Statement of Investment Philosophy

-Human inertia makes the everyday environment, the furniture, as it were, appear to be a given.

~Todd Gitlin

We are firm believers in the old, yet powerful, truism that "value will out." It is a truism because we believe that markets are efficient enough to recognize intrinsic values over time; it is powerful because we believe human investors are not always efficient enough to do so in a timely or orderly fashion. This friction, grounded in humans' bounded rationality, is the principal source of the inefficiencies we seek to exploit. Markets are efficient, but not so efficient as to shut out the diligent, value-focused investor.

The challenges for value investors, however, are manifold. As the *Wall Street Journal* put it, "some critics say the measures used to identify value have aged poorly in a market dominated by passive investing strategies and asset-light technology companies."[1] While it is true that metrics such as price-to-book or price-to-earnings that may have signaled value in the era of Benjamin Graham or even the heyday of today's venerable value investors no longer carry as much weight[2] due to structural shifts in the economy, changes in accounting standards, and increased information in markets, we maintain that it remains possible for a value investor to "buy a dollar for fifty cents" through diligence, patience, and attention to detail. No longer able to rely on simple indicators of value, value investors must zero in on cash flows and how they result and persist due to the individual fundamentals of a business. We must know our companies intimately and personally, and soberly assess their advantages and disadvantages in generating future cash. In this way we can begin to estimate intrinsic value.

By focusing on intrinsic value, maintaining the long view at all times, and sticking to highly conservative assumptions about cash flow and rates of return, it remains possible to find value investment ideas even in a broader market that is increasingly dominated by giga-cap tech stocks trading sometimes at hundreds of times their free cash flow. The key ingredient, though, is diligence and willingness to do the homework; to work around the human inertia that prevents markets from being "strong form efficient." This insight is consistent with Lo's contention that "market efficiency cannot be evaluated in a vacuum, but is highly context-dependent and dynamic."[3] These inefficiencies are often fleeting, exist in only certain sectors or certain companies, and only at certain times. They can nonetheless be found and exploited before all market participants notice them.

When we speak of inertial inefficiencies, there are four specific inefficiencies that we focus on.

a. Failure of the market to appreciate a company's advantages.
    i. In our view the principal cause of this inefficiency stems from market participants not listening to management, or management not communicating effectively. In the absence

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[1] "Value Investors Face Existential Crisis After Long Market Rally," *Wall Street Journal*, 4 June 2018.

[2] Analysis of Fama/French 3 Research Factor data (available at http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html) shows that the contribution of the book-to-market factor, known as high-minus-low or HML, has fallen. To wit: the 10-year moving average HML factor exceeded 2.3 for all years from 1946 to 2013 except 1999, when it was 0.65. Since 2014 it has been *negative*. The 5-year moving average HML was positive at all times from 1946 to 2008 with two exceptions: 1999 and 1991. Since 2009 it has been negative in 8 out of 9 years (the 5-yr MA was positive in 2016 after the "Trump Trade"). This persistency has never happened before, emphasizing the declining importance of price to book as an indicator of value. Various economic and structural factors have driven this shift.

[3] Lo, Andrew. "The Adaptive Markets Hypothesis," *Journal of Portfolio Management*, 2004.

of management's insights into the workings of the business, and assuming not everyone does the extra work themselves, the market has imperfect information.

b. Lack of sell-side analyst coverage.
    i. This inefficiency is similar to a., but arises for a different reason. If sell-side analysts do not maintain coverage on a company (because it is too small, or in an unfavored industry, or because it does not generate investment banking business), buy-side investors often must rely entirely on management for their information on the company. This is hard to do.
c. Sentiment.
    i. Often we see otherwise powerful companies dip in price because of earnings misses, or see free cash flow yields spike due to some piece of exogenous news that may or may not affect the ultimate realization of those cash flows. These moments of dropping sentiment can be ripe with opportunity.
d. Technical inefficiencies.
    i. In some situations stock price come under pressure for reasons unrelated to their earnings or cash flows or the gaps in information. They drop in price because of artificial selling pressures. The classical example is a small company spun out of a large company, which then comes under selling pressure as a result of large-cap institutional holders selling the small company because it does not fit their mandate.

We still believe it is useful to divide the world of value stocks in half, not dissimilar from the way Mihaljevic does. For our purposes, we invest in two kinds of companies:

1) Graham "Cigar Butt" Stocks.
    a. These are the classical value stocks that have been overlooked by the market and trade at discounts to their justifiable intrinsic value.
    b. They are what one might classify as "catalyst" stocks. Investors buy them, and wait for the expected catalyst to attract the market's attention.
2) Buffett "Compounding Machine" Stocks
    a. These are high quality companies that generate superior long-term returns on capital. Greenblatt "magic formula" stocks come to mind, though our approach is by no means as mechanistic.
    b. The investor earns a return from the company's own superior return on capital over time. If purchased at a moment of inefficiency at a value price, that return can be amplified, often dramatically.

We believe this approach generates long term returns because investors cannot count on the presently in-favor growth stocks to continue to experience ever-increasing valuation multiples. By relying for our returns on the margin of safety or on the returns on capital of the companies themselves, we seek to achieve consistent, long-term returns with lower volatility than our relevant benchmark.

~Evan N. Campbell, CFA

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