PENDER

Forward thinking. Finding value.

MOI Global Latticework New York 2019 – The Death of Active Management?

Dave Barr and I attended the MOI Global Latticework New York 2019 event on September 12, 2019. MOI Global, which was founded by John Mihaljevic the author of The Manual of Ideas (see our book review) is a unique membership community of investors, united by a passion for lifelong learning. Pender has been actively involved with MOI Global for the past six years, presenting investment ideas and giving keynote addresses on various investment topics as well as attending several of their global events[1]. Latticework is an interactive event where thought leaders from MOI Global's community share ideas, insights and timeless wisdom for the purpose of intellectual exploration. Previous speakers at Latticework have included Howard Marks, chairman of Oaktree Capital, Tom Gayner, Co-CEO of Markel Corporation and Chamath Palihapitya, CEO of Social Capital.

The enduring theme of Latticework is mental models for intelligent investing and there were several keynote instructors, including Dave Barr, on this year's agenda, presenting on a variety of interesting and relevant topics. If there was an overarching motif in the conversations and discussions we had with other investors, it was the demands and struggles of being active managers. Changes in the structure of the market, the ways technology has enabled businesses to grow and scale, the rapid growth of passive management and the lack of normal business cycles due to a persistently low interest rate environment have made for a challenging investment environment. But, with change comes opportunity, and attendees and presenters were excited to share new strategies, concepts and mental models which can be used to improve the probability of making a successful investment.

Analyzing and investing in a capital light business

One of the topics discussed at the event was the consequential shift in the way technology has enabled businesses to grow and scale with a capital-light model. This concept is well understood by us at Pender which we've previously discussed and have incorporated into our research process. Many companies, best illustrated by the FAANG's[2], require minimal investments in tangible assets and human capital in order to grow and scale their businesses. If Facebook wants to launch a new product, like their new Facebook Dating service, they can easily allocate their existing programmers and developers to focus on the development of the service. The service is built on existing infrastructure with minimal incremental overhead and server costs. The service is delivered via the internet which Facebook pays nothing to utilize and the company can leverage their network of 2.3B active users and the vast amount of data they have on these users to promote, distribute, improve, optimize and grow the service.

This shift to capital-light businesses requires investors to adapt. To apply a new way of thinking to valuing and assessing businesses using new mental models in their analysis. Pender's investment process utilizes predictive attributes to identify businesses which have the potential to compound value for the long-term with more emphasis placed on identifying the quality and moat of the business, and less on the company's valuation. Traditional value investment concepts, like buying businesses with low price-to-tangible-book value, or making an investment based on the expectation of mean reversion on margins and returns, have become less relevant. A study done by Harris Associates[3] illustrates a 75% correlation between stock price and tangible book value for companies in the S&P500 in 1975. But by 2018, that correlation had fallen to 14%, providing no meaningful connection. The application of fade rates in investment analysis is a concept that was been widely used by

[1] MOI Global Podcast: David Barr on Value Investing and the Business of Investing; MOI Global – Diversified Royalty and Athabasca Oil: Small-Cap Opportunities in Canada; MOI Global – Zillow: Founder-Led Online Leader Pursuing Large TAM Opportunity.

[2] **F**B, **A**APL, **A**MZN, **N**FLX and **G**OOGL.

[3] https://www.im.natixis.com/en-institutional/insights/insights/the-new-value-investing2

investors as a metric for mean reversion. The theory is that firms have a general lifecycle with a period of accelerated growth where businesses are generating high returns in excess of their cost of capital. But, over time, this excess return will invite new competition, causing returns to “fade” down which see returns eventually declining to a company’s cost of capital. The persistence of high return metrics for companies like Google over the 15 years since its IPO have negated the application of mean reversion metrics like fade rates.

Investing in family businesses and against consensus

A focus on investing in family owned and operated businesses was another topic of discussion. Many of these decade-old, in some cases century-old businesses, are conglomerates with complex holding structures which provide control and tax benefits to the founding family shareholders. These family conglomerates tend to own a large portfolio of unrelated businesses, many of which are high quality, with strong economic moats, but they can be difficult to value. Exor N.V., the holding company of the Agnelli family which owns Fiat Chrysler, PartnerRe, Ferrari, the Juventus football club and The Economist, among their many assets, is an example of a family business which Pender owns. Due to the complexity and structure of these companies, along with their idiosyncratic and in some cases esoteric holdings, they tend to be avoided by investors and trade at large discounts to net asset value. The key factor to look for in these businesses is ensuring they are managed well as there are numerous ways to create and unlock value under a good manager. This includes selling a high performing business for a premium, selling an underperforming business which is weighing down results to float underlying value, harvesting cash-flows from one business to invest in another which generates superior returns, and implementing capital allocation policies like share buybacks and acquisitions to generate long-term value.

The importance of non-consensus investing was also discussed with successful investors who not only need to make the right investment, but also find an investment that is non-consensus. A correct investment thesis should result in a positive return. But, if the market is already pricing in a high probability of that thesis being correct, then the return on that investment may not be acceptable. The largest payoffs can be realized when making an investment where a thesis is both correct and where the market is skeptical or opposed to that thesis. Our focus on understanding the quality of the businesses we own and employing a private equity approach to the public markets allows us to assess the consensus view on a company, identify opportunities where the consensus view may be incorrect and increase our confidence of a non-consensus investment thesis being proven correct.

The way businesses are forming and growing, and the dynamics of the stock market are constantly evolving. Outdated and rigid models and methodologies to assess investments are being disrupted and continued reliance on these old techniques may identify value traps as value investments. Successful investing in this environment requires investors to adapt and employ new mental models to identify and analyze compounder businesses. The opportunity to learn, share and discuss ideas and concepts about investing with genuinely passionate and intelligent investors is and will be an ongoing privilege for the Pender investment team.

Amar Pandya, CFA
September 23, 2019

PENDER
PenderFund Capital Management Ltd.