

Phil Ordway on Performance Assessment, Sources of Edge

In January, Phil Ordway, managing principal of Anabatic Investment Partners, penned an annual letter that included a three-year review of Anabatic Fund. The review was filled with timeless investment wisdom. We are pleased to share highlights.

Here is what I wrote in the first letter to partners in January 2014:

“In this first letter it is important to discuss and agree upon expectations from the onset.

“The fund’s goal is attractive, risk-adjusted absolute returns over multi-year periods. On a relative basis, the aim is to produce net results better than those attained by a low-cost index fund over rolling three- and five-year periods. However, specific benchmarks are not particularly helpful in evaluating the fund’s performance, and the problems are magnified over short periods of time. I do not make investments with a particular benchmark in mind, and our specific investments bear little to no resemblance to most market indices – specifically, we currently own no investments that are included in the DJIA or the S&P 500. The Russell 2000 is probably the most relevant index, and a low-cost index fund tracking it would be the best (but still imperfect) proxy for your opportunity cost. Five of our ten largest investments are in the Russell 2000 currently and our focus on smaller companies is likely to persist.

“In pursuing our goal, I feel no pressure to be fully invested, to conform to the constraints of many investment funds, or do anything other than make the best possible investment decisions over a period of years.

“The market will fluctuate, and it is not possible for me to consistently anticipate those fluctuations with any accuracy.

“The portfolio will generally be constructed as it is today, with significant concentration in the 8-12 best investments, but cash and short positions will vary as market conditions dictate.

“It also is very important to understand that if results are going to be above-average over a period of years, it is unlikely that they’ll be above-average every quarter or every year.”

I would also repeat that everything we do is put to a simple test: What would I want if our roles were reversed? That is, would I – as a knowledgeable, skeptical investor – be happy to be the limited partner in our fund instead of the general partner? I think applying this “golden rule” to all our decisions has been very helpful in keeping us aligned with what we’re really trying to do. And the goal remains intelligent investment decisions that generate attractive, risk-adjusted returns over multi-year periods.

With that in mind I will critique our performance across several topics.

Value-investing framework

I believe we have lived up to our principles in this regard. Results follow process (I believe more than ever in our process) and I am proud that we maintained our discipline regardless of the prevailing market conditions. We avoided action for action’s sake. We held cash while

the research process was unfolding or while waiting for opportunities to come our way. We did not speculate or chase returns, making only those investments that offered an acceptable downside-upside tradeoff. Ideas were vetted through a series of filters, both quantitative and qualitative. And those filters have been effective in narrowing our possible investments to a short list.

Do we understand not just the security but the business behind it? Do we understand it well enough to be an informed board member?

Are the company's managers good partners for our capital?

Is there a margin of safety in the price we're paying?

Are we using the market to our advantage?

If we had sufficient capital but only a limited number of opportunities to deploy it, would we buy the whole company? At this price? If we had to hold it for many years?

What are the incentives and psychological considerations at play?

Investment knowledge is also cumulative, and my mental database (along with our physical and digital library) is far better equipped now than it was three years ago. I made progress in my goal to end every day, week, month and year as a better investor than when I started.

Long-term investment horizon

I am happy with our standing in this regard. Three of the 11 investments we hold today were made in 2013-14, four were made in 2015, and four were made in 2016.^[1] I didn't intend to spread the investments so evenly across the years, but it is a natural result of our research process and time horizon.

It is reasonable to expect that we will continue to make a handful of new investments each year. The pace of new investments and the holding period will be influenced by market conditions, but an average holding period of at least a few years is unlikely to change. I will sell an investment if I've realized a mistake, if circumstances have changed, if it has appreciated beyond reason and/or if we have a better use for our capital. Balancing new ideas against existing ones is important as well, and I'm pleased with our current holdings in "new" investments that I believe will yield attractive returns in the coming years.

It is also worth noting that some of the investments that caused near-term pain in 2015 (AGO and AMBC are prime examples) were then major contributors to our successful 2016. When the analysis and logic are sound, patience will often reward us, as it did in those cases.

Mistake avoidance

This area has been somewhat disappointing. I avoided many mistakes, but there were a couple of small yet painful investments – Rentech (RTK), for example – in 2014 and 2015 that hurt our performance. I discussed those at the time so I won't reprint the full post-mortems here, although I do revisit them personally on a regular basis. There were also some small but meaningful decisions I could have made to improve performance – selling more quickly when a problem emerged or when the margin for error declined, buying more on the way down as the risk-reward improved, etc. If there is one area to improve that will yield the most benefit, this is it.

Errors of omission

I'm more comfortable missing an occasional opportunity than I am risking actual impairment of our capital. Missing some opportunities is somewhat unavoidable given our style and framework, but it is still painful and it should still be a focus for improvement.

One example is the large investment in Verisign (VRSN) common stock I should have made in 2013 and 2014. I had been looking at the company for some time, and I knew enough to act on it, but I dawdled when it was time to act. I've also followed JP Morgan for years, and I had orders for JPM's TARP warrants that went unfilled during the market turmoil of January 2016 because I didn't act aggressively enough. (The price of those warrants is about 2-3x higher today.) A similar example can be found in our community banks investments. Here I did act and we've made substantial investments on which we've earned excellent risk-adjusted returns, but we should have made more. I already knew the sector and I should have been investing here from the outset in 2013-14.

Our partnership

I believe we have lived up to our ideals of partnership. Our incentives are aligned and I would be completely comfortable if our roles were reversed. I am always looking for ways to improve, however, and all suggestions are welcome.

Results

I am not entirely unhappy with the results, although I expect to do better. "Lumpiness" in our performance is typical, and 2016 was a prime example of that. We outperformed by a wide margin, returning 26.3% as compared to 12.0% for the SPY (which tracks the S&P 500 index) and 21.6% for the IWM (which tracks the Russell 2000 index). Over the three-year period ending December 31, 2016, we fell several points short of both proxies.^[2] 2015 and 2014 were frustrating, and while I never expect to get everything right there was nonetheless room for improvement in both years. As discussed below, I believe there are reasons to be hopeful about even better returns in the future.

I also want to also address our cash holdings and taxes, two topics that often generate attention. I regard both as residuals of our process and goals. We do not target specific cash levels nor do we make decisions solely for tax reasons.

Our cash position is a result of the opportunities in the market at a given time. I want to ensure a sound financial position that can withstand market shocks and give us the flexibility to buy when others are selling, but I do not set a cash target as an opinion on the short-term direction of the market. As attractive new ideas are discovered our cash position will fall, and as investments are sold our cash position will rise until the process repeats itself. Since the beginning of 2014, our quarter-end cash position has fluctuated from the mid-/high-30s to the single digits. In the most recent year we deployed a lot of cash to take advantage of some excellent opportunities in January and February, but we also had three major investments get taken out by acquisition, sending our cash balance right back up again.

I also acknowledge that our cash holdings have been a drag on returns given the near-zero interest rate environment.^[3] Over the past three years our cash position has been higher than I would like it to be. But it is also worth remembering that today's prices and opportunities will not be the same tomorrow, next week or next month. Cash/liquidity/flexibility is often a drag on returns for certain periods but enormously valuable

in other periods, often when it is needed most.

Likewise, the relative tax efficiency of our investments is just an outgrowth of our process and time horizon. Most of our realized taxable gains have been eligible for long-term capital gains treatment and I expect that to remain the case. Specifics will vary for each partner, and if you would like an analysis of taxable gains and dividends since inception we would be glad to provide one.

To review our basic sources of advantage, it's worth revisiting what I wrote two years ago in the year-end letter to partners:

Informational advantage

Build a large and diverse business reference library, both the physical and the mental variety... "Fish deeper, fish alone"... Make one last phone call or read one last document... There will never be any substitute for doing the homework and knowing the facts... But it is hard to capture a meaningful advantage in an age with almost limitless information available to everyone at the touch of a finger... Thorough research is critical to investment success but it is insufficient on its own.

Analytical advantage

It is crucial to run information through the right filters... An analyst should have the knowledge and credible insights of an excellent board member... A bull should know the bear's argument at least as well as the bear himself does... But that level of analysis is the standard, not a point of relative advantage... A bigger advantage often comes from a range of qualitative factors... What are the psychological forces that might be masking the truth?... This second stage of analysis is especially helpful in avoiding mistakes, and avoiding mistakes is perhaps our single biggest advantage over time.

Behavioral advantage

We have to be both different and prudent, exercising an intentional but cautious contrarian streak... We have to be willing to sit on the sidelines when the party is roaring and also willing to act aggressively when times look tough... The biggest profits are made – and the biggest losses are avoided – by a willingness to steer well away from the crowd, especially when there is a strong consensus about the right thing to do... Avoiding dumb, herd-like behavior is a simple strategy, but it's not always easy in practice... Discipline rules the day.

Structural advantage

Our fund comprises a group of like-minded and patient partners who understand our strategy... The fund has low fees, it avoids leverage, and it has a flexible mandate to pursue opportunities wherever the market offers them without regard to annual benchmarks or artificial constraints... Investments are made in a concentrated fashion based on their intrinsic value, and they're often held for a period of years... None of those features may seem remarkable on their own, but taken together they nonetheless yield considerable results over a period of years.

I remain convinced as ever that these advantages hold and I still believe that our behavioral and structural advantages outweigh everything else. With market prices increasingly set by

passive and/or short-term holders, our long-term orientation combined with a value-oriented investment framework gives us a significant advantage, and I expect that advantage to persist. Many investors (or ETFs or traders or algorithms) will not or cannot look past the market-to-market numbers, the career risk, or the market's herd-like behavior to take a long-term investment approach. Put another way, if we employ a long attention span, a willingness to delay our rewards, and an open mind, we will have a different – and I would argue *better* – system than much of the market.

It is also worth flipping the issue upside down and remembering what we cannot do.

We cannot predict the future; we can only assess probabilities across uncertain outcomes.

The good news is that a value-investing approach requires a margin of safety in each investment, obviating the need for accurate point estimates. We will benefit from predictions that require us to be *roughly* right, with the odds in our favor across a range of outcomes, but we will rarely benefit – and we could well be hurt by – predictions that require us to be *exactly* right.

We cannot win by focusing too much on things that are important but unknowable. We are trying to buy fractional interests in (or claims upon) businesses at a discount to what they're worth. It's not easy, but it really is that simple. The macro factors that will play some role in determining our outcomes – interest rates, GDP growth, government policies and regulation, etc. – are important. But forecasting those factors is difficult, at least for me, and it can be harmful to our results if I start to believe that I *know* what is going to happen.

We cannot divorce security prices from the underlying businesses. A forecast that the price of a security might go higher is not enough – there must be real value in owning the underlying business. Put another way, stocks are not quotes on a screen, they are fractional ownership interests in real businesses. The market is there to provide liquidity, not instruction or diversion.

We cannot “be right” if we're not first concerned with being wrong. That leads to a skeptical, thorough research process; a search for disconfirming evidence; a consideration of our own biases and error tendencies; and a contrarian streak. We must be willing to look wrong over certain periods of time, but we cannot be wrong by committing mistakes that could impair our capital.

We cannot time things perfectly. To be clear, there is room for improvement here, and timing does matter. But the lion's share of our results will be determined by perfecting a balance of extreme patience and aggressive opportunism.

We cannot be experts in everything, and it pays to concentrate our efforts and capital into a few investments with very favorable odds. Owning 50 investments instead of 10 does not protect us from anything; our 49th-best idea is unlikely to be as good as our 10th, and at some point we're *increasing* the risks we incur by having too many balls in the air at once.

We cannot bend the world to our will. The investment landscape over the past three years has been mixed or even difficult, but I am not one to blame outside factors (the Fed, algorithms, robots, whatever) and I think it is self-defeating to look for scapegoats. It is more effective to respond to the market as it is rather than how I'd like it to be.

I also want to comment on the “active versus passive” debate. I think it is self-evident that if active managers had lower fees, acted as true partners, and took a long-term approach to

investing, most of this “debate” would be unnecessary. In the real world, of course, fees are too high, career risk encourages “index-hugging” portfolios, the shortest-possible reporting period gets all the attention, and many managers seek only to maximize their fees. With that as the competition it shouldn’t be a surprise that low-cost passive investments win over time. The only part of this story that should be surprising is that it took so many decades to get this far.

Fees were at the top of my list when I spent 2013 contemplating the terms for our fund. I considered at least a half dozen options, including hard and relative hurdles, multi-year performance fee deferrals, claw-backs, fulcrum fees, and other structures. I settled on our current fee arrangement –because I believe it is low, simple, and fair.^[4] If we achieve our goal of attractive multi-year returns the fees we charge will be deserved and roughly in line with those other options; if we do not achieve our goal our fees are still low enough that limited partners will not have been treated unfairly.

I expect the trend toward low-cost and/or passive investment to continue, but either way a debate about active *versus* passive misses the point. Even the most ardent indexer isn’t entirely passive, and almost all investors, whether individuals or institutions, will be best served by a mix of the two. When a committee determines which companies go into an index or an ETF – particularly a market-cap-weighted one like the S&P 500 – a passive investor’s fate is sealed. Value is never weighed against price, management’s incentives are never questioned, industry structure is ignored, and returns on capital are forgotten. Fund investors are left with a stake in not just the bargain securities but also the overpriced ones, and there is often a concentration in the latter.

So rather than focusing just on fees and performance as distinct issues, I think the debate should be reframed in the terms of partnership. Is the active manager a good partner, with real skin in the game? A “yes” to that question would eliminate the overwhelming majority of the problems that persist in investment management. Throw in a value-investing approach and long-term investment horizon and now the table is really set for success.

^[1] As noted elsewhere, purchases made in 2013 were made in the predecessor account and the securities were contributed in-kind to Anabatic Fund L.P. upon its launch on January 1, 2014.

^[2] Individual LP returns and variances will depend on the timing of investment.

^[3] We received our first-ever interest check from our broker in December 2016 and it contributed a return of roughly 0.001% to the fund.

^[4] For Class A partners. The performance fee is subject to a high-water mark. This is not a solicitation. Please see offering documents for further details.

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