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ELM RIDGE

“Say it Ain’t So”

Fourth Quarter Report • December 30, 2022

“Graham and Dodd investors are people who place a very high value on having the last laugh. In exchange for the privilege, they have missed out on a lot of laughs in between.”

– Michael Lewis

ELM RIDGE	4 TH QUARTER 2022	2022	INCEPTION-TO-DATE ANNUALIZED
NET PERFORMANCE	12.3%	48.6%	7.1%
GROSS LONG CONTRIBUTION	14%	15%	11%
GROSS SHORT CONTRIBUTION	-3%	25%	-4%
S&P 500	7.6%	-18.1%	6.3%

We posted a pretty good quarter to end a very good year.

Say it Ain’t So¹

“I knew I was smart; I just needed a bull market to prove it”.

– Heard on Wall Street²

“It’s not denial. I’m just selective about the reality I accept.”

– Bill Watterson

I’d like to think that folks are reacting to these diatribes with “say it ain’t so,” but that would surely be overestimating their impact. Dropping the “say” is probably more on target. We’ve been droning on and on about what might happen when markets lose the 40-year tailwind from ever-lower interest rates³ and it seems clear to us that very few investors (both professional and private) are willing to confront that possibility.

From what I have gleaned, as some of our predictions are beginning to pan out and performance has rebounded, the number of you willing to read through these letters has declined.⁴ We are all facing a different situation than we were 20+ years ago. Back then, most of you had just entered your peak earning years and our audience was split between those were kicking themselves for missing out on all the fun, and those who rode the wave and wanted to hedge their newfound gains. That is not the case today, even though most of you are relying more on your nest egg, rather than income, to fund your future. We would guess that a decade’s worth of investment success might be behind that

¹ Supposedly asked of Shoeless Joe Jackson after he was accused of fixing the 1919 World Series.

² As recounted in *RenMac*, 1/15/21.

³ Our 2q21 letter, *Imagine*, was devoted to this topic. And if you want a better version without from snide remarks or *YouTube* links see Howard Marks’ *Sea Change*. <https://www.oaktreecapital.com/insights/memo/sea-change>

⁴ As evidenced by my unscientific survey of incoming e-mails and phone calls.

stance. It is one thing for us to challenge prevailing wisdom when our investors/readers have no real skin in that game and another to say the same things when they're dug in behind it.

Tell Me Something Good

"I surely don't think ignorance is bliss. But like everything else that has survived thousands of years of human evolution, ignorance - like denial, self-delusion, and magical thinking - seems to have its uses."
– Scott Spencer

"Never think that lack of variability is stability. Don't confuse lack of volatility with stability, ever."
– Nassim Nicholas Taleb

"You want the Truth? You can't handle the truth."
– Jack Nicholson, *A Few Good Men*⁵

Look at us, taking aim at those quaint public markets that move willy nilly with daily pricing. The hot money has left the room. Sophisticated investors are almost all doing much better thanks to the wonders of less liquid real estate and private equity investments, where they expect steady reports of supranormal returns for many years before there is any final accounting (when they can actually get their hands on that dough). The Venture Capital industry posted a new record for capital raising in 2022, its fifth in a row, while exits (and cash returned to investors) fell to a six-year low.⁶ Private market valuations, driven more by NAV markups than realized distributions, have lagged declines in public ones, with the gap between private and public equity reportedly the largest since the dotcom bubble burst.⁷ Indeed, the reported returns of private real estate funds are running some forty percentage points ahead of their public competitors.⁸ And if you believe these results, I know a guy making bank selling herbal supplements who would love to speak with you.

Private investors could be betting that, as was the case in 2007-09, the markets will recover sufficiently so that they won't have to record any interim losses. It could happen (in which case the public markets will dramatically outperform privates from here). While we are not arguing there isn't a case for private investing, it appears its current popularity stems from the tendency of investors to confuse steadiness with safety, when in many cases those should be opposites. Any enduring investment offering both supranormal (above that of risk-free alternatives) and steady returns, must incur some risk in the process. Given the differing time horizons between principals and agents, the latter can produce a string of stable returns by selling what is, in effect, catastrophe insurance (what we bought in the Big Short.⁹). Avoiding the cost of protecting against less likely outcomes might lead one to report many years of steady results until those infrequent events occur. At that point, the agent looks for a new job, and the principal looks for a cheaper house.

The incentive structures in the private world are almost perfectly aligned. (1) Private investment firms have a vested interest in reporting attractive results that curry favor with (2) their immediate contacts at allocators. Those folks want them to tell them something good (and I couldn't help but write the following without Chaka Khan in the background¹⁰) so that they, in turn, get to sing it to (3) their bosses (e.g. CIOs), who repeat the ditty to (4), the people in charge of the organization (pension fund, university, charity, family office, wealth management firm) holding (or

⁵ <https://www.youtube.com/watch?v=5j2F4VcBmeo>

⁶ Pitchbook, "Q4 2022 PitchBook-NVCA Venture Monitor First Look"

⁷ See "Venture Capital's Reckoning Looms Closer," *Financial Times*, 1/3/23. Also *PitchBook*, 2023 US Private Equity Outlook.

⁸ "Same Building, Different Prices: a Two-Speed Property Market Can't Last," *Wall Street Journal* 12/27/22.

⁹ Indeed, we did play the Big Short, and earned a cameo in the book – although Michael Lewis moved us across the river to my home state.

¹⁰ https://www.youtube.com/watch?v=cm_cFzVAoo8

bundling) the dough. And those head honchos get to tout their organization's investing skills to those who fund it: (5) donors; union workers; high net worth investors.

This game of pretend hinges on the fact that the typical time in place for an individual at stations 1-4 is usually much shorter than the duration of the investment. They get the privilege of reporting less-volatile performance and will probably be long gone before any problems surface. It is the fifth group – the only one in theory who might want to hear the truth (but can they handle the truth?¹¹) – that ends up paying the price. In return, all they get is some better sleep along the way. I was just reading how my alma mater's endowment stacked up so well against other universities, in large part due to its 40+% allocation to private equity producing *reported* gains more than 15% above public markets. And I played Chaka Khan.

Professional public market investors, particularly the pundit class dependent on short-term confirmation, also prey on the propensity to confuse steadiness with safety and understanding. I don't know how many times I've heard someone pitch companies with limited line-of-business disclosure and opaque income buildups (often due to the fact that no "units" are disclosed) as more understandable than apparently more volatile cyclical ones – where it is much easier to calculate unit economics and thus expected long-run profitability. They prefer the kind of research that eschews tricky math in favor of qualitative calls with investor relations, occasional channel checks, and no obvious mid-quarter data updates that could throw their thesis into jeopardy.

Both they and their clients gain comfort as management continues to deliver for them – until they don't. The world is not as stable as they would believe. To smooth any bumps along the way, companies can pull some legitimate levers (tweaking marketing expenses, sales promotions, etc) to maintain the earnings trajectory that investors expect. As the gap between business conditions and expected results grows, then management might pull the kind of (still legal) EPS boosting games (e.g. building inventories or increasing leverage) that draw our attention on the short side. In an era of easy money, it is usually around this time they can ramp up the M&A machine, as almost any acquisition is accretive – particularly when management gets its acolytes to agree that continued acquisitions are not capex and that no "free cash" is ever going out the door. Both the pros and the public drop their guard even further with each confirming earnings release.

Today's investors don't seem to remember what happened to the steady growth heroes of the 1980s: Waste Management, Philip Morris and Coca-Cola, who each lost 50% or more after finally biting the bullet, having driven steady growth just a bit too far.¹² Harley Davidson was able to keep its streak (save the GFC interlude) until 2014, when it could no longer push more product into its existing customer base. And if steady is what sells, then there are plenty of less ethical people waiting to prey on the inevitable lack of vigilance it engenders. And sure enough, investors fell prey to Enron, WorldCom and GE, who all tried to hide the fact that their steady return machines were going off the rails. As the lower-rate tide rolls out, we're due for another round.

Of course, individuals fall for the same ruse (e.g., Madoff). A year ago, I sat with some very smart people pitching the marvels of crypto. While they at least admitted they might face some risk betting on bitcoin, et. al., they were comfortable touting the advantages of crypto-based accounts providing steady 8% yields as completely safe. My counter that the other side had to be taking risk, when the 8% figure was about 8 points above the risk-free rate, was of no concern. That 8% was steady, until it wasn't. Oops. I still don't think anyone learned a lesson. It was just a bad actor, SBF, who ruined the party. It's always the bad actors that get the blame – not the gullible investors wearing big targets on their backs.

¹¹ Yes. I'm footnoting it twice to improve the odds you click. <https://www.youtube.com/watch?v=5i2F4VcBmeo>

¹² To be fair, I don't remember Philip Morris or Coke pulling any gimmicks. They just used up pricing.

As a recent *Financial Times* piece notes: “there are three ingredients to a financial crisis: consensus optimism, leverage and illiquidity. And private markets exhibit all three.”¹³ We think we have found and are currently working on a way to play this potential implosion, with the same kind of (admittedly not as extreme) payoff structure we found with the Big Short. In fact, I was on the front lines when what might be a similar event played out very early in my career. As was the case back then, we don’t see any major systemic damage, and thus counterparty risk – just a bunch of disappointed investors.

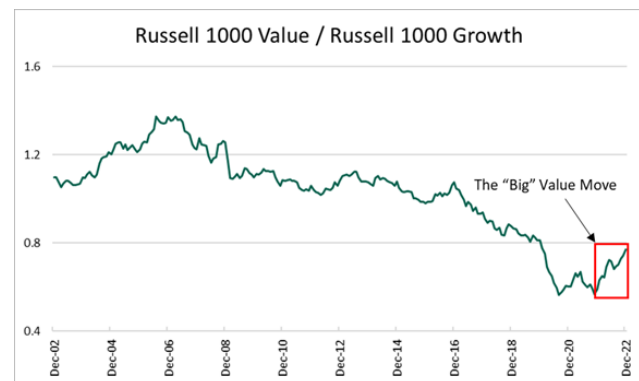
Thank You (Falettinme Be Mice Elf Agin)

*Stiff all in the collar, fluffy in the face
Chit chat chatter tryin', stuffy in the place
Thank you for the party but I could never stay
Many things is on my mind, words in the way
I want to thank you falettinme be mice elf agin
Thank you falettinme be mice elf agin
– Sly & The Family Stone¹⁴*

When some of our investors do worry that we could be barking up the right tree and contemplate adding more to their investment here, they usually start with some form of “haven’t you used up most of your opportunity?” (This is before they check back with those driving their other investments, who talk them back into the program.¹⁵) There’s no doubt that our success this past year put a dent in our opportunity. But I still feel like I did when my boss and I piloted our single engine plane to a dead stop about 1000’ into the 10,000’ runway at Calverton Air Force Base – and could have still taken off and landed once more in order to get to our contact at the other end. At this point, value itself has only reversed its 2020 drubbing (as you can see in the updated chart below). It has a long way to go to get back to where we think it’s heading.

But the value recovery is only part of the story. In most cases, our longs capitalized on market indifference (e.g. buybacks, debt repayments, dividends and some opportunistic buys of distressed merchandise) to add runway as well.

While our energy holdings posted close to a 60% gain for the year (as we opportunistically trimmed, and at times rebuilt, positions to hold its share of the portfolio in the 40% range), they also, on average, paid back debt equal to 10% of their market cap and trimmed their share count by more than 3% (as opposed to those share buybacks that merely offset dilution) while returning more than 3% in dividends. Adding in some opportunistic M&A, the average stock here grew our normalized ’26 estimate by more than 30%, leaving it with an average 180% return according to our estimates, or $\frac{3}{4}$ of what we were looking for a year ago. As a sanity check, the E&P Index would need to rise more than 250% to have kept pace with the S&P since the oil price first fell below \$70 in 2014. As most investors shun them, leaving their cost of capital at egregious levels, these firms are refraining from making what otherwise would be very attractive investments to meet future demand, and are instead returning cash to their investors – just as we want. We would argue that the pundits, up in arms over



¹³ “Venture Capital’s Reckoning Looms Closer,” *Financial Times*, 1/3/23.

¹⁴ <https://www.youtube.com/watch?v=wj5VODa-eTY>

¹⁵ I remember a friend, a personal broker for high-net-worth clients, from my Goldman days who was always telling me to “get with the program.” I understand lives on Fisher Island, so the program did well indeed.

the fact that these stocks dramatically outperformed the commodity over the past year, might want to do a bit more research.

As for our other longs, while they did cost us four points of absolute performance, they outperformed the market by nearly 10%. They too added value through real free cash flow, dropping their net debt by 5% of their market caps, cutting their share counts another 3% and paying 2% in dividends. Investors contemplating these cheap names are afraid of a severe recession, even though most estimates already reflect such a scenario. Bring it on. Their balance sheets – save two – are solid, and if markets stay depressed, they will release gobs of working capital. All but those two will be in position to capitalize on depressed share prices in the coming year. The longer they stay cheap, the more we'll get paid.

As for the shorts, we have somewhat different outlooks for the three buckets described in our last letter. Turning first to the crowded “high-quality,” supposedly “safe” tech and institutional favorites that most likely dominate your public portfolios, these did very well for us in the fourth quarter as investors might have begun to understand that they have cycles too. At this point, their multiples are no longer as demanding, but we still expect estimates to be revised downward as we echo the bump they got from consumer durables and excessive tech spending during COVID. Still, these are trading closer to our target prices and, although none are moving toward buys, we would expect to close these out in the next year.

Meanwhile, the high-multiple, steady “old-economy” stocks, providing a refuge for investors afraid to engage with cyclical issues, did provide a haven in the last quarter, trimming our gains for the year. On the other hand, these still performed much worse than our longs in those sectors. So we'll take it. Meanwhile, we are still playing for most of them to be cut in half – at which point they would still be selling at higher multiples than all but the last 5 years, which seems to be the extent of Wall Street's memory.

Finally, we have the high-multiple concept stocks, often with a flawed business model, EBBS¹⁶ accounting and burning cash, while doling out egregious stock grants to their employees. These litter the portfolios of ARKK and the Tiger Cubs. They continued to perform well for us in the fourth quarter, with many down at least 50% during the year. While this might seem like a dramatic fall, in many cases our target prices were just fractions of what they once sold for. If we reload, we can make that much all over again. To wit, if a stock that we think is worth \$10 falls from \$100 to \$50, we have only clipped 10% of the potential return (80% from 90%). To repeat: “What do you call a stock that's down 90%? One that was down 80% and got cut in half.”

I started out admitting that almost no one wanted to listen to us rain on their parade. If I didn't learn to stop talking trash when a knife-wielding friend from the neighborhood chased me down the main hall of my high school, I'm not going to learn it now. We're back to where we were when I first started writing these. And there's probably only a handful of you who made it to page five. Thank you falettinme be mice elf agin.

¹⁶ Earnings before bad stuff, where adjusted earnings strip out all sorts of ongoing expenses that management tells its lemmings not to worry about.

DISCLOSURES AND NOTES TO PERFORMANCE

Past performance should not be construed as an indicator of future performance. Inception is January 2000.

(a) The performance figures are estimates and unaudited. (b) All returns presented are calculated on a time weighted, total return basis (include all dividends, interest, accrued income, realized and unrealized gains and losses and commissions). Gross Returns do not reflect the deduction of a 1.5% management fee, applicable fund expenses, or a 20% performance allocation. Net Returns include dividends, net interest, and reflect the deduction of a 1.5% management fee plus applicable fund expenses; they are also net of a 20% performance allocation, if applicable; (c) These returns are not GIPS compliant. These returns are not AIMR compliant as they represent only the performance of the Series A, Class 1 shares. Individual investor returns may vary due to several factors, which include but are not limited to: the timing of subscriptions and redemptions; differences in fee structures; individual investor account high water marks, and differences in tax treatment. Because of certain governmental regulations, not all accounts are New Issue eligible. New Issues contributed approximately 9.6% gross to the performance figures presented for the year 2000, 0.6% gross for the year 2001, 0.09% gross for the year 2002, 0.48% gross for the year 2003, 0.47% gross for the year 2004, 0.30% gross for the year 2005, 0.17% gross for the year 2006, 0.24% gross for the year 2007, 0.03% gross for the year 2008, 0.01% gross for the year 2009, 0.03% gross for the year 2010, 0.05% gross for the year 2011, 0.00% gross for the year 2012; 0.05% gross for the year 2013; 0.05% gross for 2014; 0.01% gross for 2015 and 0.00% thereafter; (e) All performance figures are before-tax returns. Actual after-tax returns depend on an investor's individual tax situation and may differ from those above. (f) All historical performance and exposure statistics reported in this letter prior to October 1, 2001 refer to Elm Ridge Value Partners, L.P., a 3(c)1 limited partnership. (g) All S&P 500 performance percentages are shown with dividends reinvested. The S&P 500 has not been selected to represent an appropriate benchmark to compare Elm Ridge Management's performance, but rather is disclosed to allow for comparison of Elm Ridge Management's performance to that of a well-known and widely recognized index and is not intended to imply that the fund's portfolio is comparable to this index either in composition or elementary risk. The S&P 500 Index is a market-capitalization weighted index containing the 500 most widely held companies chosen with respect to market size, liquidity, and industry. The index is calculated on a total return basis with dividends reinvested. (h) The Form 13F that is filed on a quarterly basis by Elm Ridge contains the required details concerning our portfolio.

Where indicated, select performance results included in this document are hypothetical returns which have been compiled by Elm Ridge Management. Hypothetical performance results may have inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. One of the limitations of hypothetical performance results is that they are prepared with the benefit of hindsight. There are numerous other factors related to the markets in general or to the implementation of any specific trading strategy which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results.

Any hypothetical performance results do not include the reinvestment of dividends, interest, and capital gains, and do not reflect the deduction of Elm Ridge Management's investment advisory fees. Thus, actual return will be reduced by the advisory fees and any other expenses which may be incurred in the management of the fund. All investments involve risk including the loss of principal. Cumulative and annualized returns are shown. Cumulative returns represent the amount, including all interest or dividends and capital gains received on an investment over a period, usually expressed as a percentage of the amount invested. Annualized returns represent the increase in value of an investment, expressed as a percentage per year.

Contribution figures are estimated and may not sum due to rounding and compounding effects. Estimated Gross Long and Short Contributions are calculated independently by compounding the respective monthly returns.

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