

Five Easy Games for Fundamental Value-Driven Investors

This article is excerpted from a letter of [PenderFund Capital Management](#). The author, Felix Narhi, serves as Chief Investment Officer of Pender.

“Swim upstream. Go the other way. Ignore the conventional wisdom. If everybody is doing it one way, there’s a good chance you can find your niche by going exactly in the opposite direction.” –Sam Walton, Founder of Walmart

The markets rebounded and returned to a more normal state in the first quarter. Or at least as “normal” as one can expect in today’s Trumptopian world. In hindsight, market panics, like the one experienced at the end of last year, are great times to find mispriced securities.

Buy low, sell high...simple common sense, no? Unfortunately, if you rely on common sense, you are probably not accounting for the many cognitive biases at play. Opportunities will be available because although times change, human behaviour does not. The behavioural tide will continue to ebb and flow between fear and greed. Indeed, the markets appear to be tipping back towards fear again as we write.

Investing is not easy. Just ask famed value investor Seth Klarman who ruminated, *“Did we ever mention that investing is hard work – painstaking, relentless and, at times, confounding? Separating relevant signals from noise can be especially difficult. Endless patience, great discipline and steely resolve are required.”* Indeed. It may be more challenging than ever because the competition to find opportunities has reached record levels^[1].

Furthermore, today’s massive computing power has enabled algorithms to arbitrage away many of the pockets of profitable opportunities that existed historically.

To further complicate things, the world is changing fast. Many of today’s “norms” that we take for granted would have been practically unimaginable just a few years ago. How do you “model” such an environment? In most cases, the data for tomorrow’s future business models does not exist. So what data does an algorithm crunch?

As we noted last year, depending on the context, it might be [different this time](#). We believe Charles Darwin stumbled upon a universal law, also applicable to investing, when he observed, *“It is not the strongest of the species that survives, nor the most intelligent; it is the one most adaptable to change.”* We are working hard to adapt.

Humility is one of the most important traits of successful investors. One important thing that has not changed in investing is the need to understand the thinking on the other side of your trade. As a default, one should assume that in most cases, the participant on the other side of the trade is very smart and probably knows just as much, if not more, than you do. And if you are unsure if you have a defensible edge, you probably don’t.

“If after ten minutes at the poker table you do not know who the patsy is—you are the patsy.” –Poker proverb

Commentators often like to compare investing to the game of poker. Skilled poker players look to play in “easy games” frequented by weaker players. They understand math and probability, study their opponents for “tells”, bluff when needed and bet when they believe the odds are in their favour. They don’t need to wager with every hand. But bet sizing is important when they do. Lady Luck will play a role, particularly in the short term. A champion poker player with a full house will still lose to a beginner with a four of a kind. But over the course of many evenings and countless hands, luck will tend to even out and usually leave the more skillful Champ with the bigger pot^[2]. Similarly, we believe investing is also an activity where differential skill counts over the long term. Although there are some valid parallels to poker and investing, there are also some problems with this analogy.

Notably, poker is a *linear game*, which follows predefined rules and a path for the player with little, if any, deviation. After the cards are dealt in a Texas Hold’em poker game, a “four of a kind” beats a “full house” in 1934, still does today, and will continue to do so in the future. The underlying rules of the game are the same and the number of cards is finite. It is a game that favours players who are both good at math and understand psychology. The time travelling poker champ of 1934 would likely do well in 2019.

In contrast, investing is a *non-linear game*. It is much more dynamic and complex with messier external considerations, such as evolving government regulations and potential disruption from trade wars.

Sometimes a regulator will tell you that the investing equivalent of a “four of a kind” doesn’t count anymore. Too bad. There is no recourse. The market is part of a complex adaptive system where the exact outcome is largely unknowable and unpredictable. In addition, the fundamental rules of the game can change over time. A hypothetical time travelling Ben Graham from 1934, widely regarded as the father of security analysis and value investing, would likely have been befuddled in 2019. Strategies that worked brilliantly after the Great Depression work less well today. Focusing on the value of tangible assets doesn’t work as well in an environment like today where intangible assets account for the vast majority of incremental value creation. When investing, it is important to replace old mental models that may no longer work so well with new ones that fit the environment better.

With the caveat that investing is not easy and far more multifaceted than poker, here are five “easy games” that might be worth exploring.

1) Wealth transfers go largely unnoticed, but are far more material than most investors realize. Corporations make decisions that lead to large wealth transfers from one group of shareholders to another, namely with M&A-related activities, share buybacks and equity issuances. Pay attention to which types of activities and groups tend to emerge as the long-term winners. Act accordingly.

2) Compete against participants who trade without regard for fundamental value. Both human decisions and algorithm-driven (algo) trading move markets. Participants trade for many reasons. It is important to recognize that markets are not purely event-driven. The vast majority of trading today is machine-led. The good news is that sometimes Mr. Roboto has just as much disregard for fundamental value as his manic-depressive human counterpart, Mr. Market, because some algos are programmed to only pay attention to price and volume. As a result, inexplicable flash crashes and other bizarre market dislocations are becoming more common. Investors should accept this new reality and be ready to take action on the other side of the trade. Having cash reserves to draw upon in such situations can be

lucrative. Sometimes even fundamental investors don't care about fundamental value during periods of market stress. They desperately require liquidity irrespective of value. Pay attention to fund outflows during market panics and the fallout from the leverage cycle for potential mispriced opportunities. The well-documented alpha that is generated by spinoffs, which are frequently sold without regard to fundamental value, are also worth studying.

3) Compete against participants who use simple decision rules. The world is complex. Reliance on overly simple and misguided rules of thumb can lead to mispricing. Of note, passive investors are collectively the largest participant in the market by far and they continue to take share. They have no choice but to follow very simple buy and sell decision-making rules. If fund flows are positive, they must buy. If flows are negative, they must sell. This would not be material if this group accounted for only a small percentage of the total market. But they don't. And as their share grows, so does their influence as the marginal price setting player. Flows into niche ETFs, based on the hot and cold market themes of the day, can have an even more pronounced impact on stock prices. It is clear that the rise of specialized ETFs and passive investing has increased distortion in some corners of the market. Be alert for such opportunities.

4) Hiring a specialist when the task requires a generalist. To a man with a hammer, everything looks like a nail. That is wonderful if you have a nail. But in many situations, you need a more diverse toolkit, particularly to evaluate idiosyncratic businesses with no close comparables, firms with multiple business lines or those pursuing opportunities in fast growing, but still nascent industries. In short, compete against the "man with a hammer".

5) Compete against unsophisticated investors. As the saying goes, a fool and his money will soon be parted. Go and find the games that are subject to the whims of less sophisticated investors.

It is very difficult to find an analytical edge when competing against a highly educated and motivated army of specialized analysts and smart investors. *So, when possible, don't compete against them.* The difference between markets that are always efficient and mostly efficient is subtle, but important. How do you avoid the most competitive and efficient games? For starters, minimize the amount of time you play at the poker shark table and compete by their rules. Instead, look for games where differential skill might pay off. Seek out the weaker games for a potential unfair advantage.

One of the key tenets of Pender's investment philosophy is to obtain more fundamental value than we are paying for. Ideally, we want to compete against investors who are playing a different game to us. Some participants are playing mainly for entertainment value, because they love the trading action.

Others are trading for reasons unrelated to fundamental value. Still others are forced to play weaker games because of organizational constraints. Don't mindlessly follow peers. Keep in mind that conventional wisdom is often long on convention and short on wisdom. Looking for "easy games" is an important part of obtaining an edge to help to stack the odds in one's favour. It also narrows down a huge universe of potential ideas into a more manageable one. Again, investing is not easy. And we want to emphasise our view that focusing on potential "easy games" is no sure path to investment nirvana.

However, we believe there are corners of the market that continue to be less efficient for structural or behavioural reasons.

^[1] As one measure, according to its 2018 CFA Institute annual report, membership was 164,000 and 226,000 CFA candidates were enrolled for the June 2018 exams, both record figures.

^[2] New York federal judge Jack Weinstein ruled in 2012 that poker is indeed a game of skill. He based his decision on a study of 415 million hands of No Limit Texas Hold'em on PokerStars.com in the course of a year. The study showed a striking difference in earnings between the ten best and worst players.

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