17 July 2012

Dear Partner:

Davian Capital LP I and Davian Capital LP II (collectively, the "Partnerships") returned +3.10%, and +6.46% net of fees and expenses, respectively, in the second quarter of 2012, bringing the respective year to date net returns to +12.44% and +23.09%.

"Success is the result of perfection, hard work, learning from failure, loyalty, and persistence." - Colin Powell

The above quote is one of our favorites and is an excellent opening to this quarter's letter. We had a truly phenomenal quarter in which our longs held flat or went up and our short positions went down much more than the market. This performance was also generated while taking on very little risk. At the end of the quarter *Davian Capital was the number one ranked long/short equity hedge fund based on our annualized Sharpe ratio!* Congratulations to our entire team who continues to work very hard for all of our clients.

The Sharpe ratio is one of the most widely used risk metrics in the investing world and measures the excess return per unit of risk. Quite simply, it measures how much risk is taken to generate the return and a higher number is better.

Davian Capital had an average Sharpe ratio of 2.97 throughout the second quarter of 2012! This means the partnership generated nearly 3 units of excess returns per unit of risk taken. Our returns to date have been generated while taking very little risk and that should be comforting to all of our partners. Our entire team remains committed to generating handsome returns for our partners while keeping risk on a tight leash.

This quarter's performance and risk metrics had many partners asking, "how was the partnership so well positioned this quarter and year?" The answer to this is far from simple. We attribute the second quarter of 2012 and the entire year to "perpetual improvement" and that will be outlined below.

Perpetual Improvement: "Capital isn't scarce; vision is." Sam Walton

At Davian Capital Advisors ("DCap") we are not afraid to look at ourselves, our investing process, and our positions critically. Actually, we applaud and encourage this throughout our culture. We realize that in today's markets, you either improve and adapt or die. There is no in-between anymore.

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1. Take profits and stay nimble

As the markets have become more and more volatile in the past quarter, we upped how actively managed the portfolio is by our staff. When a long position has a nice run, we trim it back and sell covered calls. We then redeploy the capital on the inevitable pull back taking the position back to full strength.

The same is also true for our short positions. As our short positions collapse we have taken profit, sold covered puts and then redeployed the capital on the inevitable bounce.

2. Tighten net exposure as volatility rises

As the markets became more and more volatile we adjusted the overall net exposure bracket down from a -40% to +100% net short/long exposure to -40% to +40%. While the partnership(s) style box is classified as an equity long/short, this tighter bracket makes it more of a hybrid. It now places the partnership in between a market neutral strategy and a traditional long/short equity fund.

We feel even more comfortable running at this tighter net exposure bracket because we generate much of the partnerships' alpha on the short side of the book.

3. Hedge when it is cheap

The move from the spring into the summer showed us that investors were falling asleep behind the wheel and getting complacent. The VIX and volatility as a whole fell and hedging options became "cheap." We would pay very little for SDS calls and being long calls would also position us net long volatility.

We opened the partnerships' SDS call position into the end of 1Q12 and this position alone hedged off 30% of the long book. It also added +250bps in May!

Anytime the market moved down pushing our SDS calls higher, we would actively sell out of the money (OTM) weekly call options against our core long call position. These OTM call sales have helped finance 40% of the partnerships carry cost in these SDS call options. We continue to hold this hedging position, but have trimmed it back at a profit. We will continue to sell weekly options as we see fit and hope to have the market pay for 75% of the carry when all is said and done.

4. Our team

Since last year DCap has made a strong commitment to invest heavily in human capital. We have staffed up and broken up our coverage universes, which spread out the research burden.

With the addition of more staff, idea generation has never been stronger! Every idea/thesis is being more thoroughly challenged than ever before. Our staff is a diverse group with many different backgrounds and experiences. This only further solidifies strong idea generation and thesis analysis.

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5. Adding non-correlated carve outs

The addition of our "gravity" carve-out has been utterly huge. This is a non-correlated strategy that helps generate alpha in any market condition. Most importantly, it has no correlation to the main portfolio, which helps hedge off the main long/short portfolio.

While the "gravity" carve out is a 100% short system, it generated a near +12% gain while the S&P 500 rallied +14% earlier this year. Under normal circumstances the system being flat during this period of time would have been excellent, but this actually produced sizeable gains. Just another reason we are so excited about this carve-out.

Outlook: "It is not enough to merely know. One must know and do." - Napoleon Hill

The slowdown in China and Europe continues. Our worst fears have for the most part played out and we have the partnership in a very good position regardless of what the outcome is/was.

The U.S. Federal Reserve did not embark on another round of quantitative easing version 3.0 ("QE3"). They did however extend their current "operation twist" program. The way the Fed has structured and prolonged Operation Twist, it is very possible that QE3 could be enacted this fall.

The Fed has an uphill battle to fight with the looming Presidential election this year. No president or presidential candidate wants to support another round of QE3, but the Fed will not sit idly by as the labor market deteriorates and the economy slips back into a recession.

But, is another round of QE the answer? We do not think so. Rates cannot go any lower and it is destroying the buying power of savers and those on fixed income. The government would like everyone to believe that there is no inflation right now. These people obviously do not fill up their own gas tanks or shop for their family's food. There is definitely inflation right now and it is those on fixed income who are being hurt the most.

Let's take a look at the saver dilemma from another perspective. Everyday in America 10,000 baby boomers turn 65, which is traditionally the age of retirement. With CDs and money market funds offering little to no return, a baby boomer now needs more capital set aside to retire. If the additional capital is not there, they are forced to stay in the work force longer. Staying in the work force longer keeps young people graduating from college from finding a job and the unemployment rate ticks higher. Does not seem like QE is helping this much at all.

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The Fed assumes that with interest rates near 0%, corporations will take in the "cheap money" and expand their businesses. This expansion SHOULD cause corporations to hire more people and ultimately get more Americans back to work and lower the unemployment rate. One aspect the Fed is drastically underestimating is how much economic uncertainty weighs on this decision.

Let's pretend you are the CEO/CFO of a middle to large level corporation (some of you are, so stay with me). Interest rates drop to nearly 0% and you decide to go into the market to borrow simply because it is so cheap to do so. You subscribe to the old adage of always borrow when you do not need to, never borrow when you need the money. It is nice to have the balance sheet flush with cash. Investors, board members and stakeholders will be happy about the additional cash parked on the balance sheet and your stock price could go up. Now we turn to what do we do with the cash on the balance sheet and this is where the Fed has it wrong.

With China slowing, Europe on fire and the U.S. economic health in question, we find a very uncertain economic future. If the economic outlook is uncertain we are concerned to put the cash we raised cheaply to work. We decide as a company that unless we can buy another company with immediate synergy, we will leave the cash on the balance sheet. Why risk it?

This is the inherent problem the U.S. Fed has created. They simply thought that flooding the system with liquidity and cheap money would be enough. What they drastically underestimated would be the power of economic uncertainty. Until this uncertainty is removed, corporations will continue to suck in cheap money and park it on their balance sheets. There is little incentive and certainty to take on risk.

Equities: "If you don't have a competitive advantage, don't compete." - Jack Welch

We opened a significant new long position in Volkswagen AG (XETRA: VOW or U.S. ADR: VLKAY) and two new notable short positions in Herbalife (NYSE: HLF) and NuSkin (NYSE: NUS).

Volkswagen Aktiengesellschaft ("Volkswagen AG" or "VW"), together with its subsidiaries, engages in the manufacture and sale of automobiles worldwide. The company operates in two divisions, Automotive and Financial Services. The Automotive division engages in the development of vehicles and engines; production and sale of passenger cars, commercial vehicles, trucks, and buses; manufacture of large-bore diesel engines for marine and stationary applications, turbochargers, turbomachinery, compressors, and chemical reactors; and production of vehicle transmissions, special gear units for wind turbines, slide bearings, and couplings, as well as testing systems for the mobility sector. Its product range extends from low-consumption small cars to luxury class vehicles; and commercial vehicle sector ranges from pick-ups to buses and heavy trucks. The Financial Services division offers dealer and customer financing, leasing, banking and insurance, and fleet management services. The company provides its products under the Volkswagen, Audi, SEAT, KODA, Bentley, Bugatti, Lamborghini, Volkswagen Commercial Vehicles, Scania, and MAN brand names, as well as services under the Volkswagen Financial Services brand name.

Volkswagen AG is on track to become the number one auto manufacturer in the world and their Audi brand is set to overtake BMW as the number one super premium brand by 2016. The company has a brand portfolio to die for and covers the entire spectrum of fleet sale vehicles all the way to the exotic ultra-luxury Bentley, Bugatti and Lamborghini.

Volkswagen AG currently trades at a 3.6 price to earnings multiple and a low price to cash flow multiple of 11. We believe the company should trade at much higher multiples, but there have been two large overhangs on this stock.

The first is the overall economic situation throughout the world and specifically the Euro zone crisis. Germany is the anchor for the Euro zone and the markets are scared that Germany will get fed up of countries like Spain, Italy, Greece, etc. and simply walk away from the Euro, but that will not happen.

Germany is an export-based economy and these types of economies thrive when their currency is weak. It makes the goods they produce more competitively priced and that drives demand up. If Germany was not on the Euro currency right now, they would have a much higher priced currency and their exports would be significantly less competitive.

The second overhang on Volkswagen stock has been the whole Porsche fiasco. A few years ago Porsche tried to buy up all VW stock in the markets and a huge stock squeeze ensued. That fell apart and we are now in the position where VW is set to swallow Porsche. This will only further strengthen VW's brand portfolio, but the uncertainty being lifted should cause VW's multiple to expand and a near term catalyst to get the stock price moving in the right direction.

The partnership established our long position at €128.12 and shares ended the quarter at €118.85.

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Herbalife Ltd. (HLF), a network marketing company, offers science-based products in four principal categories worldwide: weight management; targeted nutrition; energy, sports, and fitness; and outer nutrition. The company also sells literature and promotional materials, including sales aids, informational audiotapes, videotapes, CDs, and DVDs to support its distributors marketing efforts, as well as start-up kits for new distributors. Herbalife Ltd. offers its products through retail stores, sales representatives, sales officers, and independent service providers.

We believe that at its core, HLF is nothing more than a pyramid scheme. While the company does in fact sell a product, the question is whether they provide an incentive for their "distributors" to sign up more and more people. This is actually one of the major deciding factors of whether a company is an actual pyramid scheme or a "multi-level marketing (MLM)." We believe HLF operates outside of this rule and does in fact provide incentives for distributors to add more and more people below them. HLF trades with a 14 price to earnings multiple and we think this is way too rich given the risk involved with this business model. We feel that over time the pyramid will collapse and the equity will be worth little to nothing.

The partnership established our short position at $49.26 and shares ended the quarter at $48.33.

Nu Skin Enterprises, Inc. (NUS) develops and distributes anti-aging personal care products and nutritional supplements worldwide. The company sells its personal care products under the Nu Skin brand and nutritional supplements under the Pharmanex brand. The company sells its products primarily through a network of independent distributors in north Asia, the Americas, Greater China, Europe, and the south Asia/Pacific; and through its retail stores in China. As of December 31, 2011, it operated 40 stores in China.

NUS operates just like HLF we mentioned above. We believe NUS is also operating like a pyramid scheme and rather pick the better of these two short positions, we have instead taken a position against the business model as whole. Rather than pick a horse in the pyramid scheme race, we have bet against the race as a whole.

NUS has not drawn the level of attention that HLF has and trades at a much higher price to earnings multiple of 16.24, so there is a lot of room to drop in this name. Of the two MLM/pyramid scheme companies, NUS seems to have more problems than HLF.

Of NUS's 80,000 "independent distributors" only 0.06% or 48 of the 80,000 make money. But this does not mean they make a lot of money. It could be that they make just above the break-even point and this seems to be the case according to our research. A woman distributor we talked to only made $11 the entire 3 years she was a NUS distributor. The company claims some people make millions being a NUS distributor, but if true, it is a tiny percentage.

According to a recent study, 99% of all those who have participated in multi-level marketing do not make money. Many of these people do not even break even. All of these points and more are reason as to why we are so excited to be short these two companies and the business as a whole. The partnership established our short position at $45.97 and shares ended the quarter at $46.90.

House Keeping:

We would like to welcome Anthony James Davian Junior to the DCap family! He was born April 19th to Anthony and Danielle Davian. Daddy is already talking about how excited he is to have a "little caddy."

Rajat Chadda joined DCap as a full time intern starting in June. Rajat just graduated from Akron Hoban High School in June and decided he would like to have hedge fund experience going into his freshman year of college! Not many seniors graduate from high school and spend their summer interning at a hedge fund. Rajat is obviously very different from most and we expect him to accomplish big things in his life.

Formal invitations for the Third Annual Client Event August 4th were sent out to all DCap clients. We will be attending the Bridgestone Invitational at Firestone Country Club during the day with a party at the DCap loft in downtown Akron immediately after. Please make sure to RSVP by July 25th and please mention if you will be attending the golf tournament, the party at the DCap loft, or both.

At the quarter end, the largest positions in the partnerships were Apple, Chipotle Mexican Grill, Whole Foods Market, Monster Beverage Co. and PNC. The Partnerships had an average exposure to equities of 61% long and 39% short.

Best Regards,

DCap Advisors LLC

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Positions reflected in this letter do not represent all the positions held, purchased, or sold by the Partnerships, and in the aggregate; the information may represent a small percentage of activity in the Partnerships. The information presented is intended to provide insight into the noteworthy events, in the sole opinion of Davian Capital Advisors, affecting the Partnerships.

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