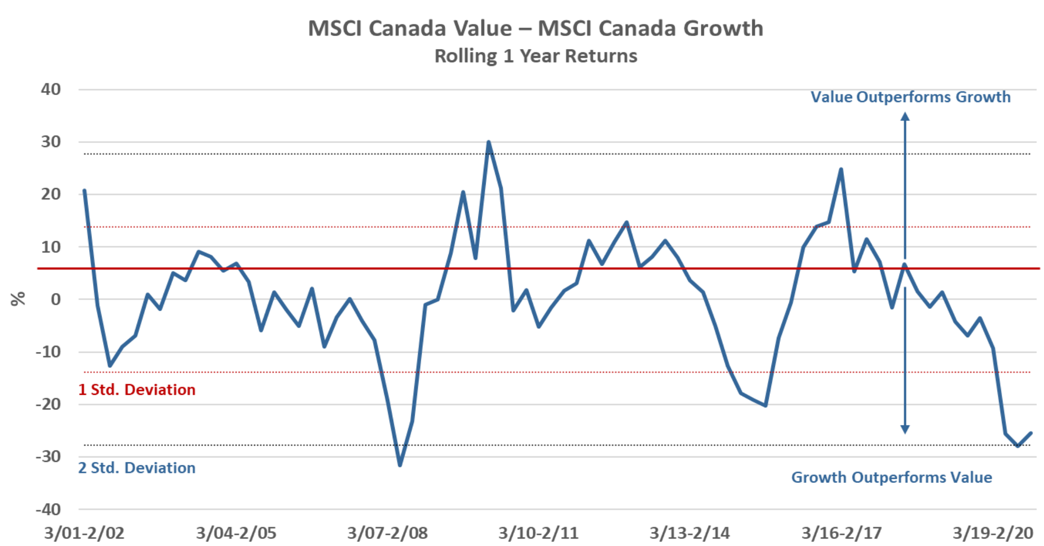
A Fundamental Approach to Value Investing

COVID & LOW INTEREST RATES HAVE TEMPORARILY DISRUPTED THE GROWTH-VALUE PARADIGM

"The four most dangerous words in investing are: 'this time it's different.'" - Sir John Templeton

A lot of time and mindshare has been devoted to the Great Divide of value and growth managers over the last number of years. This has accelerated in a pandemic-challenged world where technological disruptors in many cases have seen their businesses strengthened at the expense of more traditional "old economy" businesses. As these trends have solidified, investor optimism (and pessimism) has split large swaths of the market into winners and losers and reassessed the relative valuation multiples ascribed to them. This has resulted in examples of highly speculative market behaviour that has shades of dot-com bubble euphoria: explosion of retail trading volumes spurred by government stimulus and new "no fee" app-based brokerages, trading activity in bankrupt companies like Hertz (HTZ-N), meteoric rise and subsequent fraud accusations in concept stocks like Nikola (NKLA-O), and most recently tech IPO ecstasy taking Snowflake (SNOW-O) up 150% on the first day of trading to US$80B market cap and ~200x Price to Sales. The Canadian equivalent in 2020 saw innovation leader Shopify (SHOP-T) account for ~60% of the S&P/TSX Composite return, now has a market cap of ~$200B – the largest in Canada – and garners a valuation of ~40x sales! Early 2021 has witnessed the crowd investing phenomenon as Reddit users attacked specific companies with high short interest. These companies, which were targeted by hedge funds betting on their shares to fall in value, were subjected to a "short squeeze" where some of the short positions were forced to close. Brick and mortar video game retailer GameStop became the poster boy for this activity with its shares moving from $17 at the start of the year to a peak of $347 in late January. In this environment, its no wonder the "death" of value investing is being lamented so heavily. **Figure 1** illustrates the recent outperformance of growth versus value, a differential that is currently a 2 standard deviation event. However, like most concepts related to markets and investing the answer is not as simple as it looks on the surface. Its worthwhile to define how value investing is viewed more broadly, and specifically what it means to us.

FIGURE 1:



Source: Evestment

TRADITIONAL VIEW OF VALUE INVESTING

"Buy cheap and sell dear." - Benjamin Graham

For much of what is considered the core tenets of a value investing philosophy we have Benjamin Graham to thank. Concepts like margin of safety, determining an intrinsic value based on the facts, market sentiment versus speculation and many others have been eloquently laid out in *Security Analysis* (with David Dodd) and later *The Intelligent Investor* for over 75 years. Though many of Graham's insights remain as relevant today as ever, some have chosen to focus more on the specific applications laid out in these texts, like searching for "net-nets" (shares trading lower than net current asset value per share) or absolute levels of low price to book value (P/B), or low price to current earnings (P/E) as the way to demonstrate value discipline. Though not entirely what Graham espoused, the "cigar butt" investing style (an allegory that suggests a cigar butt left on the side of the road still has one good puff left in it) that decouples low price from any consideration to the quality of the company or the durability of their earnings has nevertheless been linked with him. Thus has followed the traditional view of value investing, buying stocks that are cheap on price to book value or price to earnings – and this is still the sole way many of the value benchmarks are compiled or stratifications take place. Like most things that get systematised, it becomes a shortcut (it is human nature to do the least work possible) and in our view results in a sub-optimal classification as it underrepresents many key investment considerations. The investment universe today does not look the same as in the 1950's: accounting conventions have changed, interest rates have changed, North American economies are much more service based, and internally generated intangibles that are so dominant in the knowledge-based economy are not recognized on any balance sheet. If the historical view and stratification is too narrow, how do we demonstrate a value discipline?

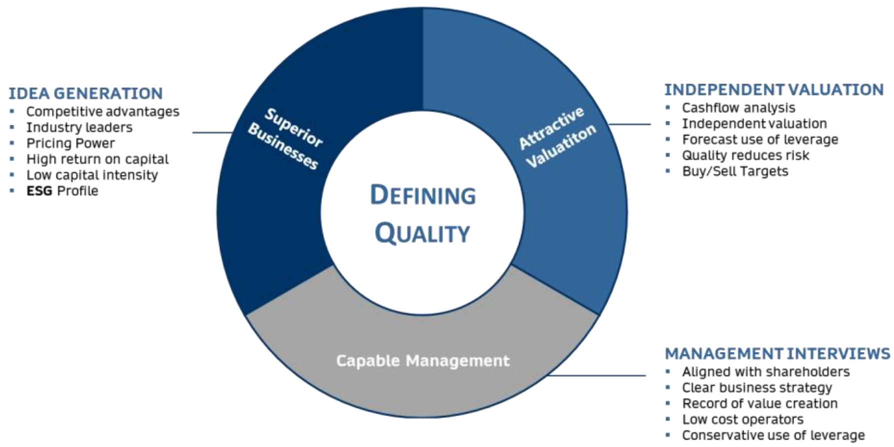
OUR QUALITY-VALUE APPROACH

"All intelligent investing is value investing – acquiring more than you are paying for. You must value the business in order to value the stock." - Charlie Munger

As a value manager, we have performed very well for our clients despite the bias to growth strategies. This is because at Barrantagh we have always approached our value investing in a broader sense than a one-dimensional historical view focused solely on current valuation parameters. We embrace the maxim "cash is king" by focusing on detailed, bottom-up cashflow forecasts which is the methodology used by businesses during merger and acquisition activity. We employ discounted cashflow methodology (DCF) to determine the intrinsic value of a business effectively discounting future cashflows to their present value. This approach involves working with forward growth estimates to forecast future cashflows and in the opposite direction an assessment of appropriate discount rates to convert these forecasts to a present day value price. We understand the fundamental dilemma that the most important factor for an equity investment is the future, but the future is inherently uncertain. Our overall assessment of a company within the framework in **Figure 2** help guide our determination of appropriate growth rates to use in our forward estimates. Profitable companies with competitive advantages, low economic cyclicality, secular tailwinds, strong management, conservative leverage and good ESG (environment, social, governance) scores all contribute to our conviction surrounding an uncertain future and the determination of a business' overall ***QUALITY***. The second part of the DCF analysis requires our estimate of an appropriate discount rate. Of particular importance is adding a company or industry risk premium to reflect potential instability in a company's cost of capital which may be attributable to a variety of reasons (high cyclicality, small company premium, leveraged balance sheet). Thus, to develop a level of comfort or conviction on a potential investment we use a conservative bias in our estimates for growth and discount rates and require a minimum return potential from the current market price. This margin of safety reflects ***VALUE***.

To do this, deep analysis of a business' fundamentals is paramount.

FIGURE 2:



Fundamental analysis in the quest for quality allows us to avoid the risks of potential "value traps" if one simply dumbs valuation down to a current multiple. Our approach provides the ability for more nuanced understanding of a business' worth based on fulsome financial analysis and probability-weighted forecasts. This may identify investment opportunities in market sectors, sub-sectors, or stocks themselves that do not fit neatly under a traditional Graham-Dodd "value" screen. If we are doing things right, we gain exposure to companies with higher probabilities that things will *improve* for them – and effectively exploit the ***QUALITY VALUE*** opportunity.

WHAT IT LOOKS LIKE WHEN IT WORKS – COMPOUNDERS

"Time is the friend of the wonderful business, the enemy of the mediocre." - Warren Buffett

Notwithstanding, the nuanced discussion of what "value" may mean to an individual investor, we believe one market observation has stayed consistent over time: people want to own good businesses and those businesses will generally garner a lower cost of capital. There is, however, ambiguity in what constitutes "good" and depending on shifting sentiment different metrics get weighed with different levels of attention or neglect. Presently there are quality businesses being undervalued and quality businesses being overvalued, with the proforma investment returns scaling accordingly. This can happen for a host of reasons that mostly boil down to either a myopic focus on the short-term or emotional overreaction/underreaction to events, which can create mismatches in the market between the strength of a business' cash flow stream and how it is being valued. This is the opportunity we seek – mispriced risk – and when encountered the rewards can be substantial. Either the Company delivers results more than market expectations, the market wises up to the quality of the business and affords it a higher multiple, or oftentimes both. This is the crux of Jim Grant's observation that "successful investing is having everyone else agree with you … later." The opposite also holds true – the business is great but stratospheric expectations on growth and valuation can implode under its own weight. There are thus two key parts when breaking down the DNA of a "compounder" – it is not just the growth but the entry point! If your forecasts turn out to be wrong your margin of safety protects/minimizes against permanent loss of capital. If you are early and right, exponential returns can result. To demonstrate this concept, it is perhaps instructive to look at a couple of successful examples.

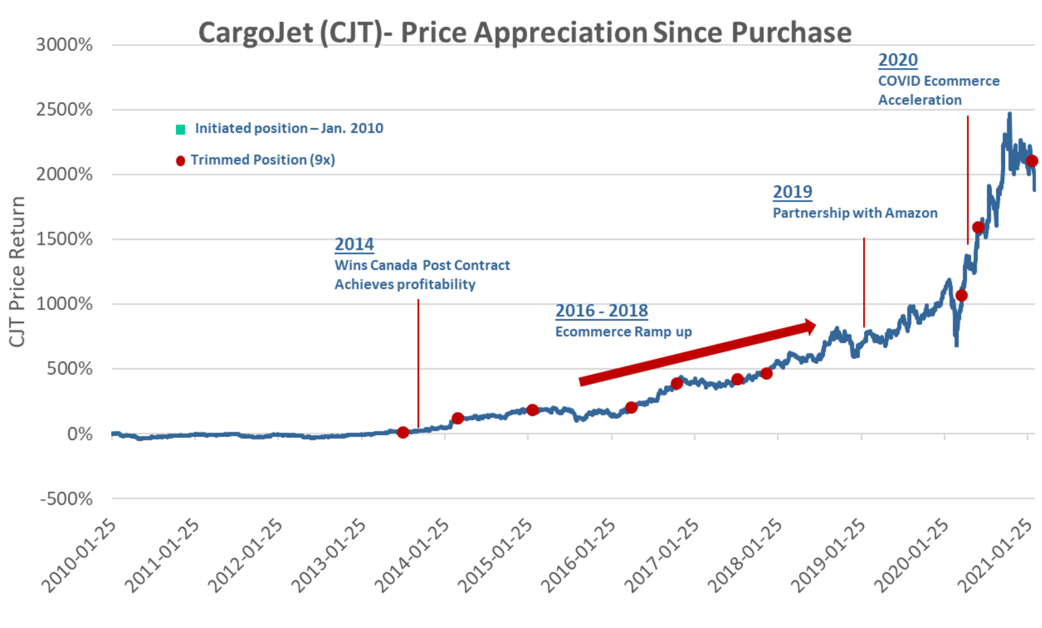
Cargojet

We initiated a position in Cargojet (CJT) in 2010 at a stock price of $9.74. We felt the Company had a good chance of ultimately winning the transformational contract with Canada Post group of companies (CPOG) which they subsequently were awarded in February 2014. Over the years the following key events have driven our internal expectation of fair value on the shares higher. These events collectively solidify Cargojet's leadership position and enhance the **quality** assessment of the firm. Our internal valuation work led to multiple upgrades in the CJT price target which reconfirms the **value** in the company's shares. Currently the stock trades at $180 and our $250 target (DCF) implies continued upside. Notable events over this time horizon:

- Winning CPOG contract (2014)
- Fleet build out and getting to profitability (2014-2015)
- Operating leverage driving increased cash flows (2016)
- Initial wave of e-commerce growth (2016 – 2018)
- Expansion of Charter/ACMI driving higher fleet utilization and returns (2016-2020)
- Strategic agreement with Amazon (2019)
- COVID pandemic accelerating e-commerce (2020)
- COVID pandemic significantly curtailing passenger belly cargo capacity (2020)
- Large fleet expansion plans to meet growing demand, including new 777 conversions (2021)

Figure 3 below illustrates CJT's share price appreciation since the initial purchase. Since that time, we have taken profit by trimming the position 10 times. Admittedly it may appear that the best course of action would have been not to sell any of the shares. However, prudent portfolio management typically limits single stock exposures to less than 8% of a portfolio which is another margin of safety for clients.

FIGURE 3



Source: Bloomberg

Trisura Group

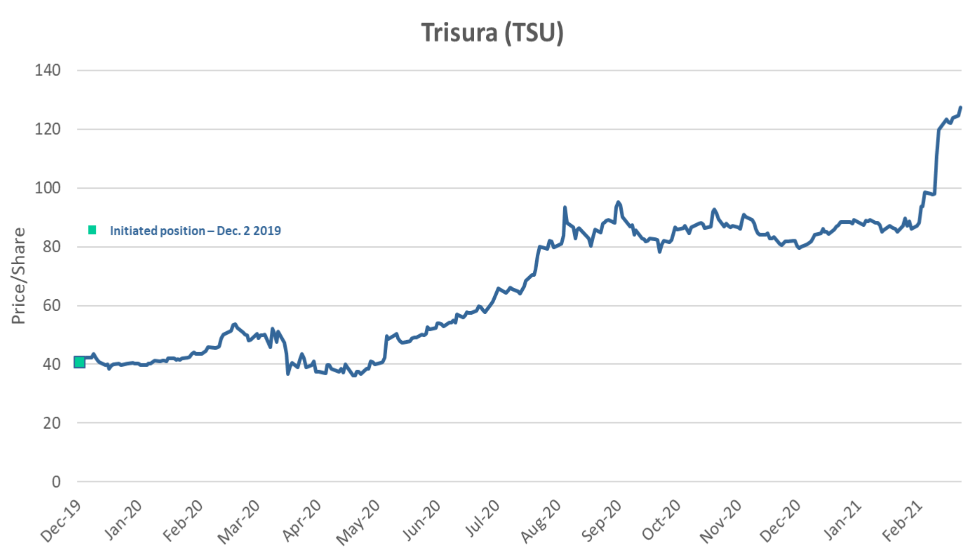
A more recent example, Trisura (TSU), was added in Q4 2019 at a stock price of $40. Our initial analysis outlined an attractive risk/reward opportunity for this steady core Canadian business with a history of profitable underwriting. Trisura's management team is highly capable with an 'under-promise and over-deliver' mentality. The stock has an attractive valuation in the context of 'low hanging' growth and larger-cap peers. They are experiencing early success in new U.S. business with a differentiated tech-enabled and nimble offering. They have effectively immunized their interest rate exposure from their International reinsurance business where they were exposed to interest rate risk, effectively removing historical earnings headwinds. With the scarcity of quality-value small cap financials, we expect Trisura's profile to grow significantly.

As Trisura delivers on their strategic plan, we note the following has taken place:

- Trailing Return on Equity from 2% to 13%; trailing Earnings Per Share growth ~9x; forward earnings expectations up ~100%
- U.S. gross premiums increased from $70 million per quarter to $210 million, more than tripling the fronting fee income
- Market capitalization increased by ~4x with an ~10x increase in trading liquidity
- Total shareholder return ~215%

On a go-forward basis, our forecast for this stock remains very positive. We anticipate continued strong underwriting and stable execution in Canada. We see further growth from their large U.S. opportunity given they're still growing off a relatively small base. Entrance into the Admitted market grows the total available market ~5x. We anticipate multiple expansion as the capital-light, fee-based fronting income grows in significance. With a 5-year growth in earnings of ~15% annually, the share price target would be $225-$250. Accretive M&A and/or a potential takeout could further accelerate shareholder returns. Though these observations represent our current constructive view, we monitor closely for any new information that will impact our expectations, either positively or negatively. **Figure 4** below illustrates TSU's share price appreciation since the initial purchase in Dec 2019.

FIGURE 4



Source: Bloomberg

SIMPLE, NOT EASY

"Don't explain your philosophy. Embody it."- Epictetus

Here at Barrantagh we let our "Quality-Value" framework drive everything we do. Looking at CJT or TSU on a superficial level would indicate these are not value stocks if one would use the traditional valuation methodologies mentioned previously. However, we identified the quality value that both companies offered, and their unique competitive positioning provides confidence in the durability of their cash generation and their ability to grow that through reinvestment over time.

Importantly, we don't get caught up in what we can't control: macro economic changes and shifting short-term market sentiment on what is currently "working" versus not. We instead focus on our disciplines: doing the work, understanding the quality of the business, making conservative estimates balancing future opportunities and risks, and buying/owning those few names where we see attractive risk/reward based on the market price. Do not confuse the simplicity for being easy. Mental horsepower and intelligence are not nearly as important as mindset and temperament. What sounds straight forward in theory can be tricky in an instant. Like the proverbial boxer getting punched in the face, extreme diligence is required to keep the plan from flying out the window at the onset of adversity. Huge market drawdowns, commodity booms/busts, irresponsible and speculative investor behaviour all try to pull you off course. However, this is where considerable value is added if we can stick to our knitting of patient, thoughtful capital allocation. Through it all, we strive to:

- Separate emotion from fact
- Avoid short cuts and do the work
- Look for quality businesses that can compound value over time
- Avoid situations where expectations and valuation are too high
- Avoid businesses that are compromised, or we do not understand
- Above all, maintain a cash-flow oriented intrinsic value discipline

We will let others debate if "value investing is dead". Meanwhile, we will keep our heads down and follow our proven quality value style. If we have done our job right, positive investment outcomes should follow quite favourably on a probabilistic basis.

"Fear not death for the sooner we die, the longer we shall be immortal."
-Benjamin Franklin