

# PENDER

Forward thinking. Finding value.

## MANAGER'S Q4 COMMENTARY – FELIX NARHI

*“We can ignore reality but we cannot ignore the consequences of ignoring reality”- Ayn Rand*

In this commentary we cover:

- The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them.
- What we did last December when “The Tide Went Out”: Comments on WYNN, SSNC, KKR
- Value traps in the age of disruption and the need to adapt

2018 was a tough year for investors, particularly the fourth quarter, including for us. A number of our holdings dropped in price in sympathy with the market correction. For the year, the S&P 500 dropped 6.2%, the Dow fell 5.6% and the Nasdaq Composite shed 3.9%, marking the worst annual performance for all three indices since 2008. Most other indices and asset classes were hit as well. There was virtually nowhere to hide. Unless an investor held cash, she likely experienced declines in annual returns. Although it always feels like an unusually difficult year when one is actually living through it, statistically speaking, from a long-term perspective, last year was perfectly normal. We began 2017's yearend [commentary](#) with a quote from Morgan Housel, *“Since 1871, the market has spent 40% of all years either rising or falling more than 20%. Roaring booms and crushing busts are perfectly normal,”* which turned out to be unintended foreshadowing. We hoped we would not get our teeth get kicked in, but it happened anyway. At least temporarily. Market swoons are inevitable. When that happens, investors need to channel their inner Kenny Rogers: *“You've got to know when to hold 'em, know when to fold 'em...”* After all, your lifetime results as an investor will be mostly determined by what you do during such turbulent times.

While we worry a great deal about the risk of permanent capital impairment, we don't take quotational losses too seriously when we believe the fundamentals remain intact. Students of market history know that [Mr. Market](#) has a long recurring history of manic-depressive behaviour, where he suddenly changes his mind and becomes desperate to unload his holdings at fire sale prices. This is perfectly normal. Unfortunately, his moods swings can be super contagious. As a result, it hard to resist herd behaviour and follow the crowd. As [noted](#) in the midst of the panic, it pays to keep in mind the timeless adage, *“this too, shall pass.”* Indeed, that truism held again. Since the year ended, Mr. Market suddenly seems to be in a much better mood, and stock prices have recovered to pre-correction levels in many cases.

The volatility driven by extreme fear in the fourth quarter had little to do with long-term fundamentals in our view. The most important thing for us was to maintain an even temperament and look for potential opportunities as dispassionately as possible. This is easier said than done. If you are wired like most folks (including us), your gut will tell you to get out or at least reduce exposure to avoid further pain. But your gut would be wrong in many cases. In his classic book *One Up on Wall Street*, famed investor Peter Lynch offered this piece of advice, *“The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them. Stand by your stocks as long as the fundamental story of the company hasn't changed.”* The queasy feeling we get in the pit of our stomachs is a sure sign that the “tide has gone out” and it was time to switch to a different mode of thinking.

### **What We Did Last December When “The Tide Went Out”**

Last December we alluded to some actions we were taking to capitalize on the mispricing caused by the extreme fear in the market. In our view, none of these additions required particularly differentiated analytical views. The relevant information and analysis that led us to act would have been known by most well-informed market participants who had studied those companies. However, it did require a

behavioural edge, “to ignore our gut” to place an order during a period of extreme uncertainty where stocks were posting new lows, day after day, with seemingly no end in sight. Below are some comments about a few notable buys we made during the market swoon in December.

*WYNN - Recycling a good [close the discount](#) idea when the price is right*

We bought a stake in Wynn Resorts (NASDAQ:WYNN) which owns and operates a number of the world’s most prestigious destination casino resorts. We frequently recycle former ideas and this is the second time we have established a position in WYNN. We view the company as a high quality, albeit modestly growing business. The gaming industry’s recurring cyclical nature, however, is an attribute that can make the stock a terrific trading vehicle from time to time.

We entered the stock for the first time in late 2015 when investors were worried that the corruption crackdowns in China would lead to permanently lower visitations and curtailed spending at its property in Macau. We believed the stock was mispriced and significantly undervalued with pent up potential when the cycle turned again over the medium term. Multi-year swoons are common for stocks in the gaming sector, but betting on the house during such times has proven to be lucrative, because the recoveries on the other side of the cycle can also be significant. Our bet was, “*this too, shall pass*”. And it did. Traffic came back, the malaise lifted and the stock soared. We bought our initial stake in the low \$60s and started to trim our stake in early 2018 at nearly \$200/share because we felt the valuation was starting to get full. Soon thereafter, the facts that were central to our investment thesis suddenly changed. Upon evaluation of the allegations of impropriety against founder Steve Wynn, we sold our entire remaining stake. Business risk had reached unacceptable levels. Nevertheless, it was a terrific trade. All told, we almost tripled our initial investment in two and a half years.

We continued to follow the company after our exit. In the aftermath of the scandal, Steve Wynn was forced out of the company and he sold his entire stake. But the stock kept falling thanks to spillover effects, such as increased scrutiny of existing development projects. Most of the board and senior operating staff also turned over - necessary steps given the serious nature of the allegations. All this uncertainty and negative publicity continued to pressure the stock. And sometimes when it rains, it pours. Most of WYNN’s value is derived from its operations in Macau and the US-Sino trade war and subsequent slowdown in China further eroded the market’s fragile confidence in the story. The final drop came in the fourth quarter, when WYNN dipped further in sympathy with the market sell off.

Despite the high drama in the executive suite and inherent cyclical nature of the business, Wynn Resorts’ reputation as one of the world’s most admired and premier hospitality companies remained intact. With the stock cut by more than half from its earlier peak, valuation risk had been greatly reduced. Moreover, business risk was much lower, in our view, following the overhaul of the company’s leadership team and board of directors. Thus, we decided to reopen a new position in December. Once again, we felt the market is pricing in a fairly bleak outlook, despite the fact that free cash flow should ramp up over the next few years as earnings from new resorts come on line and development spending winds down. We remain hopeful of another favourable experience as we “rinse and repeat” this close the discount idea.

*SSNC – Buy the high-quality [compounders](#) you always wanted to own*

Market panics tend to drive down prices of good and mediocre companies alike. In our view, *if everything is on sale*, why not buy the better companies instead of their mediocre counterparts in order to take advantage of a potential “[double dip](#)”? We have long admired SS&C Technologies (NASDAQ:SSNC) and considered it a high quality compounder. Indiscriminate selling across the board in the fourth quarter finally provided us an attractive entry point to establish our initial stake.

SS&C is a financial services and software company led by founder William Stone who owns 13% of the company. The company provides a comprehensive suite of business processes, such as fund administration and transfer agent services, and sells front to back office technology solutions for

institutional and alternative asset managers. Founder Stone has instilled a decentralized entrepreneurial culture in the organization with a strong focus on meeting the needs of the end customer. The company's solutions are mission critical in nature with very onerous implementations. Although these attributes prolong the sales cycle, they also enhance the company's staying power within organizations and this recurring revenue is very sticky. Returns on tangible capital are mouth watering. Importantly, we believe that the runway for continued growth at a double-digit pace through a combination of organic expansion and a sound M&A strategy remains long. Simply put, it is a terrific business, led by an able and aligned founder.

#### *KKR – Accumulating misunderstood compounders during periods of market weakness*

We also added to our position in KKR (NYSE:KKR) in the fourth quarter, which is an iconic name in the private equity industry and one of the largest alternative asset managers in the world. This is also the second time we have invested in this firm. However, we *now* consider KKR to be a high-quality compounder. Last year, KKR converted from a publicly traded partnership to a more traditional “C-Corp”. We think this is a game changer, because we believe it enables the company to move from a close the discount type of investment idea into the potential compounder category. Going forward, instead of paying out most of the excess free cash flow through inefficiently taxed dividends, the excess capital will be mostly reinvested, with a smaller dividend payout instead. Considering our belief that the underlying businesses have the potential to compound at a mid-teens pace over a cycle, this is a sensible *and* tax advantaged strategy for investors focused on growing their capital over the long-term.

#### **Value traps in the age of disruption and the need to adapt**

*“How did you go bankrupt? Two ways. Gradually, then suddenly.” - Ernest Hemingway, The Sun Also Rises*

*“I’m a terrified dinosaur... I’ve been living in this cozy world of old brands and big volumes. We bought brands that we thought could last forever and we borrowed a lot of cheap money because money was cheap ... You could just focus on being very efficient... All of a sudden we are being disrupted.” - Jorge Paulo Lemann, Co-founder of 3G Capital (April 2018)*

We are increasing cognizant of how today’s age of disruption can impact value creation and the investing process (see prior commentaries [here](#) and [here](#)). There is no question that embracing change, taking risks and having the courage to use today’s mature cash flows to fund new opportunities is not easy. But staying the (misguided) course and maintaining the status quo may be even more dangerous. Defensive sectors that have historically been immune from disruption have been hit hard in the markets, with many stocks tumbling as management team after management team slash their respective outlooks. Steady state strategies focused on operating efficiency, financial leverage and milking cash cows made sense in a declining interest rate environment and where there were minimal outside threats. That world no longer exists. Indeed, many investors are finding that yesteryear’s “defensive stocks” may be just as effective as France’s infamous Maginot Line in World War II. Firms that have been mortgaging their legacy moats to fund dividends and share repurchases while starving their business of innovation and marketing are now paying a heavy price. We believe change is likely to accelerate. Old business models are dying, usually slowly at first, and then suddenly. On the other side of the disruption, new business models are displacing old ones, slowly at first, and then suddenly. These are related themes, as profit pools shift from legacy moats to new customer-centric business models which are enabled by technology. These are uncertain times for those unable to adapt, but exciting times for those who successfully take the leap forward.

We look for founders and business operators who are adapting and willing to reinvent themselves periodically. Likewise, we expect to adapt as well. Now that markets have normalized into a more tranquil state, we are once again looking for “needles in the haystack”. However, in our view it is

increasingly apparent that the best “needles” are no longer found in the same haystacks of the past. When asked recently why many traditional value managers have been struggling, Charlie Munger humorously observed that they were “like a bunch of cod fishermen after all the cod’s been overfished. They don’t catch a lot of cod, but they keep on fishing in the same waters. That’s what’s happened to all these value investors. Maybe they should move to where the fish are.” What a novel idea! To increase the odds of success in a fast changing world, one needs to embrace new ways of thinking and just as importantly, discard old mental models when they no longer apply.

Please do not hesitate to contact me, should you have questions or comments you wish to share with us.

*Felix Narhi*  
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