

CIO'S COMMENTARY

"A change in perspective is worth 80 IQ points." - Alan Kay

In this commentary we cover:

- Protecting the gains when markets hits new highs
 - Inevitable trade-offs - Lower volatility vs potential higher returns
 - How fast should you pull the trigger to sell - Close-the-Discount vs. Compounder
- What might come next - Frontier investing and thoughts on Bitcoin

Protecting the gains when markets hit new highs

Markets are near or at record levels again. Some investors are getting nervous about another possible downturn. After periods of strong performance recently, and with fresh memories of the crash last spring, we are increasingly asked what we are doing to protect our gains. No one wants to go backwards. And we know another pullback is inevitable. It's what markets do. Taking some money off the table after a big run up seems like a sensible thing to do. But in our view, what you do to protect the gains depends partly on *how you think about investing* and partly on *what types of investments you own*.

Inevitable trade-offs – how people think about investing

"Volatility is the price you pay for performance." – Bill Miller

The combination of low volatility and high performance seems like investment nirvana. But like unicorn sightings, such occurrences are more common in fairy tales than reality. Magical thinking can be dangerous. There are always trade-offs in life. Another related trade-off that investors need to consider is about how value can change over time, which was probably first described thousands of years ago.

"The formula for value investing was handed down from 600 B.C. by a guy named Aesop. A bird in the hand is worth two in the bush¹. Investing is about laying out a bird now to get two or more out of the bush. The keys are to only look at the bushes you like and identify how long it will take to get them out." – Warren Buffett

Two Kinds of Investors:

- Volatility focused or "bird in hand" investors – Protect their short-term gains by selling fairly-valued or overvalued holdings quickly.
- Performance focused or "two in the bush" investors – Protect their long-term gains by not selling compounders too soon.

Investors who are focused on low volatility tend to be more worried that a periodic market downturn will rob them of their "bird in the hand" wealth and seek all means available to protect those gains. Performance-driven investors tend to be more worried that if they react to volatility and sell their holdings too soon, they will lose out on their long-term "two in the bush" returns that come from the potential rise in value in the future. One is short-term focused. The other is long-term focused. Ironically, sometimes both can be right. But the timing is different. An investor who sells just before a correction could be right to protect the existing gains, but so could the more patient investor who holds the same stock through the downturn and triples her money over the next five years as it recovers and heads to new highs. There is no one right answer for all investors all the time. Just trade-offs.

¹ It is worth noting that this timeless formula applies to both statistically defined "value" and "growth" investments. Value investing, as practiced by Buffett is different than the term cited by many in the investment industry. Buffett refers to "value" as an analytical factor (i.e. a "growth" company can be undervalued even if it looks statistically expensive). We find most people frequently confuse value as an analytical factor, with value as a statistical factor (Fama/French). They are not the same thing.

One of the best illustrations of the trade-off made by performance-seeking investors was a tweet by Morgan Housel in May 2017 about the long-term stock performance of the streaming giant Netflix.



At the time of the tweet, the stock was up almost 200x since the end of 2002. Since then, Netflix is up more than 3-fold. A \$10,000 investment in Netflix at the end of 2002 has turned into almost \$7 million today. The same investment in the S&P500 turned into \$58,000. This massive difference in end wealth is stunning. While the S&P500's return is certainly decent, a person holding Netflix through all the ups and downs would have been life changing. Of course, what is missing from this story is the price that had to be paid to achieve it. Gut-wrenching volatility. There

were a few periods in that journey when the stock plunged more than 70% from peak to trough. And many other times when the stock crashed by 30% or more.² We doubt anyone held on to their full stake for the entire journey. Even founder Reed Hastings sold down most of his stock over that time. Since none of us, including Hastings, are investors in Perfect Hindsight Capital, some trimming makes sense. However, maintaining a stake in a holding that grows at a 43% annualized pace for a long period of time will do wonders to the size of your portfolio.

"CAGR always smooths over the volatility and pain to achieve it." — Ian Cassel

On a much smaller time scale, we had somewhat similar experiences during the pandemic with several holdings in our mandates. Like Netflix, we believe they are leaders in their respective industries with long value creation runways ahead. And just like Netflix, the market drawdowns were just as vicious and indiscriminating. We faced the question, do we sell out of fear of more volatility to protect our short-term gains, or do we hold on to protect our potential long-term gains? We reassessed every holding during the downturn. We needed to see if there was new catastrophic risk that was not survivable. We wanted to understand if their business operations were permanently impaired by the fallout from coronavirus. Below are the stock charts of two core compounders which we owned pre-pandemic, and which had massive peak-to-trough drawdowns. After reviewing the investment cases for Zillow Group Inc. (ZG) and PAR Technology Corporation (PAR), we concluded that their prospects had actually improved. We believed that protecting the potential future gains for clients who understood our strategy (including the capital we ourselves had invested alongside our clients in the Funds) was worth the price of volatility.

² Despite the stock's huge volatility, revenue was up every single consecutive year over that period.



Source: Bigcharts, PenderFund

As we [highlighted at the time](#), we remained bullish on Zillow because our opinion was that this crisis could very well accelerate a technology-driven re-platforming and digitization of the industry that was already gathering momentum. Likewise PAR could benefit from a re-platforming of the restaurant industry as digitization accelerates... and seems well positioned to thrive in a world where the immense value of integrating online ordering, third party delivery apps and digital payments is being highlighted. These companies offered real-world solutions to their customers to deal with the immense pressures unleashed by the pandemic.

These secular growers were beneficiaries of the tsunami of digital acceleration which was sweeping across almost every industry. This meant that there were probably going to be far more potential birds in their respective bushes than even our most bullish scenarios had previously envisioned. This thinking also extended to the breakout digital leaders in other large industries. We bought initial positions in some other digital leaders who were also disrupting their industries like Square Inc. (SQ) (payments/banking), Stitch Fix Inc. (SFIX) (hyper personalization of online apparel) and IAC/InterActiveCorp (IAC) (home services)³. These were ideas we had researched before but had passed on for one reason or another. When we revisited these ideas, we found that the facts had materially changed. Stock prices were *way down*, and intrinsic value was *way up*. Our belief was that this was a highly unusual but favourable set up for outsized gains.⁴

With red flashing on trading screens and losses showing up on investment statements, few cared about potential future “two in the bush” gains. Never mind the prospect of having three birds in the bush. What a difference eight months makes. If the recent strong price action is any indicator, investors are starting to believe that these very same companies might have *four birds in the bush*. Our original insights and theses (see [Zillow](#) and [Stitch Fix](#) examples) are no longer contrarian views. We have come in full circle. Should we sell now to protect our gains? *It depends*.

Pulling the trigger to sell – what types of investments people own

Two Types of Investing

The type of investment you hold should also weigh into your decision on whether to sell or not.

Close-the-Discount Investing:

- Pay \$0.70 for \$1 of value, then sell at \$1
- This strategy pays off once

Compounder Investing:

- Pay >\$1.30 for \$1 value that can grow into \$10
- This strategy pays off multiple times
- A gift that keeps on giving

³ Internally we have been calling these digital accelerator beneficiaries the ZIPSS (ZG, IAC, PAR, SQ, SFIX). There are others in our portfolio with similar models, but for simplicity’s sake, we wanted to keep the acronym describing this theme short and “zippy”.

⁴ During the last market crash in 2009, stock prices and intrinsic values were both way down for most notable companies. It took many years for the market to recover to new highs.

Fortunes rise and fall over a business cycle, as does investor enthusiasm. Trading around this cycle is a sensible thing to do in most cases. We categorize such opportunities as Close-The-Discount (CTD) ideas. We aim to buy a dollar of value for \$0.70 and sell it when the stock hits \$1. These are the proverbial bird-in-hand ideas. There are very low odds that their \$1 of business value will grow into two-in-the-bush anytime soon. When such holdings hit our short-term valuation targets, we are usually quick to sell, or significantly trim, to avoid round-tripping on such stocks. With CTD ideas we are more volatility focused and will sell in the short-term to protect our gains.

On the other hand, we aim to be more patient and long-term return focused with our Compounders. If our thesis remains intact, and we see a path of reasonable returns ahead, we are reluctant sellers of such holdings. We often trim our sizing for portfolio management purposes, but do not typically sell unless our thesis becomes impaired, or the valuation becomes so extreme that decent long-term returns are hard to envision *even if our bull case scenarios come true*. During the panic, many Compounders were selling at CTD prices. That \$1 of business value was growing fast, but you could buy it at a discount to that value, essentially getting a potential double-barreled return. First when the price reverts to a more sensible valuation range, and second when the stock follows the growth of the business higher. But as the example above illustrates, it is possible to get a good return even if the stock appears overvalued in the short-term.

Consider the Compounder investing example above. Is paying \$1.30 for a business that is worth \$1 today a bad deal? It depends on how fast that \$1 is growing and your required rate of return. Let's say that company grows from \$1 to \$10 in business value over 10 years. That is a 25.9% annualized return. If you paid \$1.30 for that stock, but it then traded at its business value of \$10 in 10 years, your return would be 22.6% return. If you paid \$2.50 for it, your return would be 14.9% per year. This is an oversimplistic example, but the point is that you can pay an expensive-looking multiple on day 1, but it could still be undervalued and mispriced when you consider the runway ahead. There is one attribute that all Compounders have in common. Despite inevitable volatility as we have seen with examples like Netflix, these types of ideas have a habit of hitting new 52-week highs over time. Think twice before you say goodbye to such value creating companies just because they are hitting all time highs, if you are interested in your wealth doing the same.

We find that true Compounders have a way of surprising us on the upside (i.e. our bull case scenario was not bullish enough), whereas CTD ideas tend to have a habit of surprising us on the downside (i.e. our worst-case scenario was not bearish enough). In our experience, one of the biggest mistakes investors make is selling their winners too soon, assuming they have been justifiably identified as Compounders. Sometimes we don't have a choice. Although we usually celebrate take-outs for good reason, occasionally a buyout, even at a decent premium, can be wealth sapping if you planned on building long-term wealth. [Case Study: Panera Bread – When News of a Take-Out at a Premium is Bittersweet](#). The most common rationale for selling such winners is to protect the gains but this strategy makes the most sense for those stocks that fall into the CTD camp, because you should sell before they round trip again. For leading businesses, that are still in the early innings of their value creation journey and will likely be worth far more five to ten years from now, selling to protect today's gains makes less obvious sense. As famed investor Peter Lynch memorably noted, *"Selling your winners and holding your losers is like cutting the flowers and watering the weeds."* Before you do too much trimming, make sure it's a weed and not a flower!

What might come next: Frontier investing and thoughts on Bitcoin

Pender's investment slogan is "Forward thinking. Finding value." We have benefitted from being forward thinking on digital acceleration starting this spring, and we have been giving more thought to what might come next. One area we have been exploring lately is decentralized finance in general, and Bitcoin more specifically. Decentralized finance, commonly referred to as DeFi, is an experimental form of finance which does not rely on central financial intermediaries such as brokerages, exchanges, or banks, and instead utilizes smart contracts on blockchains. In many respects, we consider this fast-developing field as "Frontier Investing". Most mainstream investors are still grappling to fully understand it (including us!), but it is quickly gathering momentum.

Bitcoin is a cryptocurrency invented in 2008 by an unknown person or group of people using the name Satoshi Nakamoto. It was implemented and released as open-source software in 2009. It has had a bumpy ride since

then. But after battling many competitive alternatives, Bitcoin has emerged as the break-out leader of a new digital monetary network. It is by far the largest of the various competing peers by market cap. Some might even be tempted to say that it “won by a lot”. This go-to status essentially makes it the “safest” crypto asset from an institutional point of view, which helps it attract larger capital pools, and which has led to a positive feedback loop, further cementing its leadership. Belief in Bitcoin appears to be in the process of moving from the early tech innovators (and frankly, sometimes the lunatic fringe) into the early majority. Numerous notable investors, regulators, corporations and governments are increasingly taking Bitcoin seriously. When a growing wall of demand meets limited supply, interesting things can happen. It is an area we are taking seriously because of the disruptive impact it could have on several important industries.

A significant part of our interest comes from studying the unintended second and third order consequences of the unprecedented central bank and fiscal intervention effort to fight the economic slowdown from Covid-19. It remains a relatively early stage, controversial and divisive asset class, especially in the western world, hence the “frontier” label. Skeptics consider crypto assets as a mania-driven bubble of illusionary value. Some of the more recent bulls view it as a credible hedge against runaway central bank money printing. And many investors are starting to appreciate that in a world of no coupons, one needs to rethink opportunity cost. If the latter view is true, Bitcoin may be at the relatively early stages of growing into a significant asset class, akin to digital gold. What should an investor do when potential outcomes are binary?

When considering a non-consensus emerging asset like Bitcoin, we believe legendary investor Howard Marks best explained the problem, *“extraordinary performance comes only from correct non-consensus forecasts, but non-consensus forecasts are hard to make, hard to make correctly and hard to act on.”* We believe some exposure to Bitcoin makes sense because the payoff could be sizable. But we also want to avoid catastrophic risk. Our approach has been largely to initiate our initial exposure through low-risk optionality. Call it a *“heads I win a lot, tails I don’t lose that much”* strategy. We have some modest indirect exposure across a few mandates. Some Pender holdings that are indirect beneficiaries of this trend include BIGG, MSTR, SQ and FRMO. The good news is, as of this writing, these holdings are well above our initial purchase prices. The bad news is that these higher prices change the risk profile. Nevertheless, we remain constructive as long as we see Bitcoin continuing to gain credibility and momentum. Time will tell whether the bulls or bears are right. Whatever happens, it won’t be a smooth journey. Once again, don’t be surprised if volatility continues to be the price that you need to pay for potential performance.

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

Felix Narhi

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