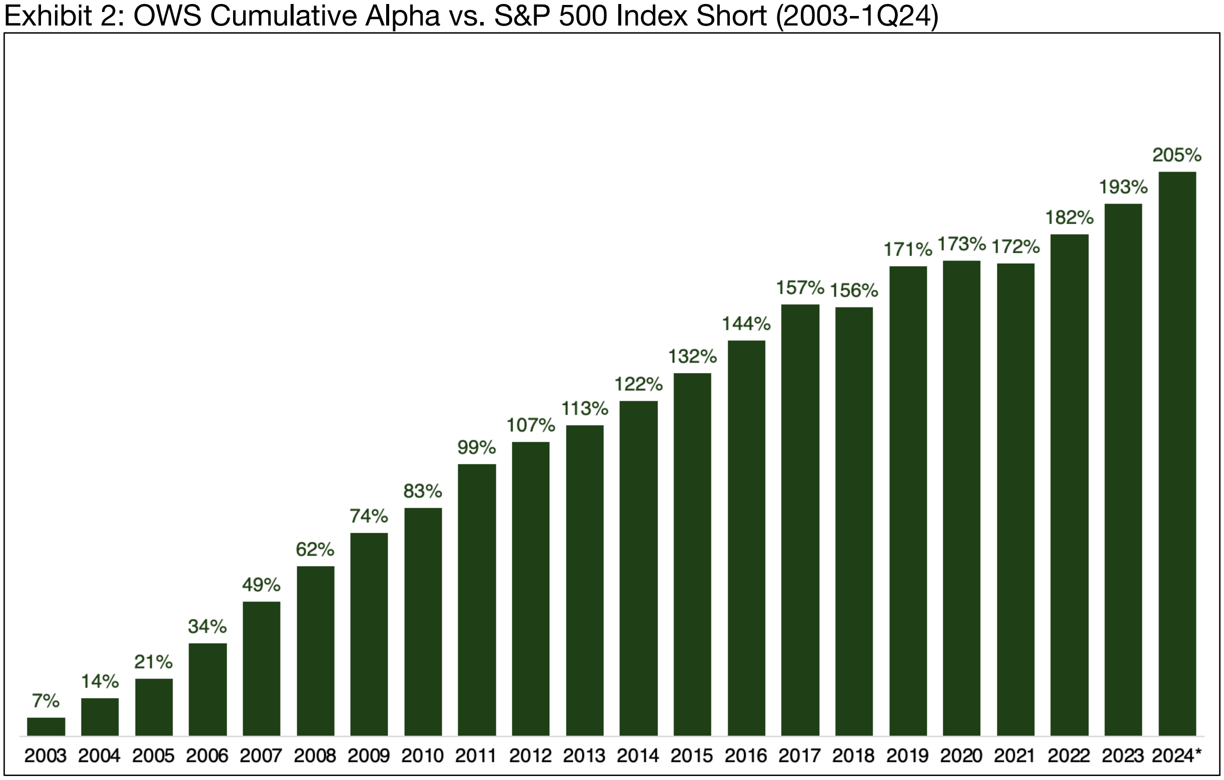
OWS Historical Performance

Exhibit 1: OWS Annual Alpha vs. S&P 500 Index Short



Source: Bloomberg, OWS

Exhibit 2: OWS Cumulative Alpha vs. S&P 500 Index Short (2003-1Q24)



Source: Bloomberg, OWS. *2024 YTD