

## Reviewing Our Process and Overall Investment Framework

*This article is excerpted from a letter by MOI Global instructor Phil Ordway, Managing Principal at Anabatic Investment Partners, based in Chicago, Illinois.*

A detailed review of our investments and performance follows, but first is an evaluation of our process and overall framework.

- **Process** - Our value-investing principles work over time, and it is my job to stay disciplined at all times. I remain focused on our process and I am pleased with its implementation.
- **Patience** - Our 2019 dollar-weighted turnover was less than 20%.<sup>[1]</sup> Investments will often be held for years, and when companies are performing well they will be held indefinitely. Similarly, our results will take years to develop and to evaluate. The returns shown in a given year are actually the product of decisions made years earlier.
- **Partnership** - We strive to be a true partnership. All decisions are made knowing that I would want the same treatment if our roles as managing and limited partners were reversed. Applying that "golden rule" is a win-win proposition.
- **Returns** - As noted in the January 2018 letter, "I cannot predict volatility and there is plenty of reason for worry in the world, but I believe there is attractive value and more than sufficient safety in the portfolio today. The broader market could suffer a decline at any point, but I believe all the companies we own will be more valuable 3-5 years from now." I reiterate those sentiments today.

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In 2019, all but one of our companies made steady progress even though the market returns varied quite a bit. Among our top five holdings, two showed large gains while three lagged the broader market. Two smaller positions which are not discussed in this letter were up 11% and 30%. The only loser in 2019 was Spirit (SAVE), which posted a decline of 30%.<sup>[2]</sup>

Last year's letter stated that our investment opportunity was as good then as it had been in several years. That was not a market forecast - the simple thought at the time was that there had been a lot of fear-driven selling late in 2018. Lower asset prices, all else equal, bring the prospect of better future returns...if the prevailing uncertainty and volatility can be properly digested. Investing is not a contest of pure intelligence, but it is a contest of discipline. Success requires a level head when things get rocky, as they briefly did in 2018. "Anyone can hold the helm when the sea is calm," as the saying goes.<sup>[3]</sup> What matters is preparing to hold the helm when the sea is not calm. Unforeseen risks are the most dangerous kind, and problems of all types tend to correlate when the going gets rough.

In almost any aspect of this business it is impossible to accurately forecast the next quarter or year, but that effort gets almost all of the market commentary. Our focus is elsewhere. Can our companies handle inevitable adversity, regardless of when and how it arrives? Will their cash flow and balance sheet stand up to unexpected problems? Will they go beyond mere survival and turn volatility into opportunity? Will earnings be meaningfully higher in 3-5 years? Is the price we're paying reasonable? Responding to those questions is my primary job, and answering correctly will take care of many other problems.

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Prior letters have made a point of emphasizing our rolling three-year record because it is the shortest period over which any useful conclusions or comparisons can be made. Three years also coincides with the shortest intended holding period of any individual investment, and it is just less than the average holding period of the investments currently in the portfolio.<sup>[4]</sup> A period of five or 10 years would be an even better interval for evaluation.

A good or bad relative result over just a few months can stand out in the numbers even over a period of years. The emphasis should remain on the investment process, letting the results develop as they will over ensuing years. To outperform over long periods, some level of underperformance is inevitable over shorter intervals. The scorecard will be updated each year, but no individual year should get too much weight.

On a related note, comparing our results to a benchmark can be both helpful and hazardous. First and foremost, a comparison is useful in giving a sense of our opportunity cost. The S&P 500 is the most liquid, most referenced index in the world, and its results can be obtained for a very low fee. It also happens to represent more than three-quarters of the total value of the public equity market in our home country.<sup>[5]</sup> If our returns do not exceed that opportunity cost – over an appropriate length of time – there is a problem.

That’s where the usefulness ends. Our results and those of any index will diverge, sometimes by a wide margin, even if our eventual results develop as hoped. We also do not hold any investments with the S&P 500 or other benchmarks in mind. Many fund managers are afraid to deviate too much from their benchmark, and that psychological anchor can be expensive; we are free to ignore it. If the idea is to make the best possible investments, artificial constraints can only hurt the odds of success.

As a practical matter, our portfolio of nine companies looks almost nothing like – and has very modest overlap with – that of the S&P 500 (or any other benchmark). Our goal is a concentrated group of standalone commitments that promise a return of our capital and then an adequate return on our capital. If a company’s future prospects are too difficult to understand, or if its valuation is too expensive to offer any safety, it is eliminated from consideration. Avoiding mistakes is paramount, and a conservative estimate of value should enable us to weather any storms along the way.

An index fund takes a different approach. The committee at Standard & Poor’s is, by definition, agnostic to a determination of price versus value. Size is the key threshold, and individual company weights within the index are determined by relative market capitalizations.<sup>[6]</sup> Over the past two decades the performance of the S&P 500 has also varied in a remarkable way. From 2000 through 2009 the S&P 500 declined more than 9% (with some vicious drawdowns to boot). Just as the dust was settling from the Global Financial Crisis and we were told to strap in for a “double dip” recession or stagflation (or worse), the tide reversed: 2010 through 2019 produced a total return of almost 257%, or 13.6% per year.

The disparity of those two results shows how hard it is to make sweeping predictions. It is impossible to forecast the market’s return over the next decade with any precision, but it would be reasonable to expect something between the returns of the past two decades.<sup>[7]</sup> Either way, it is often more effective to analyze and own individual companies over the long run.

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Portfolio turnover in 2019 was low, even by our standards. A dollar-weighted average holding period of the investments in the portfolio is approaching three and a half years, up from two and a half years at this time a year ago.<sup>[8]</sup> During 2019 we made one new investment (see below) and we sold our small remaining investments in two community banks. We also sold our shares in Spirit Airlines.<sup>[9]</sup> We

executed sales or purchases on 17 days in 2019 compared to 48 days in 2018. And unlike 2018, Christmas Eve in 2019 was quiet as a mouse.

Another benefit of our low-turnover approach is tax efficiency. Our investments were made with the intention of holding for multi-year periods, and as a result most of our realized gains will qualify for long-term tax treatment.<sup>[10]</sup> That said, individual buy and sell decisions are not made with taxes as the primary input. It's a consideration, but a marginal one.

Our prevailing mantra of portfolio construction is that no news is often good news. I always look for evidence that I'm wrong about an investment, and the search for better ideas never ends, but holding on to what we own means that things are going as expected. Occasional bouts of market volatility will offer superior bargains, and we aim to take advantage of them as we did in 2018. We hope to find one or two – at most a handful – of things to do each year. If there's nothing worth doing, we'll wait. Good results are often a slow-motion success story.

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Last year's letter covered the idea of a *business-first investor* as compared to a *securities-first investor*: "A business-first investor considers an entire business on its merits and then looks to see if the securities offer an attractive investment opportunity. A security-first investor considers the security first and the business second (if at all)."

As business-first investors, we focus on the business itself. Our framework relies on the cash the owner will be able to take out of the business in the future. What will the business produce in earnings and cash flow that could actually be distributed to us, and how much could those distributions grow or shrink as the years go by? The level of that distributable cash and the returns on the owner's capital are likely to correlate with the ultimate investment returns over a reasonable length of time.<sup>[11]</sup>

The last two years offered an excellent example of this idea. Overall business conditions in 2018 and 2019 were more similar than dissimilar. There were variations and trends in many datapoints, but the general picture did not change much. Market sentiment, meanwhile, swung like a pendulum. Many market prognosticators revved up their recession-forecasting machines in 2018, and a short but sharp bout of pessimism contributed to a decline in the price of many assets. December 2018 was notable for its gloominess – the S&P 500 dropped 12% through the first 21 calendar days of the month. The selling accelerated on Christmas Eve, and the month finished as the equity market's worst-performing December since 1931. In 2019 the mood flipped: a recession never arrived and the price of almost all financial assets increased.

In both years most of our businesses grew, improved their operations, and became more valuable. By relying on the results of the business we can ignore most of the screeching market-level debate, and a disagreement between the business results and the stock price can be an opportunity instead of a threat. The market is a venue for transaction, not a drill sergeant to be obeyed at all times.<sup>[12]</sup>

<sup>[1]</sup> This is an approximation – for illustrative purposes only – using the dollar-weighted average of the investments in the portfolio.

<sup>[2]</sup> This is not meant to be a comprehensive attribution analysis. Please note that discussion of any positions currently being bought or sold, or any that may be difficult to buy or sell in the future, will be omitted.

<sup>[3]</sup> That thought is attributed to Publilius Syrus and it was recently a well-timed "quote of the day" on the Bloomberg terminal.

<sup>[4]</sup> This is an approximation – for illustrative purposes only – using the dollar-weighted average of the investments in the portfolio.

<sup>[5]</sup> The S&P 500 remains the most prevalent index and therefore the best measure of opportunity cost for most investors, but it only captures the performance of the large-cap segment of the market and other indexes could also be applicable. The Russell 3000 and Wilshire 5000 are broader, while the Russell 2000 encompasses smaller companies that are closer in size to the median company we own. Certain global indexes also have some merit. The various “value” and “growth” indexes, however, use an arbitrary methodology that does not align with our way of thinking.

<sup>[6]</sup> At the same time, the multi-decade shift toward passive investing deserves praise. It’s cheaper and simpler for many investors, and it guarantees the average result. The possible downsides – negligible oversight of corporate governance and less efficient price discovery – are still outweighed by the positives for the foreseeable future.

<sup>[7]</sup> A decent over/under might be something like 5% per year from 2020 through 2029. It also seems reasonable to expect with roughly 75% confidence that the S&P 500 would produce a total return between the (1.0)% and 13.6% returns realized in the most recent two decades. Of course, that implies that we have a one-in-four chance of getting something outside that range. Going back 12 decades, four of them were outside that range (with all of the outliers on the positive side).

<sup>[8]</sup> This is an approximation – for illustrative purposes only – using the dollar-weighted average of the investments in the portfolio.

<sup>[9]</sup> Our last Spirit shares were sold in January 2020.

<sup>[10]</sup> Reasons to sell, particularly within a year of initial purchase, include the recognition of a mistake in the analysis; a major change in the company’s strategy, culture or results; an acquisition of the company; and/or the discovery of a far superior idea. Partners should also be aware that any given year’s reported tax position may not be indicative of investment performance. None of this is tax advice. Please refer to your K-1 and consult a tax professional if necessary.

<sup>[11]</sup> To state the obvious, relying on the business to produce earnings and cash flow that ultimately result in investment returns only works over time; it doesn’t (appear to) work all the time.

<sup>[12]</sup> The market does offer valuable information in the form of prices, but that information often comes with noise that can overwhelm any investors who are not clear about their intentions. Every transaction has two sides, and I want to be able to argue the seller’s case at least as well as she or he could if I’m buying (and vice versa) – only then can I ignore the price signal.

*Disclaimer: Gross Long and Gross Short performance attribution for the month and year-to-date periods is based on internal calculations of gross trading profits and losses (net of trading costs), excluding management fees/incentive allocation, borrowing costs or other fund expenses. Net Return for the month is based on the determination of the fund’s third-party administrator of month-end net asset value for the referenced time period, and is net of all such management fees/incentive allocation, borrowing costs and other fund expenses. Net Return presented above for periods longer than one month represents the geometric average of the monthly net returns during the applicable period, including the Net Return for the month referenced herein. An investor’s individual Net Return for the referenced time period(s) may differ based upon, among other things, date of investment. In the event of any discrepancy between the Net Return contained herein and the information on an investor’s monthly account statement, the information contained in such monthly account statement shall govern. All such calculations are unaudited and subject to further review and change. For purposes of the foregoing, the calculation of Exposure Value includes: (i) for equities, market value, and (ii) for equity options, delta-adjusted notional value.*

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