Muddy Waters Capital LLC
(Working from Home)
Austin, Texas
USA

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Dear Investor:

In almost six years of managing your and other investors' money, this is the first investor letter that I've written. The catalyst for writing this one is to talk about our new fund, which launched in mid-February of this year. After I get through the fund-speak, I have thoughts you'll hopefully find interesting on the intersection of monetary policy and the future of humanity, a newfound understanding of Elon Musk, and the political decay liberal democracies are experiencing.

The Domino Fund

On February 16th, we launched the Domino Fund. The Domino Fund takes its name from the analogy I've used for years to describe short activism – i.e., that it's a "power game" (in contrast to long side activism, which is a "finesse game"), in which you knock down as many dominos as possible at the outset. Successful short activism relies on an occurrence of a sequence of metaphorical dominos falling, such as auditor changes, director resignations, or managerial unwillingness to act as aggressively, in order to generate "wins."

The problem for short activists is companies that are subject to short activist campaigns tend to manage their information dissemination far more carefully than before the campaign. In a world in which the market playing field is angled sharply in favor of charlatans, I have not felt confident that I can tell with "the naked eye" when a management is going to pull a rabbit out of the hat, and jam up the share price over the long-term, versus when the gig is up. (I think that fortunately the substantial majority of our campaigns bring an end to the financial rewards of the chicanery.) However, this inability for the naked eye to see what's going on internally creates a timing problem for short activists – specifically, when should we cover? If we hold on too long, we can see the fruits of months of hard work (possibly followed by years of litigation) erased. I've been able to survive 11 years as a short activist by always being willing to close too early, versus too late. However, it has been clear to us that we've left real money on the table over the years.

In early 2018, we began working on a fund that would try to avoid the "too early problem" using AI to advise on when to close positions. Working with a team of data scientists, we readied the AI by the end of 2019. We dubbed the AI "LANA", which stands for…I don't remember. But the point is that we think we learned something from watching tech bros over the years, and so we gave our AI an attractive-sounding female name. We were more thoughtful about the new fund's name though. Because the purpose of Domino is to maintain sizable risk positions that break the too early barrier, we named it after our favorite short activism analogy.

The Domino Fund was supposed to launch in 2020. But we were also supposed to move the office in 2020, and I was supposed to drink less and exercise more in 2020 too. 2020 happened, and so the launch was postponed until 2021. And then another "funny" thing happened on the way to the launch: Fucking GameStop.

Just before GME, we were set to launch with probably ~$70 million. But then GME and Melvin Capital happened. This carnage spooked some investors, and we launched with much less, and are presently at approximately $30 million in commitments (Domino uses a draw structure). We're shit at marketing, but we're no stranger to that fact, so we're not uncomfortable with this launch. However, I do feel that Gabe Plotkin owes me a nice steak dinner along with a sublime bottle of wine.

We've approached Domino more conservatively than we had planned in 2019. Our initial position sizes were smaller than we anticipated, although since April, we've generally been fully-sizing our positions at their inception. We've also been quick to de-risk positions, at times somewhat overruling LANA. The result has been lower volatility than we expect over time, but results that we're reasonably happy with.

Since inception on February 16, 2021, Domino has returned approximately 10.9% net through August 6th,[1] which compares nicely to our hard closed Global Opportunities Fund ("GOF"). GOF has returned approximately 7.4% since Domino's inception.[2] Interestingly, Domino got a roughly 2.6% boost during the first week of August, while GOF ticked down approximately 0.2%.[3] Domino had a sizable position that GOF no longer had in size, and which fell apart last week.

While Domino won't always look smarter than GOF, we're nonetheless pleased by this early performance.

<u>A Cancelled Visit from The Prophet</u>

This is a true story, even though it's hard for me to keep a straight face while writing it. One of the accomplishments I've had this year is to stick Chamath Palihapitiya with the name "SPAC Jesus." I came up with this name after waking up on a Sunday morning and seeing that the erstwhile SPAC promoter had, during a run of faux populism, Tweeted "There are only two priorities: Inequality + Climate Change." There are few expressions of human proclivities that I can stand less in this world than fake populism. Like a proud father, I smile whenever I see someone using that name for Chamath somewhere in the Twitterverse.

Last week, I dreamt that (for some reason) I had reached out to Chamath to schedule a meeting. (To be clear, I wouldn't mind meeting the guy so long as he has a sense of humor – and a willingness to share his leg workout routine.) Anyway, there I was in my dream waiting for him to show up when his assistant arrived instead. She told me with bureaucratic relish that Chamath would not be meeting me after all. Then after a few scenes of a Los Angeles that doesn't actually exist, I woke up at 3 am in a panic. I had a revelation – one that I still believe is true several days, and many hours of sleep, later.

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[1] Muddy Waters' estimates for an investor in the Muddy Waters Domino Master Fund LP (the "Domino Fund") based on net returns from February 16, 2021 through August 6, 2021. These net returns are calculated based on capital account balance invested during that period (not the commitment amount), are unaudited and not verified by any third party.
[2] Muddy Waters' estimates for an investor in the Muddy Waters Global Opportunities Onshore Fund LP (the "GOF Onshore Fund") based on net returns from February 16, 2021 through August 6, 2021. These net returns are calculated based on capital account balance invested during that period, are unaudited and not verified by any third party.
[3] Muddy Waters' estimates based on net returns from August 1, 2021 through August 6, 2021 for an investor in the Domino Fund and the GOF Onshore Fund, respectively. These net returns are calculated based on capital account balance invested during the first week of August (not the commitment amount, in the case of Domino), are unaudited and not verified by any third party.

Interest rates must stay at ridiculously low levels in order to de-carbonize the economy. I believe that for the coming few decades, interest rates will be at these levels in order to stimulate investment in technologies to de-carbonize. I think that will become the express policy of the ECB, BOJ, and eventually the Fed. To the extent that governments ever had the ability to allocate technology investments well, those days are long gone. I don't believe government-directed spending will be the answer. So much of the needed investment will be value-destructive – as Tesla (absent accounting bullshit, subsidies, and credits) shows. And I'm no environmentalist – my two-driver household is the proud owner of 30 cylinders of ICE collectively producing almost 1,400 horsepower. But seriously, our way of life isn't sustainable.

Does this mean that what we do as activist short sellers is – or will be – futile? I don't think so. There will be a torrent of charlatans who come out of the woodwork to cheat people out of their money based on false promises of disruptive technologies – witness RIDE, NKLA, and our short of XL. We at MW have no edge when it comes to evaluating technologies, and I suspect that our short activist brethren like Hindenburg don't either. But we excel at playing the man – not the ball. And that's what's needed to ferret out the shysters from the Elon Musks.

But haven't I publicly called Elon a "liar" and railed against his lies and cheating? Yes, but let me digress for a moment. Last month, we took a small group of summer interns to New York to meet with accomplished people from various corners of Wall Street. One of the meetings was with one of my favorite people in the investment business. He's as successful as one can be, having built a fantastic business over multiple decades. We were at lunch with him, and he stated that "integrity is everything in our business". Playing the role of sidekick, I chimed in by stating that if I realize that someone has ever lied to me, that person "is dead to me". (It's been chronicled why I'm so sensitive to even the slightest whiff of dishonesty.) Then this person went on to tell a great story, but one that on the surface completely belied the point about integrity.

He graduated years ago from a non-Harvard type university, and he badly wanted to be in finance. He applied to all of the investment banks, but kept getting rejected before getting the chance to even interview. After receiving a rejection from an HR manager at First Boston, he called the First Boston switchboard and asked to speak with a "Vice President." Amusingly, he didn't know that Vice President was probably the most common title on Wall Street at that time. The switchboard operator connected him to the first VP who came up in the alphabetical directory. "Tom", as we'll call the aspiring banker, then told the random VP that the HR manager (who'd signed the letter) had instructed Tom to call the VP and schedule an interview. The VP was a little surprised, but agreed on a day and time.

Tom went to the city and had a great meeting with the VP. The VP said, "Let me introduce you to somebody else", and did. The rest of Tom's day went the same way, with everybody liking Tom and introducing him to more senior colleagues. At the end of the day, somebody quite senior phoned the HR manager and said he wanted to make Tom an offer. The HR manager demurred, explaining that First Boston had already rejected Tom. The banker then insisted that First Boston would make Tom an offer. Tom got the offer, and went on to have an amazing career that he's still building. As I heard this, I thought admiringly of 22-year old Tom and his chutzpah. But how to square this with an emphasis on integrity?

The reality is that a certain amount of bullshit is necessary – even desirable – in life. I tried on the spot at that lunch to formulate a bright line rule for the interns – i.e., a way for them to know what the necessary / desirable bullshit is, versus what is a lack of integrity. I was unable to. The truth is that acceptable bullshit versus lack of integrity is situational and requires accurately reading the bullshit tolerance of your audience. Jedi Mastery is being able to set your audience's acceptance level for the amount of bullshit you want to deliver. Nobody embodies this better than Elon.

It was only after the Prophet SPAC Jesus canceled his visit to me in my dream that I understood Elon Musk. Or at least got a far greater understanding for him than I had. To be fair to myself, I was telling people as early as 2013 that I wouldn't short Elon Musk. My saying at the time was "Whether you want to go long him or not is a different question, but he is way too skilled at pulling rabbits out of the hat to short." Some years later, an interview I did with my TV foil, Wilfred Frost, generated clickbait headlines about me saying we were short Tesla and that it would go bankrupt. The reality is that we had been long TSLA bonds, and had used the coupons to buy long-dated deep OTM puts. The puts came tantalizingly close to paying off in 2019, but Elon pulled the requisite rabbits out of the hat, the Fed loosened in response to Covid, and our puts went to Put Heaven.

While I always admired that Elon demonstrated the viability of EVs with the Model S and has built rockets that really do innovate and work, I disdained his incessant bullshit. I felt it was an unnecessary stain on his legacy. But with what I think is newfound wisdom about the way the world needs to work, I'm less hostile. In my view, the Tesla shorts have been right and wrong all along about Tesla's problem.

Tesla shorts have focused on Tesla's lack of scale to compete in EVs with GM, Ford, VW, etc. They are correct in that lack of scale would have been the death of Tesla. But they were looking at the wrong scale. Tesla is here not because it has scale in terms of manufacturing base or unit sales. It has scale because of its *capital base*. At the end of the day, for someone who can actually make the fucking car drive and the rocket fly, that is all that matters. All those years of lying (e.g., "funding secured"), wars with short sellers that we assumed were driven only by his pathological narcissism, and trampling rules he found inconvenient have given Tesla capital base scale. With Tesla having an enterprise value of ~$700 billion, it has far more capital scale than any competitor.

One could look at Tesla's market cap and think it's fragile – that reality will shatter it. However, Tesla should be able to raise many billions before its cap becomes sub-scale – and keep in mind that Tesla equity raises tend to push the stock higher. (Those "dumb money" investors actually knew that capital base scale is what mattered all along.) The other issue with the fragility view is that while the cap could crumble under the weight of reality, it's not actually that hard to keep it up. It certainly doesn't require selling the number of cars that Toyota does! It just requires Elon to continue setting his audience's receptivity level of bullshit to Absurdly – if not Adoringly – Accepting. Might he fail? Maybe. But look at the iterations of Elon's image – from that of a humanity loving environmentalist to gladly letting Ted Cruz hang from his jock while flouting the law. The market cap, the luster, the elan of Elon, is still there.

But I return to the proposition that there are still numerous opportunities for activist short sellers. Most charlatans will be too charlatany to make a real car or rocket. If we retain our focus on playing the man, but with a better-informed framework for assessing him, we can continue to do well. The biggest threat to our model comes not from infinite emergency monetary policy, but from the erosion in the rule of law that liberal democracies have experienced.

In my wars in continental Europe, I've repeatedly made the point that you cannot separate politics from capital markets. The capital markets are where political and financial power meet. The French and Germans value relatively free expression when it comes to matters of government and politics, but have been notoriously averse to capital markets-related critiques. (Credit where credit is due though – France seems to have evolved a decent bit in the past five years.) I believe that there is a feedback loop between the lack of rule of law in the markets and in broader society. The more that our elite enrich themselves while violating the spirit – if not the letter – of the law without negative repercussions, the more it erodes the rule of law because the public becomes increasingly radicalized and viscerally opposed to institutions. As institutions erode, you have more untouchables like Elon Musk (or numerous other people of whom you've never heard), which creates more radicalization, and so forth.

I see both political parties as nihilistic in their own ways, trying to destroy institutions directly while egging the other party on to do the same. Additionally, both the left and right routinely assault the freedom of expression, which is the lifeblood of what we do. Therefore, the political dysfunction of America is the largest threat to the viability of the activist short selling model. Because at some point, government actors must hold market participants accountable at least some of the time. Without that, there really is no financial disincentive to be long a debt-fueled fraud.

I believe that President Biden is a centrist, and that his win was a triumph for anti-nihilism. I am concerned though that centrism, while holding the break in the dam, cannot hold the dam itself. We're going to remain out there for the foreseeable future, pulling down the pants of the grifters in the markets. If there comes a day when that's completely ineffective, grieve not for us, but for the national greatness that is lost. In the meantime, if you want to join us on our mission of tilting against windmills while trying to make some scratch, give us a shout.

Sincerely,

Carson Block

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