

MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC

150 N. MICHIGAN AVENUE, SUITE 800, CHICAGO, ILLINOIS 60601

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Dear Fellow Investors,

It's been a great year for the markets so far and an excellent quarter for our portfolios as well. We never take our eyes off the risk factors, though. In this letter we share lessons learned from some of the most important decisions investors have to make – saying “no” to an opportunity. The pitches that we don't swing at are just as important as the ones we choose to hit.

Midway Capital Value Portfolio Returns

| | Midway Composite (net of fees) | S&P 500 TR Index | Difference |
|--|-----------------------------------|------------------|------------|
| Q2 2019 | 6.31% | 4.30% | +2.01 |
| 2019 Year To Date | 18.38% | 18.54% | -0.16 |
| Annualized Return Since Inception | 10.09% | 10.19% | -0.1 |
| Total Return Since Inception | 187.9% | 190.7% | -2.8 |

Data reflect total returns (including dividends) net of fees as of 6/30/2019. Inception date is 7/1/2008. Returns are unaudited. Your individual returns reported on your statements may vary from the composite depending on when you invested and upon any special instructions or restrictions applicable to your account. The composite return is the time-weighted return of all our accounts added together into one big pool. We believe it is the best indication of how the average client fared during these time periods.

Bad Blood – Four Investor Lessons from the Implosion of Theranos

There's an important lesson at the root of every failure. Sometimes there are many lessons. We recently read *Bad Blood* by Wall Street Journal reporter John Carreyrou¹. The book documents the failure of Theranos, a former Silicon Valley startup that made blood testing equipment. The story is painful to read with the benefit of hindsight – the lessons all seem so obvious now. Yet they weren't at the time, causing many professional investors to lose many billions of dollars. It's difficult to believe that so many prominent investors were

¹ Carreyrou, John. *Bad Blood: Secrets and Lies in a Silicon Valley Startup*. New York: Knopf, 2018.

duped. Theranos provides a powerful lesson about the fallability of human judgement. Case studies like this give all of us the opportunity to benefit from the expensive lessons others paid for.

Lesson 1: Don't be persuaded by a good show

By all accounts, Theranos' founder and CEO, Elizabeth Holmes, is a brilliant presenter. Even in the face of overwhelming evidence to the contrary, her supporters remained committed to whatever Holmes was pitching. Carreyrou writes, "One after another, she wrapped people around her finger and persuaded them to do her bidding. The first to fall under her spell was Channing Robertson, the Stanford engineering professor whose reputation helped give her credibility when she was just a teenager. Then there was Donald L. Lucas, the aging venture capitalist whose backing and connections enabled her to keep raising money. Dr. J (Jay Rosan) and Wade Miquelon at Walgreens and Safeway CEO Steve Burd were next, followed by James Mattis, George Shultz, and Henry Kissinger."²

George Shultz, who at various times was Secretary of Labor, Treasury, and State, as well as dean of the University of Chicago's business school, was a Theranos investor and board member. Shultz's grandson, Tyler, landed an internship and eventually a full-time job at Theranos. After working with Theranos' equipment, the younger Shultz became acutely aware that his grandfather had been sold a bill of goods. He raised a red flag, but Holmes persuaded the grandfather that Tyler was pursuing a misguided vendetta against her. As the truth about Theranos came out, Tyler became an important source for Carreyrou. The elder Shultz orchestrated an ambush by Theranos lawyers against his 20-something grandson, seeking to coerce him into recanting his statements and signing more forceful confidentiality agreements. So taken in was Shultz that he eventually communicated with his grandson only through lawyers while Tyler racked up more than \$400,000 in legal bills.³

Shultz's zealous devotion to Theranos was not unique. The company's supporters represent an impressive amount of brainpower that fell hopelessly under the spell of a charismatic leader. It's important to remember that no matter how strong one's instincts may be about a given situation, judgement is always subjective. Holmes could persuade plenty of investors to believe her technology worked, but she couldn't persuade science to bend to her wishes.

Lesson 2: Don't copy off your neighbor

At its peak, Theranos was valued at close to \$10 billion. We'd guess at least 90% of the losses stemmed from ignoring lesson two. One of the company's last funding rounds occurred in February 2014, when Partner Fund invested \$96 million giving Theranos a total valuation of \$9 billion. The previous round – occurring just six months earlier – placed a \$6 billion valuation on the firm. According to Carreyrou, the reputation of Theranos' board of directors played a big role in attracting the Partner Fund investment⁴. In effect, Partner Fund was betting that Shultz, Kissinger, and Mattis were keeping a watch over things. In reality, the three had no medical training and were all completely under Holmes' influence. All three received stock grants in exchange for their board membership.⁵

² P. 299

³ P. 287

⁴ P. 182

⁵ P. 181

Partner Fund didn't ask for audited financial statements. Audits aren't required for nonpublic firms, and as far as we can tell, Theranos didn't pursue one. A company with a \$9 billion price tag can easily afford to pay for an audit, and receiving one indicates the company's financial operations are at a bare minimum, functional. Holmes and her team routinely gave out grossly inflated and inaccurate numbers. Carreyrou states that in 2013, Theranos engaged a consultant to price stock options. The closest thing Theranos had to a chief financial officer offered the consultant projected revenue of \$134 *million* by 2015. Partner Fund had been told six weeks earlier that 2015 revenue was projected to be \$1.68 *billion*. Both numbers were optimistic⁶.

Shortly before the Partner Fund investment, Lucas Venture Group made an investment following a similar research approach. They were told the company "had been cash flow positive since 2006," and "had signed contracts and partnerships with very large retailers and drug stores as well as various pharmaceutical companies, HMOs, insurance agencies, hospitals, clinics, and various government agencies."⁷ Yet Lucas Venture did not request an audit or audited financial statements, nor did it seek to verify details of these claims independently.

Lesson 3: Remember the fat pitch.

Warren Buffet made a famous comparison between baseball and investing. In a baseball game, a batter gets three strikes. The batter may find a pitch too high or too low, but if it's in the strike zone, he'd better swing. Investors, Buffet points out, don't have a three-pitch limit. Investors can let dozens of borderline pitches pass by waiting for the perfect opportunity – a fat pitch right down the middle of home plate.

Theranos was incredibly secretive about its technology. Partner Fund didn't perform any inspections of Theranos' machines. Prospective partners were shown information from studies that had already – allegedly – been completed. Details were scant. When a consultant with Walgreen's asked to perform his own studies, his concerns were brushed aside⁸. The same consultant proposed breaking the machine's security seal to inspect the internal mechanism; this was strictly forbidden by Theranos' contractual language. The consultant was eventually removed from conference calls with Theranos because "they felt he was creating too much tension and that it interfered with getting work done."⁹ Holmes' charisma was enough to ensure her boosters could push her viewpoint past any objections.

A lot of Theranos' secrecy was explained as protecting trade secrets. But aren't prospective co-owners entitled to a greater degree of access than the general public? Without independent confirmation, what assurance exists that Theranos has a positive balance in its checking account? Or that it even has a checking account? Theranos' reluctance to give its investors more than a Power Point presentation should have flashed a signal: this is not a fat pitch.

Lesson 4: Controlling, intimidating executives are bad news

Holmes' public persona was of a bold and innovative genius. But behind the scenes, she was ruthless, and was backed up by her even more ruthless chief operating officer. The company threatened those who offered dissenting viewpoints with lawsuits alleging defamation, violations of nondisclosure agreements, and

⁶ P. 181

⁷ Pp. 177-178

⁸ P. 89

⁹ P. 93

disclosure of trade secrets. An Army lieutenant colonel who evaluated Theranos' products for use in the field came under fire from 4-star general (and later Defense Secretary) James Mattis after his warnings resulted in a surprise inspection of Theranos' headquarters. As Carreyrou started making inroads building his story, he and his sources noticed they were being followed; this surveillance continued for more than a year. Other sources including Theranos' former employees and even medical professionals who had used Theranos products were threatened with lawsuits and reputational harm if they didn't recant their critical statements.

The notion of a tyrannical chief executive as an uncompromising visionary was romanticized following Steve Jobs' success. But most tyrannical executives are destined for failure. They don't have the facts on their side, so they resort to bullying and intimidation to get what they want. In the Theranos case, they were trying to perpetuate a lie, and they lashed out vengefully at anyone who casts doubt on their supremacy.

Conclusion

After reading *Bad Blood*, we were paranoid about nearly every investment we owned. How could we be *sure* Pfizer's newest drug actually worked? How could anyone without a medical degree know if its purported JAK1 inhibitor was science or snake oil? Fortunately, investing in public companies offers many assurances unavailable when dabbling in private investments.

For starters, audited financial statements are mandatory. These include plain-English descriptions of a company's main business and products. Also, the amount of overall information is far greater in public markets. Pfizer issued a press release announcing the results of its JAK1 study; the full results are published in a peer-reviewed medical journal, and the internet has no shortage of patients eager to share their opinions about a given medication. Wikipedia describes the relationship between atopic dermatitis, cytokine receptors and Janus kinase (JAK) inhibitors in great detail, complete with helpful links to related definitions and explanations. In short, the data is available and can be assessed independently, making us confident that we can evaluate a firm like Pfizer. Since the day Midway Capital opened its doors, we have committed to doing our own original research, not following the crowd. These founding principles at Midway are still the core of our investment philosophy and the lessons in *Bad Blood* remind us why.

Crypto, Weed, and Dangerous Things

Doctors are asked for health advice. Actors are asked about how to break into show business. Investors are asked about hot investments. Right now, that means cryptocurrency and marijuana. Rachel's hockey coach pulled her aside in the middle of the ice during practice to ask about Canadian marijuana stocks! Many of our clients have asked similar questions and we are glad that you ask. We are always happy to discuss investments of any sort and we hope you will ask us if you have questions about some of these riskier parts of the market. Typically we have already done quite a bit of reading and thinking about those topics and we have a considered opinion. If not, we can do some homework and get back to you with one. As investment professionals, it's our job to research these developments.

If you have ever wondered whether you should buy a Bitcoin, you are in good company. But do you understand how cryptocurrencies work? If so, you are definitely in the minority. Thinking about the lessons from Theranos, that should definitely give you pause. To truly understand the potential of these types of currencies as stores of value, you first need to understand blockchain and the mining or minting processes. Then you need to understand currency markets and why they work (or don't). That involves more than a

quick evening's reading. After doing our own work on these topics, we think the Achilles heel of cryptocurrencies, including the new Libra being floated by Facebook, is government regulation and the potential for criminal activity. Anonymous and untraceable currencies offer tools for criminals that would make Al Capone's Chicago Outfit look like small potatoes. Consider the potential for money laundering and for buying and selling illegal goods and services. Drug dealers could avoid having to carry around suitcases of cash. Terrorists could easily and anonymously receive money from backers anywhere in the world. Countries could avoid sanctions. Venezuela recently floated its own cryptocurrency called the "Petro" to avoid international sanctions on selling its oil. Law enforcement would need a way to track transactions in cryptocurrencies. That would mean they couldn't be anonymous.

The other big sticking point is competition with existing currencies. The point of currencies like Facebook's Libra is to make transactions cheaper. Typically, online payments are done with credit cards which charge fees of around 2%. These new coins would eliminate those fees, making virtual transactions both fast and cheap. Customers could have an account full of Libra Coins and transact with almost no frictional costs. This might cause consumers to prefer Libra to dollars or euros. Regulators have already realized that competition with national currencies could be devastating and they are seeking to regulate them like banks. This is partly to prevent people's life savings being vaporized. (If your checking account is all in Libra Coin and there is no FDIC for cryptos – one hacker could take it all and it would be gone forever.) But also, governments don't want to risk losing control of their currencies. The German finance minister is reportedly worried that the Libra could become an alternative to the Euro. It would be difficult to implement monetary policy if citizens switch to another currency. Those are huge, scary issues and it's unlikely that governments will give much quarter here. In the best case scenario, cryptocurrencies could become highly-regulated storehouses of value – like the dollar or the euro. This would make them functional, but not exciting. Right now the value of these coins fluctuates wildly, making them suitable only for speculators who don't mind losing their shirts.

In contrast to the high-tech cryptos, marijuana is a farm product that already has issues with oversupply and falling prices. The excitement around legal cannabis has enticed many entrepreneurs to open up little dispensaries and it is becoming a very competitive industry. The excitement has also led many investors to salivate over all the growth that could happen if pot becomes legal in more places. But look beyond the hype, and we see nothing more than a farm commodity with regulatory issues. As a whole, the industry is losing money. Sales are growing but profits are not materializing. Competition is fierce, from both legal and illegal dealers. Taxes are high in many states, and the usual farm issues make supplies volatile (harvests are affected by weather and growing conditions). Since cannabis is still illegal under federal law, routine activities like opening a bank account can be impossible for even legal dispensaries. In short, it's a tough low-margin business with lots of competitors. We're not interested. Even if we were, growing or distributing cannabis is illegal under federal law and financing this in any way (such as buying a marijuana stock for a client) is a criminal money laundering violation even in states where pot is legal. So we won't be risking any jail time to put cannabis stocks in your portfolios. That said, we don't feel like we're missing much. Call us squares, but we'll pass on grass.

Your partners in investing,



Rachel Barnard, PhD, Todd Schrade, CPA, and the Midway Capital Team

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