Relativity Capital Advisors

Hawk Alpha Discovery
Annual Letter

January 15, 2019

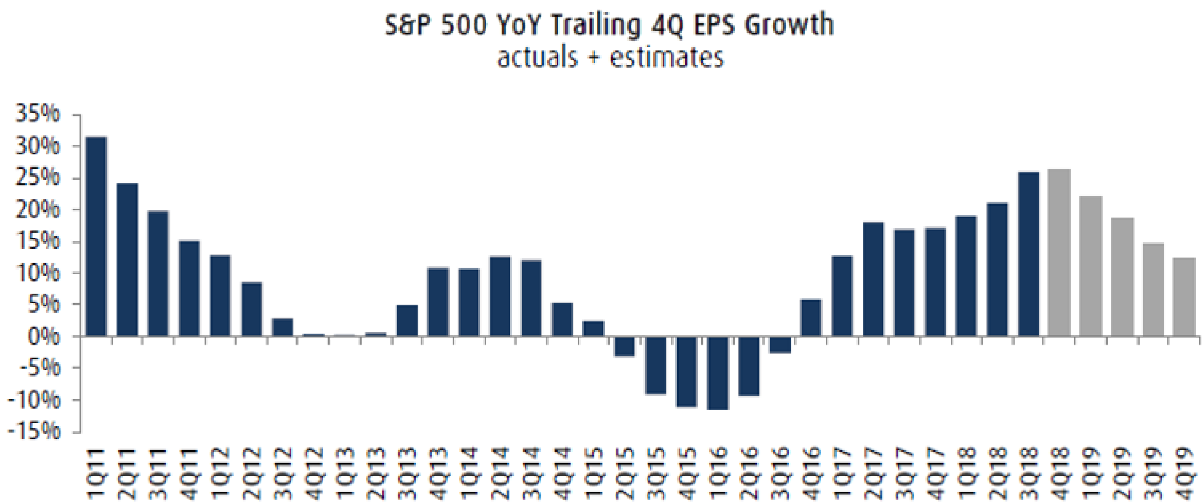
Dear Investors:

In 2018, Relativity Capital's *Hawk Alpha Discovery Portfolio* declined approximately 12% (audited returns will be made available shortly), compared to the Russell 2000 (IWM) losing 11%. Performance saw a boost in December and carries some momentum into 2019 (shown below). Our max drawdown was -18.68%, compared to the IWM at -26.8% and S&P at -19.34%.

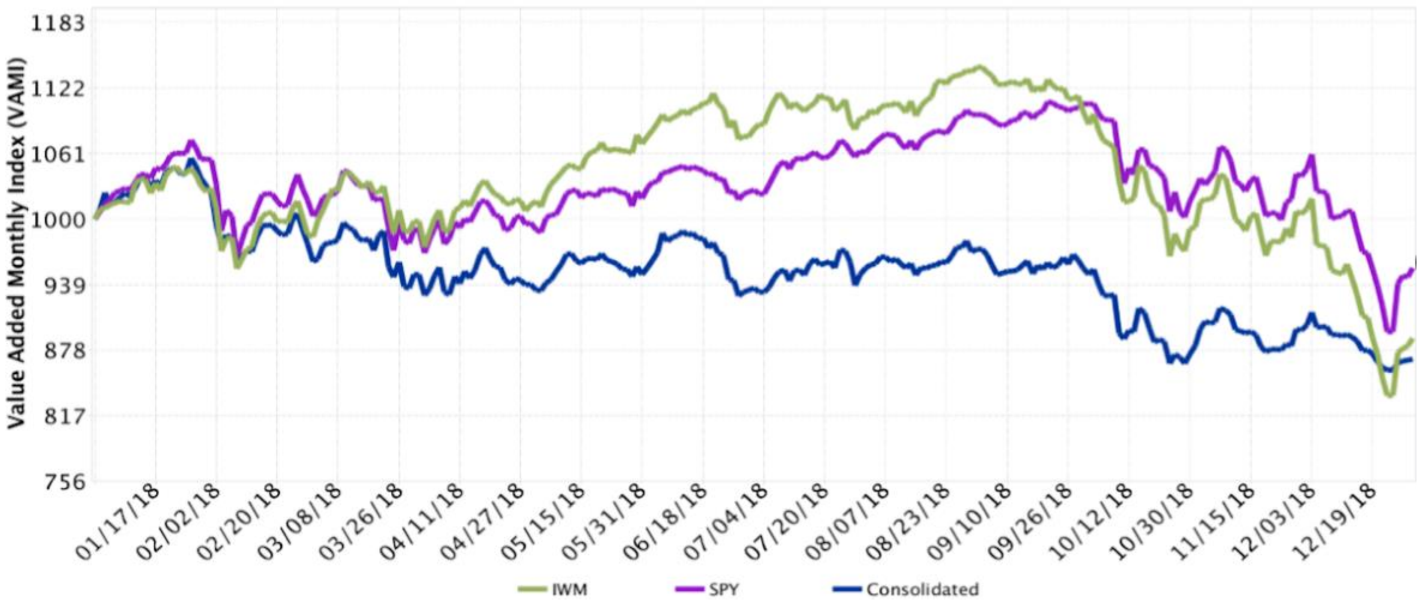
Cumulative Attribution Effect

In 2018, we closed 449 trades with a win rate of 57.14%, down from a 71.92% win rate in 2017 which was wildly strong. A few top contributors included SodaStream (SODA) call options as it was acquired, Foundation Medicine (FMI) call options as it was acquired, call options in Diamondback Energy (FANG), Mercado-Libre (MELI), Harris (HRS), Align (ALGN), Intuitive Surgical (ISRG), Spotify (SPOT) as well as stock positions in Twitter (TWTR), Alteryx (AYX), Trex (TREX), Atlassian (TEAM), and Proto Labs (PRLB). Directional options positions resulted in most of the negative contribution in 2018 as many positions moved through stops with gap opens during the time of heightened volatility and wide overnight trading ranges. A few of the negative contributors via call options included Masco (MAS), Mohawk (MHK), Electronic Arts (EA), PACCAR (PCAR), Air Products (APD), CDK Global (CDK), and Moody's (MCO). A few earnings event-driven plays were also negative contributors with Autodesk (ADSK), UPS (UPS), Visa (V), PayPal (PYPL), and Broadcom (AVGO). The main negative contributors for stock positions centered around commodity related names with EnCana (ECA), Pretium (PVG), Arcelor (MT), Parsley Energy (PE), and Total SA (TOT). We had 10 earnings plays, which we keep allocations smaller, expire for 100% losses, while 8 regular option positions expired for 100% losses. On the flip-side, we only had 6 positions close for 100% or greater gains in 2018, a year that lacked the homeruns and weighed on overall results. On 114 call option positions, we had a win rate of 56.14%, though a net negative dollar return, so tighter loss controls on these positions is an objective in 2019. On 39 earnings related directional trades, the win rate was 58.97%. We saw positive net dollar returns on stock positions paired with puts. On directional put positions, we had an 85.7% win rate, something we want to incorporate more especially with multi-year uptrends broken. The win rate on equity positions was 55.94%, 20 positions with a 10% or greater loss, and 15 with a 10% or greater gain.

After 2017 closed very strong, 2018 brought a return to a new era of volatility with sharp corrections in February and March that caught us a bit off-guard and put us behind the eight ball early. We were unable to catch up in the strong May-September period with a new sense of hesitancy expecting further market woes ahead considering a lack of liquidity in markets, group think and high concentration at hedge funds, and numerous Macro/Market headwinds including but not limited to slowing China, Trade Wars, Political Instability, Fed Rate Hikes, Inverting Yield Curve, and Peak Earnings concerns following a sugar high from a one-time occurrence with Tax Reform. It was a frustrating Q1 driven by headline risk, often from Presidential tweets, and/or other key policy makers discussing China Trade and/or the Fed, resulting in a number of unfortunate stop outs in names that later rallied sharply higher in Q2/Q3.



The hesitancy did bear fruit in Q4 when global markets suffered historically bad returns while the Hawk Alpha Discovery Portfolio was more focused on capital preservation with low exposure levels and utilization of protective puts, covered calls, and collars boosted results. Managing risk took precedence and although many risk management strategies used in 2017 were a drag then, in 2018 staying disciplined and maintaining our core investing strategy helped weather the storm in Q4. 2018 went down as a historic year in which no asset class performed well and there really was no place to stay invested in Q4 when nearly every sector was pulled lower in a global risk-off and rush to liquidity. These kinds of moves are exactly why being active and moving to low-exposure equity holdings is ideal. We will continue to target “best of breed” names in growth industries that have strong profitability, a wide moat, strong management and fit into one of the seven classes of great investments. These main classes, and there are more, include pure revenue growth stories in growing markets, sustainable MOAT, market share takers and disruptors in large TAMs, product mix shift and margin expansion stories, accelerating growth causing multiple re-ratings, new product and replacement/upgrade cycles, and consolidator stories with synergies and growth.



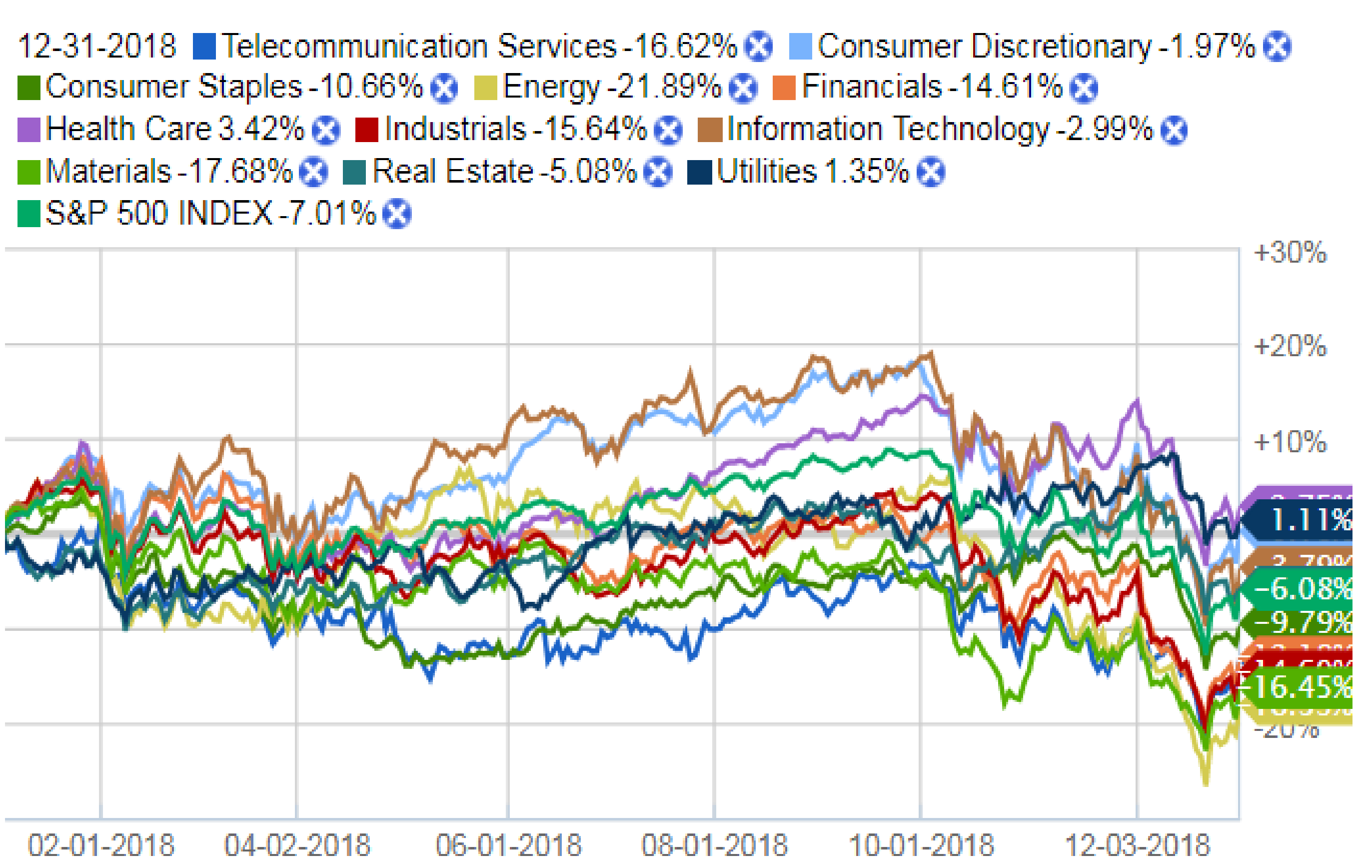
We are in the midst of a major investing environment shift and must be mindful of balance sheets avoiding high debt companies in a rising rate environment, though the Fed has recently turned more dovish in its approach for 2019. There were a number of concerning economic readings in December showing the US is slowing rapidly with China, and Europe is likely also to suffer a slowdown in 2019. After years of strong performance, cyclicals are seeing multiple compression while defensives gain attractiveness. It will be important to continue to closely monitor Macro data as well as quarterly earnings reports and management commentary. After breaking down each and every industry, we have 350 top names to focus on in 2019. We also want to be focusing on Late Cycle leaders with Healthcare, Energy, and Materials typically outperforming. One positive for markets is that years of double-digit earnings growth with PE contraction, like 2018, have tended to perform well the following year.

Sector	Early	Mid	Late	Recession
Energy	−−		++	
Health Care	−		++	++
Materials		−−	++	−
Consumer Staples	−		+	++
Utilities	−−	−	+	++
Consumer Discretionary	++		−−	
Info Technology	++	+	−−	−−
Comm	−−			++
Financials	+			
Industrials	++	+		−−
Real Estate*	++			−−

++ Consistently Overperform   −− Consistently Underperform   No Clear Pattern
\+ Overperform   − Underperform

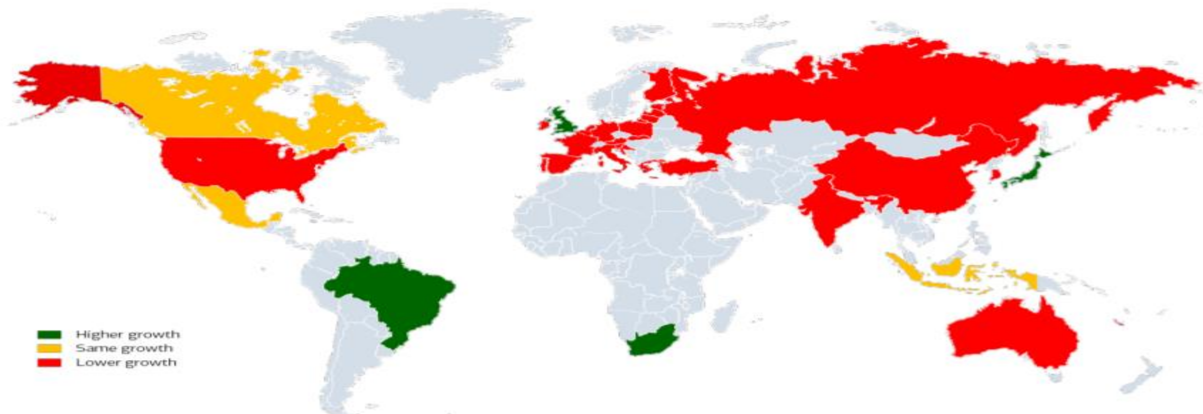
2018 In Review

2011	2012	2013	2014	2015	2016	2017	2018
UTIL 19.9%	FINL 28.8%	COND 43.1%	REAL 30.2%	COND 10.1%	ENRS 27.4%	INFT 38.8%	HLTH 6.5%
CONS 14.0%	COND 23.9%	HLTH 41.5%	UTIL 29.0%	HLTH 6.9%	TELS 23.5%	MATR 23.8%	UTIL 4.1%
HLTH 12.7%	REAL 19.7%	INDU 40.7%	HLTH 25.3%	CONS 6.6%	FINL 22.8%	COND 23.0%	COND 0.8%
REAL 11.4%	TELS 18.3%	FINL 35.6%	INFT 20.1%	INFT 5.9%	INDU 18.9%	FINL 22.2%	INFT -0.3%
TELS 6.3%	HLTH 17.9%	S&P 32.4%	CONS 16.0%	REAL 4.7%	MATR 16.7%	HLTH 22.1%	REAL -2.2%
COND 6.1%	S&P 16.0%	INFT 28.4%	FINL 15.2%	TELS 3.4%	UTIL 16.3%	S&P 21.8%	S&P -4.4%
ENRS 4.7%	INDU 15.4%	CONS 26.1%	S&P 13.7%	S&P 1.4%	INFT 13.9%	INDU 21.0%	CONS -8.4%
INFT 2.4%	MATR 15.0%	MATR 25.6%	INDU 9.8%	FINL -1.5%	S&P 12.0%	CONS 13.5%	TELS -12.5%
S&P 2.1%	INFT 14.8%	ENRS 25.1%	COND 9.7%	INDU -2.5%	COND 6.0%	UTIL 12.1%	FINL -13.0%
INDU -0.6%	CONS 10.8%	UTIL 13.2%	MATR 6.9%	UTIL -4.8%	CONS 5.4%	REAL 10.9%	INDU -13.3%
MATR -9.6%	ENRS 4.6%	TELS 11.5%	TELS 3.0%	MATR -8.4%	REAL 3.4%	ENRS -1.0%	MATR -14.7%
FINL -17.1%	UTIL 1.3%	REAL 1.6%	ENRS -7.8%	ENRS -21.1%	HLTH -2.7%	TELS -1.3%	ENRS -18.1%

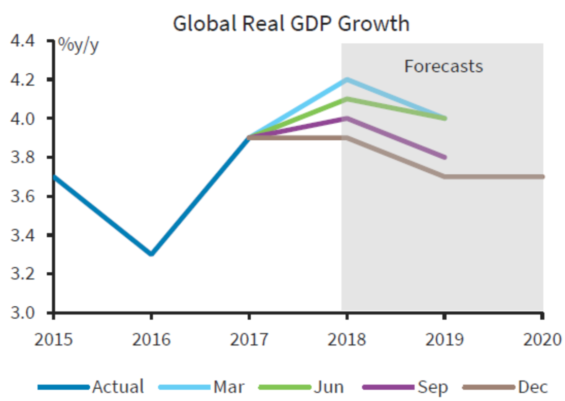


A few notable strong sub-sector performances included Home Health Care, Cleaning Products, Hospitals, Auto Parts Stores, System Software, Department Stores, Business Software and Textile & Apparel. The sub-sectors hit the hardest over the past year include Synthetic Chemicals, Recreational Vehicles, Home Furnishing, Oil Services, Cigarettes, Construction, Brewers, Semiconductors, Food, Gaming, Steel, Building Materials, and Life Insurance.

Chart 1: Global GDP growth set to slow in 2019



2018 was a year of revising down…



as the synchronized global upswing had peaked in late 2017 …

A Look Ahead to 2019

We enter 2019 with a market seeing large daily swings up and down and in a firm downtrend, though yet to break the uptrend off the 2009/2011/2016 lows. The market put in a large weekly reversal candle in late December right at the 200 week MA which tends to be support in cyclical corrections within a secular bull market, and the level was also a 50% retracement of the 2016/2017 range. There has been plenty of technical damage and prefer to target names of relative strength within industries still experiencing secular growth trends leading to strong top and bottom line growth. Software remains a very attractive area ripe for further M&A and valuations have moved back off extremes while offering outsized growth in large available markets. Healthcare also remains a focus area for longs due to demographic trends as well as its late cycle outperformance trend. A new playbook is required for the slowing growth, late cycle environment. The Fed Funds market is shifting to show a likely pause throughout 2019 for rate hikes which can boost sentiment for risky assets. There remain plenty of short and long term opportunities, but certainly a period to be more selective and control risk more tightly. A number of key market headwinds need to abate to return to a pro-growth environment, namely China Trade.

Strategy, Theme, and Stock Ideas

As we are seeing a shift to defensive from cyclical and towards value from growth there is a need to remain flexible in terms of strategies and themes. Housing related stocks fell sharply in 2018 but there remains a fairly positive demand/supply imbalance and with yields back under pressure, a potential area of outperformance in 2019. Software and Med-Tech remain the focus for longer term growth upside and continue to favor a number of names. Within the Industrial space we have concerns with a number of peak markets like Auto, but Automation, Aerospace, and Defense remain in favorable environments with a number of opportunities after the recent "baby with the bathwater" style sell-off. Biotech is always an area where stock selection is critical, and the year started with a massive M&A announcement as Bristol Myers offered to acquire Celgene at a healthy premium. The payments space with leaders like Square, MasterCard, Visa, and PayPal still has ample room for growth. The casino group was one of the first to signal China trouble selling off, and also one of the first to bottom out in Q4, so easier comps may be a positive theme there in 2019. The Semiconductor group was one of the worst performing in 2018 as the cycle peaked, and it is important to avoid the ones connected to weaker themes like Memory, PC, Mobile and focus on Data Center, AI, 5G, IoT and other areas of growth. There also may be some shorting opportunities in the more defensive groups where valuations remain fairly rich, especially if the fears of slowing growth are shown to be overblown early in 2019.

Having screened each industry on the appropriate fundamental metrics we already have a playbook ready for whatever environment the market shows in 2019, as it's much better to be reactive than predictive in uncertain environments.

Bullish Theme	Preferred Stock	Bullish Theme	Preferred Stock
Self-Driving Cars	Google (GOOG) - Waymo	IoT	Silicon Labs (SLAB)
Rising Healthcare Costs	United Health (UNH)	LIDAR	Teledyne (TDY)
Oncology	Novartis (NVS)	Swiss Tech Vendors	Alteryx (AYX)
Streaming Media	Disney (DIS), Spotify (SPOT)	Home Renovation	Trex (TREX)
Diabetes	Abbott (ABT), DexCom (DXCM)	Space Age 2.0	Raytheon (RTN)
Heart Health	Edward's (EW)	Global Waste	Waste Connection (WCN)
Robotic Surgery	Intuitive Surgical (ISRG)	Latin America	Mercado-Libre (MELI)
Online Payments	PayPal (PYPL), Square (SQ)	Retail Treasure Hunt	Ross (ROST)
Alternative Energy Sources	NextEra (NEE)	Faster Product Cycles	Proto Labs (PRLB)
Entrepreneurial Economy	Intuit (INTU)	Storage Tech	Pure Storage (PSTG)
Beauty Spending	Estee Lauder (EL)	Mobile Data Boom	SBA Comm. (SBAC)
Genetic Analysis	Illumina (ILMN)	Cloud Computing	Salesforce.com (CRM)
Alternative Beverages	Keurig Dr. Pepper (KDP)	Cannabis	Innovative Industrial (IIPR)
Chip Complexity	Xilinx (XLNX)	Animal Health	Zoetis (ZTS)
Collaboration Software	Atlassian (TEAM)	Gene Therapy	Sarepta (SRPT)
Network Security	Palo Alto (PANW)	Defense Spending	Aerovironment (AVAV)
Small/Medium Business	Shopify (SHOP), Etsy (ETSY)	Aging Population	LHC Group (LHCG)
CPaaS	Twilio (TWLO)	Millennial Spending	Lululemon (LULU)
Digital Advertising	Trade Desk (TTD)	Big Data	Splunk (SPLK)
Healthy Living	Herbalife (HLF)	Electric Vehicles	Sociedad Minera (SQM)
5G	Ciena (CIEN)	Climate Change	TPI Composites (TPIC)
Gaming Regulations	Churchill Downs (CHDN)	Water	Danaher (DHR)
Cloud Contact Centers	Five-9 (FIVN)	Social/Mobile	Match (MTCH)
Home Automation	Alarm.com (ALRM)	Shale Boom	Diamondback (FANG)

Conclusion

In closing, Relativity Capital is approaching 2019 with an open mind, seeing valuations much more attractive than last year at this time, but also realizing a shifting late-cycle environment calls for a modified approach. Once broader markets calm, the best of breed names will outperform and our ability to screen for these names both fundamentally and via relative strength technical indicators positions us to capitalize. We look forward to expanding our client base and also looking at a more quantitative approach to entries and exits utilizing machine learning and AI. We will continue to work diligently to allocate client capital with a methodical approach and optimizing the reward/risk balance.

Sincerely,

Joseph Kunkle
Head Research Analyst
Relativity Capital Advisors

(Dow Jones US indexes are used for analysis)
(Market data above are derived from Senteo, Interactive Brokers, and Reuters Datalink)
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