MOI GLOBAL

Stable Patient Capital Allows Pursuit of Invisible Companies

This article by Scott Miller is excerpted from a letter of Greenhaven Road Capital.

The lack of market volatility and low risk-free rates of return, as evidenced by negative yielding government bonds, has created a tricky environment to invest in. For me, the most attractive companies to invest in are those with high free cash flow yields and sustainably growing businesses. There is a large margin of safety when a company is generating one-quarter or one-fifth of their market capitalization each year in cash. Management has a lot of flexibility and can reinvest in the business, buy back shares, or pay a dividend. Unfortunately, in a low volatility world and low-yield environment where every investor has basic quantitative screening tools available to them, growing companies with high free cash flow yields just do not exist. Yield-hungry investors and ETFs/index funds have bid up the prices of stable cash-producing companies to the point where there is no margin of safety, and, in fact, everything has to go right for the investment to yield attractive returns. When we are several years into an economic recovery, paying 30 times cash flow for even the highest-quality companies is not an appealing option in my mind.

What are we to do? One option would be to try and time the market – we could just accumulate cash and wait for a correction. However, I would argue that timing the market is virtually impossible to do well or consistently. Valuations are not that stretched relative to the prevailing interest rates. The Nasdaq returned 21% per year from 1991-1995 in a period during which the United States had a recession. The prevailing wisdom at the time said that the returns were dramatically above historical returns and were thus not sustainable. Yet, investors who waited for the correction missed another quadrupling of their money over the next four plus years before the market "topped out" in 2000. The point here is not that we must continue to invest because we fear missing out. The point is that timing the market is very difficult and sitting in cash is effectively accepting zero return. Our cash level has been rising as new capital has come into the partnership, but because we are small and nimble, there should be investments that are more attractive than cash.

Fortunately, we do not have to own the market as a whole. Sheryl Sandberg, the COO of Facebook, wrote a beautiful essay (dealing with the loss of her husband and the challenges of raising her children without him and continuing her life) in which she recounts a conversation with a friend where she kept saying how much better life would be if her husband was still alive. Eventually her friend made a statement that resonated with her, "…option A is not available. So let's just kick the shit out of option B." This phrase went on to become a rallying cry within Facebook for less serious matters than raising children, and the expression resonates with me when considering how to approach the current investing environment. We can bemoan the lack of high free cash flowing opportunities and curse the yield chasers who bid them up – or we can adapt and "kick the shit out of option B." I think Murray Stahl from Horizon Kinetics articulates plan B best in his must-read series on indexation:

> "The beauty of the markets, though, is that when one door closes, another opens – for the tide of money to flow into one particular direction, it must drain from somewhere else. That somewhere else means the securities not caught up the indexation vortex. Those securities are relatively invisible: they are not being evaluated or priced actively; the efficient market has passed them by. These are the idiosyncratic securities, available for individual inspection and purchase that we believe have obviously favorable expected outcomes, not obviously unfavorable outcomes. They are artisanal

> selections, so to speak, curated, and the once traditional fare of the active manager."

(Full series available at horizonkinetics.com)

In my shorthand, I now refer to option B as invisible companies. I think that term best describes where and how we have been investing for the past six months – spinoffs, the pink sheets, nano caps, etc. They are the current plan B. The result of pursuing plan B should be the same as day one – a portfolio half invested in high-quality companies with very long holding periods and the other half in special situations which are often "invisible" companies.

Stable Patient Capital Allows Pursuit of Invisible Companies

In a world where information flows easily and companies are restricted from sharing information selectively, real advantages for investors are hard to come by. Our fund has a couple, by virtue of our setup. Our small size means that we can invest in a $150M market capitalization company and still have the investment impact returns in a way that a $5B fund cannot. The second advantage is the stability of our capital allows us to pursue everything from the largest most liquid companies to small companies that "trade by appointment." We are built to invest in invisible companies if we choose. Even as we have grown to 50+ limited partners, my family group still represents 20% of the capital, and the Royce family and Stride Capital will eventually become the largest investors as they continue to invest each month. My family, Royce, and Stride create a very strong foundation. In addition, the majority of new investors have committed to the long-term class with a three-year lock-up. The net result is that I believe that we have exactly the type of investor base we need for the style of investing we are pursuing. We can sacrifice liquidity for a portion of our investments if the return potential justifies it, something we could not prudently do with daily, monthly, or even annual liquidity.

Lessons from the Practice Courts — Don't Watch the Ball

One of the challenges of "invisible" companies is that their strength is often not revealed in their financials. These are companies that do not "screen" well. How do we find companies that don't screen well? Besides looking under a lot of rocks? I know a number of our investors are tennis players – so let's use a lesson from the tennis courts. This summer, my wife (who takes her tennis very seriously) had a big match which I really wanted to see, so I made a field trip. Her match turned into a slow, grind-it-out affair. Over time, I started to watch a lesson the pro was giving on the next court. This was not a kids' lesson where the pro spends time on how to hold the racket or getting the children to watch the ball. This was three players who have "been to nationals," which is USTA code for "serious players," with an even more serious coach playing out points simulating a match.
Every tip the pro gave was about watching the set-up of the opposing player. Really good tennis players are watching so much more than the ball. The pro can tell from an opposing player's knee bend and racket position if a lob is coming or if a hard shot is on the way, and starts to move before the shot is hit. Really good tennis players can tell from the toss of a serve where the ball will be hit – wide or up the middle. Think of the difference between the tennis player who can tell by the toss where the ball is going vs. the player who is figuring out the destination as the ball speeds over the net. I would rather be the player who can anticipate the next shot before it is even hit than the player reacting as the ball sails over the net.

The search for invisible companies is in part about the ball (earnings, revenue, etc.), of course, but the set-up is perhaps even more important. What is the insider ownership? What are the incentives for management? What is the competitive landscape? What is management's track record? Who are the shareholders? What is the margin profile for the business? Is there operating leverage? What parts of the business are growing? What parts of the business are shrinking? What has changed such that historical financials are misleading? How are the “visible” comps valued? Why is the company invisible? Is there a path to greater visibility? The set-up matters; we are trying to invest before all of the results show up in the historical financials and before companies screen well for others.