Forward thinking. Finding value.

MANAGER'S Q3 COMMENTARY – FELIX NARHI

"You cannot swim for new horizons until you have courage to lose sight of the shore."
— William Faulkner

To date, 2017 has been a much better year for the S&P500 than we had imagined. The flip side of an above average year, especially within an extended bull market, is that prospective returns will likely be more muted. With the major indices regularly hitting new records and valuations at historic highs, finding good value and the proverbial "needles in the haystack" is increasingly difficult. Nevertheless, we believe there will almost always be mispriced securities available in some corner of the market, whether the S&P500 is at all time highs or not. However, an investor needs to have a contrarian mindset and the capacity to follow an idiosyncratic approach to find them.

Some Thoughts on Passive Investing - The More You Know

Stock prices are increasingly driven by non-fundamental factors because investor inflows are going to passive and quant strategies that are, by definition, largely valuation agnostic. A positive feedback loop can develop when new capital *must* be invested in certain asset classes regardless of valuation or fundamentals. This can move prices higher, which in turn attracts more capital thanks to the favourable price action. In a report released last summer Marko Kolanovic, global head of quantitative and derivatives research at JPMorgan observed, *"While fundamental narratives explaining the price action abound, the majority of equity investors today don't buy or sell stocks based on stock specific fundamentals".* The study estimated that "*fundamental discretionary traders*" accounted for only about 10 percent of trading volume in stocks today.

The shift toward passive investing and other forms of rule-based investing, such as index funds, factor-based investing, quantitative investing and exchange-traded funds (ETFs) is raising important considerations for investors. The decline of active investing means that, in many cases, stock prices have become more correlated and more closely linked to a company's "characteristics", such as its index membership, ETF inclusion or other quantitative-factor attributes. As a result, companies' stock prices have become less correlated to their own fundamentals and cause market distortions, particularly over the short term and for stocks that are liquid enough to absorb large inflows.

However, it is important to keep in mind correlations between similar firms based on their "characteristics" break down when observed over longer durations. The longer one owns a stock, the more its returns will reflect the underlying economics of the business itself. But stock prices frequently detach from their fundamentals over the short term. Being on the other side of the trade of investors who care less about valuation and other important factors that drive long-term returns is not necessarily a bad thing in our view. It is an opportunity for those investors who *dare to be different, take a bottom-up value-based approach to investing and maintain a long-term view*.

A trade only occurs when two parties have contrasting world views, different investment strategies or other motivations for buying and selling a stock. Increasingly, the counterparties are not even human, but rather algorithms that have been programmed by humans to mechanically follow rules-based trading strategies. Unfortunately, these rules are often limiting or worse, misleading.

For example, the S&P500 index represents a portfolio of 500 of the largest US headquartered firms. If the S&P500 holdings were to be split up between two ETF groupings in order to reflect opposing world views, say "value" or "growth" investing, one might understandably think the total would still add up to 500. That is not the case. Consider that the iShares S&P500 Value ETF has 349 holdings while the iShares S&P500 Growth ETF has 331 holdings. Collectively, these two funds hold 680 names. Why does ETF math add up to more than 500? Because a number of holdings are cross held in the both the Value ETF and the Growth ETF. Instead of remaining

faithful to the demarcation lines that traditionally separate “growth” and “value” stocks, the designers of these ETFs had other more important priorities.

Since there are only a limited number of S&P500 stocks that have enough liquidity to satisfy the needs of ETF manufacturers, the most liquid stocks of the S&P500 will go into both indices, regardless of whether they have “value” or “growth” characteristics. Regrettably, an iShares S&P500 Value ETF investor who thought she was getting the representative “value” stocks of the S&P500 actually got a lot of very liquid “growth” stocks as well, and vice versa. Not surprisingly then, the long-term returns have been very similar for both ETFs, because the funds are highly correlated to each other due to their ownership of the very same liquid large stocks. And this is just the tip of the misleading ETF iceberg. When it comes to ETFs, it is still important do your own homework on what is actually in the ETF and not "*judge a book by its cover*". (Note: this ETF example aside, we believe value and growth are actually connected concepts rather than opposing investment styles (see For a Winning Portfolio, don’t just think Value vs. Growth)).

Risk evaluation is at the forefront of our investment process (see How Pender Thinks about Risk). One of the three pillars of our Trinity of Risk (Montier) framework is *Valuation Risk*. If an investor over pays for a stock, it doesn’t matter how well the underlying business performs, the returns will likely be mediocre or worse. Prospective long-term returns for any given stock will largely depend on whether the stock was bought at a discount to its intrinsic value *and* the underlying economics of the business itself. As a group, we believe the valuation risk for the large caps listed in the S&P500 is high. According to a recent report by Goldman Sachs, the prolonged bull market across stocks, bonds and credit has left a measure of average valuation at the highest since 1900. Strategists Christian Mueller-Glissman wrote, *“It has seldom been the case that equities, bonds and credit have been similarly expensive at the same time, only in the Roaring ’20s and the Golden ’50s*”. Price-to-value considerations are an important part of our investment process – we will buy a stock when we believe we will obtain more intrinsic value than we are paying for. Importantly, as a small and nimble investment firm with flexible mandates, we are not forced to look for our ideas in the S&P500 or the TSX. We are able to search for ideas outside the box. And in the absence of compelling investment ideas, we believe an investor’s default position should be cash (see Cash as a Strategic Asset Class).

Source of New Ideas - Unloved, Underfollowed or Misunderstood

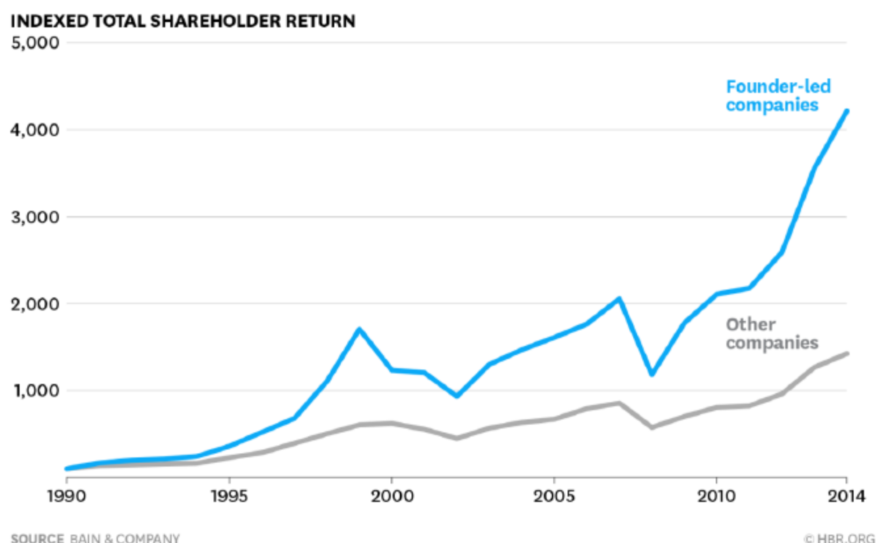
In general, our *new ideas* can best be described as *unloved, underfollowed* or *misunderstood*. These three buckets provide an ever-changing list of potentially mispriced securities. We are not finding a lot of good ideas in the S&P500 or TSX because they are *well-loved* and *over followed*. The average large cap stock has 22 sell-side analysts covering it. Sell-side analyst coverage dwindles with size, so the odds of finding mispriced ideas increases as market cap declines. Indeed, a significant portion of the micro and small cap universe has no analyst coverage at all. Most of our portfolios skew to holdings that are not listed in the major indices or individual stocks that we bought after the company had a “hiccup”. Some stocks are medium and large cap, but are more likely to be mispriced because they are systemically excluded from the major indices like the S&P500. These include limited partnerships like KKR, an alternative asset manager, and tracking stocks, such as LiLAC, the tracking stock of the Latin American cable and wireless business of Liberty Global. Note, we recently sold KKR following a nice run up which was held across multiple mandates, but continue to own LiLAC (LILA). Tracking stocks are transitory investment vehicles which many investors avoid so they often trade at a discount to fair value. The good news is the LiLAC will soon become a fully asset backed company, which makes it more eligible for inclusion in ETF strategies and more palatable for institutional investors.

In the third quarter, we purchased an initial stake in TripAdvisor, a founder-led firm. We see a disconnect between the fundamental value of the world’s largest travel platform and the near-term “monetization gap” of the franchise. TripAdvisor offers consumers a comprehensive travel platform to research and book hotels, attractions, and restaurants with enviable global reach that is unmatched by peers. In short, we believe either

the current management team will be able to bridge this monetization gap, or the firm will be put up for sale and someone else will do it for them. Perhaps the world's largest travel platform would be worth more to a strategic buyer with great monetization capabilities than to public investors?

Founder-led Companies Tend to Outperform the Rest

Followers of Pender's strategies will know that our Funds tend to have much greater weights in founder-run companies relative to benchmark weights. This preference first became part of Pender's investment strategy thanks to lessons learned from our historical roots in private equity and venture capital. We found that identifying and investing alongside great management teams, often led by their founders, was often one of most critical factors that separated success from failure. Not surprisingly, this experience also translates well into the public markets. Our long-held thesis that founder-led firms as a group tend to outperform the market is backed up by persuasive empirical data. [According to an analysis of the S&P500 firms by consultants Bain & Co], founder-led companies created three times more end wealth over a 24-year holding period than firms run by professional CEOs, but investors should be prepared for a bumpier journey (see chart below).



Not only do founders tend to have much greater *skin-in-the-game* than their professional counterparts, they also have more *soul-in-the-game* and the long-term term orientation that is critical to build thriving enterprises. According to the study, most companies that achieve sustainable value creation are run with "the Founder's Mentality", or a set of motivating attitudes and behaviours that can usually be traced back to a bold, ambitious founder. *Founder's Mentality* consists of three main traits: *a sense of insurgent mission, an obsession with the front line and an owner's mindset* and we can attest to the benefits of this mindset first hand when investing in smaller-sized private companies. The study further shows that firms that are able to maintain the *Founder's Mentality* as they age are four to fives times more likely to be top quartile performers in the public markets.

S&P500 Index - The Anti-Founder Index?

There are important implications for investors who believe in the premise that founder-led firms tend to outperform over the long haul. Of note, the S&P500, which accounts for almost 80% of the market value of all US publicly-listed equities is comprised of mostly mature firms where the majority of the original founders have long since departed the scene. Today, only five percent of S&P500-listed firms are still founder-led. In practice, S&P500 investors obtain even less than five percent exposure. In 2005, Standard and Poor's altered their US

indices in a two-stage process from a simple market capitalization weighting to a free float weighting to reflect the number of shares available for trading. By acknowledging the impact of supply to the demand, S&P's included a liquidity adjustment on the pricing mechanism. This was a perfectly logical change for index funds. They want to sell more index funds and investors can't buy what the founders own because it is not for sale. However, it is an ridiculous constraint for individual investors with smaller portfolios.

As a result of these changes, many of the great entrepreneurial firms that create the most value have had their weighting in the index reduced by the amount of insider ownership. On the other hand, when a founder's ownership declines, likely near the end of his or her career, and after much of the big returns have already been generated, the index is *forced* to buy more shares because the free float is increasing. *That's to say the S&P500 index is fundamentally structured to be biased against founder-led firms.* All things being equal, investors who believe in the thesis that *founder-led firms tend to outperform over time* should make the opposite trade to the S&P500's mechanical rule-based weighting mechanism. *Buy stakes in firms when they are still founder-led and sell or lower weights when the founders move on.* Again, similar to the iShares Value and Growth ETF discussion earlier, the S&P500 index is not necessarily constructed in a way that produces optimal results for investors, but rather oriented to make it more liquid and sellable.

Irrespective of the index' shortcomings to weighting, the S&P500 may not be the best place to find tomorrow's founder-led success stories. As a practical matter, newer firms that still trade outside of the mature larger indices are more likely to have young founders at the helm who still have many years of value creation ahead of them.

Forward Looking, Seeking Value

Investing is a probabilistic endeavour. There are no certainties. It is not important to know what will happen, but it is important to understand the world for what it is, take the long view and apply some reasonably high probability outcomes to compelling opportunities when they arise. We actively seek out securities and markets where our counterparties buy and sell their stocks without much regard to valuation. We also seek to buy securities that have attributes that we believe the market is systemically undervaluing, such as founder-led firms. We continue to seek idiosyncratic idea in small-to-mid cap names, large caps that are still founder-led and amongst securities listed outside the popular benchmarks.

Please do not hesitate to contact me, should you have questions or comments you wish to share with us.

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