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Investing during Uncertain Times: What Is Pender Doing?

When the facts change, we change our minds

The nature of most human activity is that the facts involved tend to change, but often not as abruptly, and rarely on such a wide scale as we are seeing today. That said, COVID-19 is unprecedented in the modern world. There has been no time in our living memory when the facts have changed quite so suddenly and broadly. The reality is that some business models will prove very resilient and even benefit as demand for products and services soars in this crisis, while others are adapting with varying degrees of success, and still others will be destroyed by COVID-19 related fallout.

So, what are we doing? In short, we are seeking to protect capital. We are applying our experience of prior market downturns and sticking to our investment process of staying focused on business characteristics, risk assessment and aiming to rotate into quality. Beyond dealing with today's immediate headlines and looking into a potential post COVID-19 world, we are asking, "*And then what?*" With that in mind, we are also repositioning our portfolios to companies that might benefit in a recovery.

"When we have market corrections like this, uncertainty is priced into the market. By the time certainty returns, the opportunity is probably gone", David Barr. Now is the time to be active.

What's Under the Hood

At the portfolio level: We are anticipating that the world will change in significant ways as a result of COVID-19. We see the global health crisis accelerating the adoption of health tech and self-isolation accelerating a range of new consumer behaviours, positive news for sectors able to meet demand in areas of heightened consumption. At the same time many sectors are in the direct cross hairs of massive disruption from COVID-19, such as restaurants and travel. These factors are informing some of our buying and selling decisions.

At the company level: The facts have changed for practically every business out there. So our first priority was to re-evaluate the investment thesis of every company we own to confirm whether we should still hold, buy more or to sell entirely and move on; to test every assumption and to factor in a range of new scenarios. The first priority for any company is to survive this downturn. Are management teams doing the right thing, can balance sheets weather this storm, do we think products will still be in demand and generating profits when the dust settles?

The Trinity of Risk

Assessing the trinity of risk is a key part of our fundamental analysis.

- Valuation Risk – This is always important. Today, most stocks are well off their highs, so all things being equal, there is less "valuation risk" than just a few short months ago. But all things are not equal.
- Balance Sheet Risk – This is at the forefront of our analysis and we are reducing or eliminating weightings in companies that are over-levered relative to our assessment of their businesses risk. Survival is key. Debt reduces flexibility and can be potentially fatal for businesses with high business risk. A reasonable level of debt in normal times can become catastrophic when business activity comes to a halt.
- Business Risk – The facts have changed for almost every business due to COVID-19. Some industries have been hit very hard over the short term like airlines, offline retailers, restaurants and the travel sector, but some businesses have seen a massive demand boost, such as online grocery delivery and work-from-home related firms like video conferencing solution providers. It is important assess business risk because it impacts the fundamental value of a business. If a business risk is so high that the fundamental value is likely to be zero, no price is too low to sell.

The situation remains fluid, but we are focussed on updating our thinking about potential risks and opportunities of existing holdings.

Rotating into Quality

We are working on improving the quality of our portfolios by increasing weightings and buying higher quality companies while they are deeply discounted. In addition to established compounders that we believe will not only survive, but potentially emerge stronger in post COVID-19 world, we are also looking to emerging compounders. These are earlier stage companies that have strong, sustainable revenues which they are re-investing for long-term growth, but which lack the longer history we seek for established compounders. After all, most established compounders started their value creation journeys as lesser known emerging compounders. Compounders offer potential near-term gains as stock prices rebound to fair value, and possible further long-term gains as business value continues to grow over time. Win, win.

We are agnostic in the sense that we are looking at stocks with the best potential returns after taking real risk into consideration, irrespective of the category into which we might place any particular idea. While we prefer compounders, if we see a low risk close-the-discount opportunity with a significant potential upside, then we will act in anticipation of the rebound in value and that discount closing again.

See Four Potential Investment Strategies in a Stock Market Correction

Positioning for the Recovery

Buffering portfolios against the current climate is goal number one, but with that in hand we are also turning our attention to positioning portfolios for a recovery. A whole new generation of winning companies will likely emerge from this period of uncertainty, as happened after the financial crisis of 2008-09. We have noted recently how small cap stocks have been lagging large cap stocks, but research has shown that small cap value and growth stocks often lead during the recovery. Being nimbler, more accustomed to facing down challenges to the business and able to be more aggressive and opportunistic, they can recover faster than larger caps. In addition, our portfolios tend to be skewed to businesses led by their founders or owner-operators. We believe these types of leaders are better equipped to deal with adversity and adapt when the facts change compared to managers who were groomed or climbed to the top spot. In our view, groomed CEOs are often reasonably well equipped for "peacetime" value creation and preservation. But we believe founders and owner operators are better equipped during "war time" periods like today, because successfully starting and growing a company has more in common with navigating the current environment (in both cases, the facts are changing quickly). Indeed, while studies show that founder run firms tend to outperform over time, research shows *much of the upside is accumulated when coming out of periodic downturns*.

We continue to be guided by our investment process, seeking to own undervalued stocks, while taking into consideration the trinity of risk. We are looking for businesses that will not only lead coming out of this crisis but will compound wealth over the long-term.

Also see Positioning for the Recovery [link]

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