

## Volatility-Based Alpha, Our Framework, and Compounders

*This article is authored by MOI Global instructor Matthew Peterson, managing partner at Peterson Capital Management, based in Los Angeles. The article is excerpted from a transcript of the latest annual meeting of Peterson Capital Management.*

*Matt is a featured instructor at Best Ideas 2021.*

The agenda today will begin with volatility-based alpha, we'll move into our process and framework and then discuss some of our wealth-building compounders.

During these uncertain times we are once again in an extraordinary environment to execute our core value investing principles and combine them with the structured-value approach that we have been employing since inception. Some of you will recall how we use this very unique and advanced approach, but I'm sure many of you won't realize the potential in this environment.

We buy our securities through an entirely different manner than any sort of retail investor would. This is best explained with an example – we do things very differently.

If you look at this slide here, let's consider an equity that was maybe trading for 200 dollars per share, and has fallen to 100 dollars per share – something that we might want to own, and through deep understanding of the business and valuation, we believe its actual true value to be perhaps, 125 dollars a share.

So, what are our options? You can go into the New York Stock Exchange and buy this security through a market or limit order, but that's actually not what we do, particularly in extreme volatility as we're seeing right now. Volatility is one of the factors that feed into the Black Scholes Model, and that's what is used to price things like these contracts that we use. These are basically put contracts that I am going to describe, and it's the primary way that we enter into these securities.

So, what happens is instead of going to the New York Stock Exchange to buy the security, we head to the Chicago Board of Exchange, where we can engage with an individual counterpart and make a contractual agreement with them, and sell them a cash-secured put contract guaranteeing that we will purchase their shares for \$100 dollars over a period of time.

So, instead of buying for \$100 in the New York Stock Exchange we just commit to buying it for \$100 through the Chicago Board of Exchange, and we are paid for that commitment. And when volatility is extremely high, the IRR – the [amount] that we are paid, the premium, grows significantly.

And so, in an environment like we're in today it's quite easy to pick up, say, 25 dollars for this commitment to purchase a stock for \$100 that we think is worth \$125. And, we pick up a 25-dollar premium, and then we basically hang on to that along with our 75 dollars in collateral. And then we wait, we wait over the course of the year. If the shares go below \$100, our counterpart has the right to sell us their stock, and we actually love it when they do – we've now gained ownership of those securities for 75 dollars a share. So, we bought them at a discount to what they're selling for at the New York Stock Exchange, a discount to what any retail investor would pay for these shares.

Alternatively, should the shares appreciate in value, the contract ends after a year, they've paid us the premium, we keep holding that premium, and we now have a 33 percent return on our 75 dollars in

collateral over one year. So, we've earned 33 percent just on the premium due to this increase in volatility.

So, everyone - we are in a zero-interest rate environment. The fact that we have this opportunity at the moment is just incredible. And most importantly, volatility is back.

During Q1, markets experienced the fifth decline in excess of 30 percent going back 40 years. Peak to trough, the S&P 500 fell 34 percent. The Dow fell 37 percent, which was the fastest rate on record. And the VIX, which is the fear index, exploded from lows of low teens. In fact, for several years it was sub-10, and it exploded to 85, which is also another record. This is the fear index- we are at the highest amount of fear ever. Most of us rationally know to be greedy when others are fearful, so it seems maybe obvious, but here is the secret - if you want to make money when fear is breaking all records, you need to ignore the noise and get hyper-rational. It's important to do this right now because theory and practice are actually inconsistent quite often. The inconsistencies between economic theory and reality become more obvious during times of volatility and uncertainty.

So, in theory, for example, we have the Efficient Market Hypothesis. The Efficient Market Hypothesis tells us that markets are efficient pricing mechanisms and that everything is priced perfectly all the time. It's amazing that even the professors who teach this stuff know it's not true - it's pretty funny. In practice, we know that markets are made up of people who are swinging to emotional extremes. So, it is better to conceptualize a market, not as a perfect pricing mechanism, but as a pendulum. This pendulum is swinging around at different prices in the short term based on human herd psychology.

So just think about it for a moment- where are we today? We are in a global pandemic, there is social unrest, we have political uncertainty, we're in a recession, fear is at a maximum, the VIX is volatile and we have 5 trillion sitting in cash in customer money market accounts at banks - this is an incredible record - earning zero percent. The unemployment record also hit [nearly 15] percent. People are worried, people are scared and people are really uncertain.

In fact, we're in a period of greater uncertainty right now than most people alive have ever experienced. And, the vast majority of stock market participants talk about markets, and one of the positive aspects being its liquidity, which means that underlying their investment thesis, they are focused on the short-term, or at least are aware that they have the ability to exit. They are certainly not long-term business owners like we are, and this is where long-term business owners can really thrive.

So, after we were up in 27 percent in 2019, our performance took a short-term hit as well. We were down 29 percent during the first half of 2020. But, as I'm going to prove to you all, this is not of any concern for long-term investors. This is not a concern for me, and should not be a concern for you. You may ask, "Matthew, how are you going to prove that volatility, and is not a concern?" We are going to clear that bar.

Risk is the probability of a permanent loss in capital, and we are incredibly risk-averse. Volatility, however, is not synonymous with risk. That's why on March 25th, I sent the first special memo in 9 years of our fund's history to every limited partner urging them to invest.

I quote from the memo that I sent out:

"Amid the daily tragedies, this historical moment happens to be one of the rarest and most unique opportunities to buy equity in our lifetime. With volatility peaks combined with new deep value opportunities, this is by far the most exceptional moment to invest we have experienced since the inception of the fund in 2011, 2012 and 2013 when returns were extraordinarily strong....Two

situations alone create a 30 to 40 percent upside return in the near term and do not include many other promising aspects of our portfolio...We do not fear price volatility around high quality opportunities.”

Now, some of you jumped at that opportunity, and your rationality will be rewarded. More of you are joining now, and you too, will be rewarded. For the rest of you, you have to ask yourself what are you waiting for. This is hell freezing over. This is the plague. You have to be greedy when others are fearful. But nobody said it would be easy. It is actually very difficult, and that is the point.

I mentioned that in H1, our portfolio prices dropped 29 percent, all of our very valuable holdings went on sale. My hope, before I show you the next slide, is that you recognize that because of this environment, we are at the very beginning of a long runway packed with extraordinary opportunities for the fund. And so, thus far during the second half of 2020, we are up over 33 percent. So, that's in the last 7 weeks, exactly as I explained in the memo. But the world has changed. We are now getting paid 30, 40, 50 percent IRRs in premiums for commitments to buy deeply undervalued companies from counterparties on the Chicago Board of Exchange who are very fearful, and maybe do not have a grasp of the qualitative aspect of the business. So, we now have the wind at our backs.

Our focus is on managing this downside risk. We own superior, high-quality, valuable businesses, and we are certainly concentrated, so we experience short-term price movements. However, if the businesses we own are growing – if the value is growing – the prices in the market will ultimately catch up to that value.

So, again – we're in a new environment and the volatility and uncertainty is extreme. But, if you focus on bottom-up business analysis like we do, this is the environment where we're all going to thrive. We're looking at businesses that go out far beyond this uncertainty. We're looking through this uncertainty. Those of you that do the same will certainly be rewarded.

Process is essential for this success. I've actually written on this extensively in annual reports of the past. We have a very specific and unique process, and each of these steps is an alpha enhancing step over the long term. We use very specific channels in step 1 including 13F analysis and reports to identify a pool of potentially deep-value opportunities. And, like Charlie Munger says, you have to fish where the fish are. So, we are narrowing down the global set of securities, let's say, 10,000 potential investment opportunities, to maybe 100 that we can reasonably look at. What we're really doing is finding needles in a haystack- sort of sorting for needles among needles.

The second step here is that we employ fundamental analysis to identify the deepest value, along with things like the top management and the very best business models.

The three in the process, as we discussed from the very beginning, is our unique approach to gaining exposure to these businesses where we're paid a premium, and then use the short put as a tool to purchase our equity. Very much today, that allows us to get in far below market prices or pick up very high IRRs on the premium.

And then finally, we need to focus on portfolio construction. We apply methods like the Kelly Criterion, which optimizes the portfolio construction. It recommends and suggests that we are much more concentrated. And so, we optimize the portfolio and definitely don't over diversify. As many of you here on this call have heard me speak about, [this happens] in most other mutual funds, index funds, and all sorts of other opportunities. So, we are optimally diversified, which means that we will have some volatility.

There is also another framework that I think is important to share with you, and this is our co-

priorities framework.

When we are looking for a portfolio position that is going to compound at high rates of return, we're looking for a very rare gem. These co-priorities are very hard to find. We're looking first for an exceptional business model, superior management and extraordinary value. When you get an exceptional business model and superior management it is typically very hard to find it at a good price.

But this framework is essential because an exceptional business model will draw significant cash flow into the hands of management. So, you better have high-quality management, because one of the primary responsibilities of the c-suite managers of these companies is allocation of this business cash flow. So, they need to be exceptional capital allocators.

When the c-suite has cash, they have options- they get to make decisions. They can re-invest in their own business, they can pay off debt, they can issue a dividend, they can engage in some merger acquisition, or they can start buying back stock. There are really five major buckets, and they need to make these decisions from the perspective of a long-term shareholder. Because when those decisions are made well, the compounding can then continue, and it can even accelerate and become a nice system.

So finally, the third co-priority.

We are value investors, so we are not going to overpay, even for great businesses and great managers. We are looking to pay far less than the intrinsic value of the underlying business. Our portfolio is comprised of these rare opportunities.

As you know, we manage an extremely concentrated portfolio. In fact, these four holdings - Daily Journal, Berkshire Hathaway, Dhandho, and Talas make up over 50 percent of our portfolio. So, we are not immune to short-term price swings.

In fact, Daily Journal has gone from \$300 to under \$200, and back to \$290 in six months. And, as I'll show you, it's worth over \$1000, so I was never worried. It never gave me one moment of concern.

We are also focused on very asymmetric risk-reward situations - firms that have embedded downside protection with the potential of parabolic upside. We want great firms run by great people selling for a cheap price with asymmetric upside - and believe me, there's not a lot of those out there.

So why is there so much value in these firms here? Because for one, a lot of the value is hidden. You won't find these stocks showing up in your stock screener - there's off financial statement value here and they are misunderstood by the market.

I'm going to briefly provide some details on Daily Journal and Berkshire Hathaway, with the caveat that I typically do avoid the discussion of current holdings due to the well-known commitment and consistency biases. But in reality, these are long-term Fisher compounders. We're going to hold these for a decade or longer. I actually don't mind sharing them, but I am aware of the biases that it creates.

So, as we hold these for this decade plus, we will of course continue adding to these positions, or selling puts and earning premiums during the dips along the way.

So, Daily Journal Company.

This is basically a big secret. Most people have never heard of this amazing firm, and anybody outside this room who has will mostly tell you that Daily Journal is a newspaper business. It's not a newspaper

business at all. It was a 10-newspaper business that now contributes to less than 25 percent of the revenue. And what is happening today is totally misunderstood.

I actually presented a few of these slides in Switzerland last year, and titled my talk, "Hiding in Plain Sight" because this is such an obvious example of a terrific business model, exceptional managers, and deep value that is not apparent by looking at the financial statements.

So, who runs Daily Journal Company and who is the management?

Daily Journal is managed by many of the best business managers in the history of the world. Charlie Munger, Buffett's partner of 55 years is the chairman. He bought the company 43 years ago for 2 million dollars with Rick Guerin, who is on the board as well, and was written up in 1984 by Warren Buffett as being one of the 6 super-investors of Graham and Doddsville.

Peter Kauffman is on the board as well. Peter Kauffman is incredibly wise and known for writing Poor Charlie's Almanac, and is the CEO of Glenair, which is a very successful aerospace manufacturing firm. Many of you are probably familiar with his work there. Regardless, the point is that the company is completely stacked with hand-selected talent by Charlie Munger over four decades. So, we have the management covered in spades.

What's the business? Well, this company has one of the top business models in the modern economy. It's a SAS business model - it's software as a service. They have a family of software products that are provided to courts and municipalities around the nation and around the world. These products help courthouses manage cases and information electronically, interface with other critical justice partners, and they extend electronic services to the public so they can pursue things like electronic filings. There is also a website where they can pay traffic citations and other fees.

So, when it comes down to the third bucket for co-priorities, the valuation bucket, that's all we really have to understand. They have the best managers and they have the best business model. So, what is the valuation?

This requires a bit of background.

Forty three years ago Rick Guerin and Charlie Munger bought a newspaper for 2 million dollars called Daily Journal. Over the decades they accumulated 10 newspapers, which is why people mistakenly assume it's a newspaper business.

During the financial crisis it is important to know that they had about 50 million in cash. And so, in March of 2009 Guerin and Munger bottom ticked it to the day and put all of their money in at market lows. They bought - I think 75 percent of the portfolio is Wells Fargo and Bank of America. They also clearly believe in concentration. They have turned it into a 150-million-dollar equity portfolio today.

And by the way, that equity portfolio is down from 200 million at the beginning of the year. But I guarantee to you that it is absolutely no concern to them at all. So, 150 million in an equity portfolio.

This is a 400-million-dollar market cap company. And let's put the newspapers at a value of zero - it's really not at zero at all, but we can just ignore them and have a secret asset inside. So, they basically have a 150-million-dollar equity portfolio, they have 16 million in real estate - they own a few offices - and then they have 10 million in cash. And, if you account for the 60 million in long-term debt, it is actually the most amazing type of debt - it's deferred capital gains tax - they never have to pay it and it's at an interest rate of zero. This is because their equity portfolio went up.

So, they have deferred capital gains tax, and then kind of a 30 million noncallable margin loan on the equity portfolio. So, they borrowed 30 million to build out the technology piece. It's noncallable- they

never have to pay it, or can pay it whenever they want - and the interest rate is 0.75 percent. So if you thought your mortgage was low, Munger has figured out a way to finance his business for 0.75 percent.

So, they've got the equity, real estate, cash minus debt - it leaves 115 million in solid assets that are actually liquid - net of debt, and then all you're left with is this technology business. That has the perceived market price here of 285 million. It's a tiny microcap run by a group of the best investors of all time.

So, the question really is - what is the value of the technology and software firm?

To understand this, I need to share with you a brief story. After 10 years of following the firm and some attempts to understand what was happening in software space, I began to discover that the information was so sparse that none of the professional fund managers or Munger fanatics knew anything about what they were doing in a tech space. So, my search continued. During this extensive search I discovered that there was a customer training seminar that was taking place in Utah. I thought that I would try to attend a training. But, without government credentials or a court ID it was impossible for me to register. Ultimately, I flew to Utah during the training, booked a room at the hotel, and sat in the lobby for three days interviewing the customers as they moved between all of their training sessions.

The information that I uncovered was enormously valuable. I learned that customers live and breathe in this software. When I say customers, I mean courthouse employees, and the customers of Journal Technologies. They live and breathe in this software all day. I learned how much more efficient it made their jobs. But most importantly, I learned that one of the main competitive advantages that Journal Technologies had created was approaching the bureaucratic RFP process with a 4 to 7-year billing delay. So, they're getting a major government contract and not billing them for 4 to 7 years. Imagine that. All of the ongoing costs are on their financial statements, but the revenue is being totally unaccounted for.

That was so shocking to me. I'd never seen something like this. That means that 10's and perhaps 100's of millions in revenue are missing from the financial statement of a 285-million-dollar tech firm. And further, a lot of it is going to drop right to the bottom line, or at least be able to be re-invested in new high-growth opportunities. The management is excellent, which is why this is hiding in plain sight.

So, I brought in an intern to focus intensely on searching for these government contracts. Because although this was absent from the Daily Journal financial statements, I realized it would probably be accounted for in cities and municipalities pursuing an RFP process or implementation.

We searched across 3,000 counties in the United States, scanning state and mobile government meeting minutes. It was an incredibly onerous process. We were searching for key words like, "Daily Journal," "Journal Technologies," and all sorts of software just for some clue that a court software solution was being implemented. And we found incredible things. We found contracts in Los Angeles. Los Angeles owes them 5 million dollars. Austin Texas owes them 1 million dollars. And, we found two software implementation contracts in Australia for 16 million and a whopping 89 million dollars - all unaccounted for on the Daily Journal financial statements because of their deferred gratification ethos and approach. In total, we ultimately identified over 100 implementations across America, Canada and Australia. Many of these contracts are huge contracts.

As we think about how we're going to value this firm, I also learned in the training conference that the software was sold in 100 license units for 100k per year, with an inflation-based price escalator and a

10-year commitment. This meant that the revenues were going to be incredibly sticky and that they had pricing power once the implementation was complete.

And by the way – as you all know; no bureaucratic municipality is going to switch software programs after 10 years of use and experience.

So further, I understood and learned that demand was growing quickly. Once these implementations were complete, I learned from the customers that demand for the individual licenses was growing. This is because each employee benefits from ultimately having their own independent log in.

And again, I discovered that with all of the interfaces that they had created for the external justice partners meant that once the implementation was complete, many of these partners would then request their own implementation so that they could seamlessly interface with the courthouse electronically.

So, the whole ecosystem is pointing in the right direction. This is all happening right now – it's just incredible. Many of these municipalities and courthouses run really terrible antiquated systems. And frankly, that's why you see attorneys carrying around massive briefcases filled with paper. And here is a little-known newspaper company run by the most brilliant man alive, providing a major efficiency to this enormous space. Ultimately, I do not know how large this is going to become, but they have incorporated all of these moats into this business and designed it to thrive.

So, what are some of these? They are operating in a huge space with network effects, they have pricing power, there's enormous switching cost, and they've implemented invariant strategies like deferred gratification and trust. They also have win-win relationships with the whole ecosystem from the courthouses, to the regulators, to the customers, to their shareholders. Furthermore, the customer becomes completely dependent on their service, and they operate a SaaS business with huge margins. On top of that, the way that they present this to the courthouses, it actually delivers a great IRR for the buyer. It's a better product and continues to improve with societies dependence on technology. With all of that said, and good luck competing with that, we've modeled out, high margin revenues [may] reach 150 million for the subsidiary this decade, and it will still be very early in their long-term potential.

So, with a reasonable multiple on high-margin income, this is perhaps a 1 or 2-billion-dollar business tucked inside of a little microcap newspaper priced at 285 million dollars. I will also add that there is the growing 150-million-dollar equity portfolio. With all of this that we discussed and the business basically evolves as it's evolving. The \$200 – \$300 price range of the stock is going to go over \$1,000. We just have to be patient.

So again – \$300 to \$200 to \$300 in 6 months sounds scary, I know. But I can't emphasize enough that this volatility is absolutely no concern. We have firms that should be selling for \$1000 or more this decade. And in fact, I don't want to start speculating too much, but they could start offering all sorts of additional software. I see new businesses popping up in the contracts like cloud hosting services all the time. And should they start wanting to manage public school technology or adoption agencies, or handling sensitive government data, the prospects just jump further. They have a long runway ahead, they're in a huge open space, and if the business reaches 3 billion market cap, we will end up with 10x on our investment.

Finally, regarding Daily Journal – thank you for all your patience with Daily Journal, I promise not to do this with Berkshire – let's talk about the asymmetric risk-reward.

So, if you wanted to argue that the technology business would completely fail, it's worth zero – that's



hardly a possibility. The 150-million-dollar equity portfolio that they have is going to grow into the market cap of the entire firm this decade. So, despite the volatility, the risk of loss over a few years is close to zero, while the upside is conservatively many multiples of the current price, and the risk-reward is completely asymmetric.

And so, I wanted to go through this in detail here because it hopefully helps explain why I am completely comfortable with firms like Daily Journal as a large, volatile long-term holding in the portfolio, and it actually makes dips in the price exciting opportunities and not scary ones.

Lets now examine Berkshire Hathaway. I'll be brief here.

Berkshire is another core holding that hardly requires that type of introduction. They have extraordinary management - many of you will be very familiar, they have exceptional diversified businesses. These businesses have been hand selected by Warren Buffett and Charlie Munger. The business model is primarily is based on float, or a negative cost to capital. And finally, they are very cheap and have significant downside protection.

Last year at this meeting that some of you attended, I showed their pathway to 1.7 trillion valuation. I wrote about it extensively in our annual letter as well. I'm now going to simplify this even further. A breakdown of Berkshire can be viewed as follows. The market cap is 500 billion today, they hold 145 billion in cash, they have a 210 billion equity portfolio, and nearly half of that is Apple. They also have 100 subsidiaries like BNSF Railroad, NetJets and Geico. And, if you put a really reasonable multiple in this environment on these operating companies earning 22 billion per year - put a multiple of 15 and you get a 330-billion-dollar valuation.

So, that gives us the value today, 685 billion and growing. That's a full 35 percent upside to today's price just to reach a conservative fair value. That doesn't include things like stock buybacks that are basically going to approach, or looks like they will approach, 10 billion this year. So again, this is a firm that thrives during uncertain times. Berkshire has 145 billion dollars in cash sitting and ready to be put to work, which will clearly enhance that value further.

You will all recall from the very beginning the secret we have on volatility is that we use puts to enter these positions - we're selling counterparts puts. At the Chicago Board of Exchange people are paying us to buy their undervalued Berkshire. In the previous few years, we might have picked up a 5 percent IRR, but now we are getting enormous premiums on Berkshire Hathaway.

So, during dips in Q1 with a current value of \$280 per share, which you saw on the last slide, we were able to commit to buying these shares from a counterpart for 165 dollars over a six-month period. We would be delighted to buy Berkshire for \$165. Those contracts expire in September - it's coming up next month. We were paid 18 dollars for our commitment to buy their stock for \$165. That reduces our price further down to \$147. But we're not going to buy those shares.

Actually, what they handed us was a 25 percent [annualized] IRR on an extraordinarily safe opportunity in a zero-interest rate environment. I can't emphasize this enough, it's just so remarkable that you take a company as secure, maybe the most secure business available, and when it's dipping in price, people are paying us a premium to buy their shares for a price below the current market price. We're earning 25 percent annualized premiums from what people are paying us. It's incredibly safe and it's remarkable. These types of situations are why it's such an extraordinary time to be putting capital to work right now.

I would like to remind everyone of our mission statement:

Our mission is to provide a world class capital appreciation vehicle that builds enormous wealth for



our long-term partners.

*The content of this website is not an offer to sell or the solicitation of an offer to buy any security. The content is distributed for informational purposes only and should not be construed as investment advice or a recommendation to sell or buy any security or other investment, or undertake any investment strategy. There are no warranties, expressed or implied, as to the accuracy, completeness, or results obtained from any information set forth on this website. BeyondProxy's officers, directors, employees, and/or contributing authors may have positions in and may, from time to time, make purchases or sales of the securities or other investments discussed or evaluated herein.*