Heijin Capital

2018 ANNUAL INVESTOR LETTER

An overview of the past year and projections for 2019

A Message From Our Managing Partner & CIO

Dear Prospective Investors, Clients and Friends,

It is no doubt that 2018 was a year full of surprises, whether this was in the markets or in the political world. In fact, I believe it's fair to say that the world was 'shaken up' over the past year. After a tumultuous November and December most markets erased their gains for this year and last year, which came as a surprise to most investors. Again we are seeing huge outflows in the hedge fund world as well as various once great investors closing shops. So one may wonder why would we, Heijin Capital, still be willing to enter the hedge fund business after most have barely managed to survive? And the answer to that is simple: the Heijin team and I love what we do, and unlike most, we now see what key structures have to be kept in mind in order to thrive in this industry.

Almost two years ago Heijin Capital was initially founded as an investment research firm, and today we are almost ready to fully transition into a real hedge fund. For the past 4 months the team has been working extremely hard on our soon-to-be flagship fund that we have decided to call the Vulture Fund. At its core, the Vulture Fund will take advantage of a 'post-crisis' environment and build a lasting portfolio for our investors. All in all, history has proven that humanity is often influenced by psychology and emotions and that in business it's almost always best to start 'when blood is running in the streets'. Or just as J. Paul Getty said 'Buy when everyone else is selling and hold until everyone else is buying.' These are also some of the core principles of Heijin Capital.

Since the founding of Heijin Capital, I have always strived to not only make sure we have a team that is flexible in their thinking, but also grounded by the fact that we work with our clients as if they were family. This culture was instilled within the team from early on as we managed some of the capital of each others' families as well as our own together. And from my perspective it seems as though the world of fund management has lost its touch because people do not trust it. Now, most manage capital with algorithms or artificial intelligence influenced systems. Where have the real partnerships gone?

We believe that the investment strategies that will maintain a balance between high conviction speculation and long term value-driven asset allocations will work best. In the long-run we expect that these will outperform the ones that depend on all sorts of mathematical and computer-based models. Of course it's important to take advantage of some quantitative and big data breakthroughs, which we are doing with our research. But, it is also vital to reflect on the kind of work that we are doing for society and that businesses such as high frequency trading are not the type that will truly make us proud at the end of our careers.

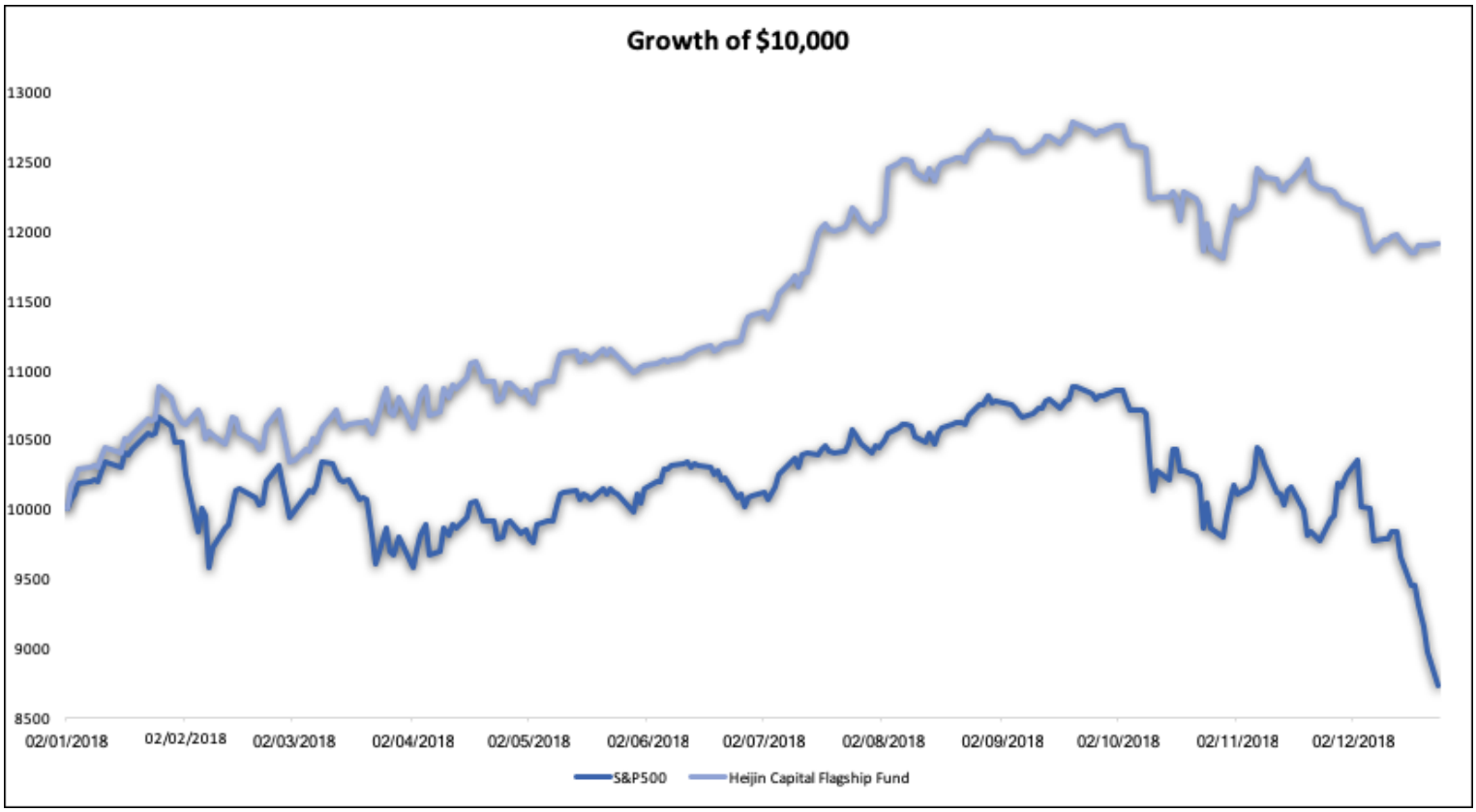
The year ahead will, once again, undoubtedly be full of surprises and we should expect more turbulence in the financial markets. Unfortunately, it seems as though things will get worse before they get better. But that also means that there will be many opportunities to be seized. At Heijin Capital, 2019 will without a doubt be one of the most endearing times. Our team will ensure to continuously work hard in order to add value to our clients.

The Heijin Capital Team wishes you an incredible year ahead full of joy, happiness, and fulfilment.

All the best,
Gregory Laurent Josi

Main Fund Performance Overview

Main Fund Alpha v. S&P 500: **+18.91%**
Main Fund Alpha v. DJIA: **+16.57%**
Main Fund Alpha v. Global MSCI: **+24.63%**



New Improvements for 2019

Algorithmic Research Strategy

This year Heijin has begun working on a proprietary quantitative research strategy to streamline our process to search for opportunities. The reason for our step into the quantitative finance world is that we have observed that some of our core tasks like analyzing companies' financials could be done by an algorithm and thus give the Heijin Capital Team more time to focus on different tasks. Thereby, we do not want to build high-frequency, hyper complex trading algorithms as some quantitative hedge funds use as we do not have the resources to compete against them and it does not align with the culture at Heijin. However, we want to leverage the means technology gives us as an aid to our research and decision making process and help Heijin generating higher alpha with lower risk exposure.

Our quantitative strategy uses a vast amount of different pointers ranging from fundamental signals targeting the yield, growth or quality of a financial product to statistical pointers targeting the momentum or reversion of a stock. Although the concept of creating an quantitative research algorithm is quite straightforward, it has proven to be actually very difficult to generate consistent alpha generating ideas due to many reasons. The first difficulty is to find the right parameters for the algorithm. Although we basically just have 5 different types of alpha generation parameters, they can be combined in infinitely many different ways and thereby require a lot of trial and failure in order to find the right parameters. Another caveat of developing quantitative research strategies emerges from the backtesting process, which means testing a strategy on historical stock prices. The first problem is finding high quality quantitative data as most free data sources have inaccurate data. Other problems that arise from the backtesting process is the overfitting of an algorithm, the consideration of liquidity and spreads and errors that most open-source backtesting libraries have.

Nonetheless, despite all these problems, Heijin is still convinced that it can benefit from the huge potential of algorithmic research strategies and helping generate a solid return for our fund. The ideal outcome of our work on the quantitative research strategy would be an algorithm that gives us suggestions/frameworks that would be analyzed by us and eventually executed.

And now onto our performance.

Heijin's Best and Worst Picks of 2018

Petrobras (NYSE:PBR)

Underlying	Instrument	Type	%PnL
NYSE:PBR	Common Stock	LONG	40.67%
NYSE:PBR	Jan 2019 Call Option @ $13 Strike	LONG	270.69%
NYSE:PBR	April 2019 Call Option @ $12 Strike	LONG	300%

The Petrobras position is a prime example of Heijin's key principles, finding undervalued stocks with pivoting financials and a firm platform for growth. Petrobras had been hit with a plethora of bad press, including a high profile corruption case involving the 64% state-owned oil giant (in addition to low oil prices), subsequently, leaving the stock grossly undervalued.
We combined our research on Petrobras' brilliant debt restructuring programme and their joint ventures with other oil bohemouths, with our bullish outlook on oil, and our confidence in the election of the right wing President Bolsonaro, resulting in the confidence to go forth with the position.

J.C. Penney (NYSE:JCP)

Underlying	Instrument	Type	%PnL
NYSE:JCP	Common Stock	SHORT	65.00%
NYSE:JCP	January 2019 Put Option @ $2.5 Strike	LONG	67.92%

JCPenney's financial profile was irretrievably damaged with a poor ecommerce standing and overexpansion, in particular, a large amount of unserviced debt on their books.Their business model of constant markdowns on price and the reliance on coupons to generate store traffic, although propped up revenues in the short run, was wholly inadequate to secure long term growth.

Moreover, since approximately 30% of the price movement of this stock was due to it's sector & industry performance, we researched into the health of the american highstreet and concluded JCP was a failing firm in a shrinking sector.

While high-gross margin categories could improve (women's apparel lapping mid-single digit percentage declines in '17), most growth will still be from low-gross margin categories (appliances, eCommerce). Importantly, we're particularly concerned that competitors will reinvest tax savings in lower prices. J.C. Penney's ~2% EBIT profit margin ex-gains in '17 leaves little room to lower margins to compete. In '18, we assume comparable store sales up 1.1%, gross margin up 40 basis points, and operating expenses down 2.7% year over year (which may be aggressive as industry credit income slows), resulting in $920 million in EBITDA (Street: $919 million). However, we think any investment in price by competitors could create incremental downside EBITDA risk for J.C. Penney.

Chesapeake Energy (NYSE:CHK)

CHESAPEAKE ENERGY

Underlying	Instrument	Type	%PnL
NYSE:CHK	Common Stock	LONG	25.35%

Chesapeake has a growing crude production but still is predominantly a natural gas provider. Thus the decline in Nat Gas prices has put Chesapeake's high operating costs into the spotlight, causing investors to lose confidence. Oil accounts for 16% of production and nat gas is by far the largest, making CHK heavily exposed to Nat Gas price fluctuations. Many investors see this as an intrinsic weakness but we at Heijin see this as a core strength in the coming months and years, due to over bullish outlook on Nat Gas. Heijin believed that this fall in Chesapeake's stock price was caused predominantly by the disruption in the sector, rather than the firm itself. We held 3 positions in CHK common stock, one of which was closed at a profit, and we currently have the other two at a 30% loss after a complete decimation in its sector. However, we haven't booked these losses as we know that CHK moves in cycles and it is not rare for it to move 50% or more in just a couple of months due to the wild NG prices (why it's a commodity nicknamed the widower) and swinging volumes.

Natural gas is the new wave of power in the US and on the global stage of electricity production with no other technology coming even close to the potential of Nat gas, effectively bridging the game between coal and renewables.

Although many LEDC's and developing economies will continue to use the more "crude" (apologies for the double entendre) forms of energy i.e. Coal and oil. The more developed nations, especially the G20, are under increased pressure to reduce pollution, therefore although coal and oil will remain dominant for the coming years, it will lose major market share to natural gas. The global energy outlook predicts a 45% increase In global natural gas production and use by 2040.

GoPro (NASDAQ:GPRO)

Underlying	Instrument	Type	%PnL
NASDAQ:GPRO	March 2018 Put Option @ $9 Strike	LONG	50.00%

Heijin saw that GoPro had begun to stagnate in regards to the innovation of new products and had very little room to grow in their saturated market. The decreasing technical innovation of their products year on year meant that despite their best efforts , each new release become more and more homogenous to the last. GoPro's innovation curve completely flattened out, thus heijin saw the potential for the initial trade idea. Our base research (1D and 2D) indicated that GOPRO was well past its prime and that their stock was both overvalued and had falling financial health.

Micron Technology (NASDAQ:MU)

Underlying	Instrument	Type	%PnL
NASDAQ:MU	Common Stock	LONG	-15.04%

Micron had been solid financially and proved itself by beating earnings on consecutive releases. We believed that Micron due to its solid financials and strong growth structure would have been a brilliant addition to our portfolio.

However The oversupply in DRAM industry may have been overlooked, whatsmore Micron's 20% loss occurred, amongst other things, in response to Trump's tariffs announcements, as investors have priced in a trade war risk premium. Thus despite our analysis, the socio-political climate has of course, taken its toll on the portfolio. On top of that we were too stubborn on Micron Technology as we had no gradual position selling as it approached our target price. And with Micron it's price fell $1.2 (or 1.8%) from our sell target price at $65/share where we would've secured a 43.8% gain in just 3 months.

Facebook (NASDAQ:FB)

Underlying	Instrument	Type	%PnL
NASDAQ:FB	Common Stock	LONG	-12.20%

When the FAANG stocks took a slump in late july, Heijin believed that Facebook had fallen too much, and had begun to trade at a discount. This, in addition to their robust financial profile and superb growth strategy led us to open a position in early August. Despite our detailed analysis, we could not have foreseen the unfortunate events that Facebook experienced in the following weeks and months. The main slump in the stock was caused by shock events that were out of our hands. The combination of the Cambridge Analytica scandal and the subsequent highly televised meetings between Facebook management and Congress was the primary reason for the disappointing performance of this position.

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Thank you for your understanding,
Heijin Capital Management

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