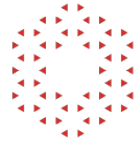


In Pursuit of the Misunderstood: Quality Amongst the Junk

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It is easy in the world to live after the world's opinion; it is easy in solitude to live after our own; but the great man is he who in the midst of the crowd keeps with perfect sweetness the independence of solitude.
- Ralph Waldo Emerson

Does Quality, by Any Other Name, Smell as Sweet?

In our experience, investors seem to have an affection for “high quality” companies, understandably so. JPMorgan notes that “quality has historically shown to be a ballast within diversified portfolios... better equipped to weather economic storms. While quality tends to protect during market downturns, it also tends to provide meaningful upside participation during market rallies.”ⁱ After all, who in their right mind prefers junk over quality? Today’s markets seem to reflect this, with significantly higher multiples applied to securities that are widely considered high quality. This appears to be further exacerbated by the shift towards passive investing and the resultant increasing representation of the largest market capitalization companies, which, at the current time, consist largely of those perceived to be the highest quality. In some ways, this feels like an echo of the Nifty Fiftyⁱⁱ heyday of the 1960s and 1970s. To us, it feels like the market views today’s high-quality companies as “one-decision” stocks, in that you buy them and never ever sell them, regardless of valuation. JPMorgan further finds that these stocks have been rewarding for investors, with the “Magnificent 7”ⁱⁱⁱ estimated to have accounted for over 40% of the return of the S&P 500 in each of the last three calendar years.

“High quality” is a subjective term, but we believe there are three main attributes much of the market focuses on in determining a company’s quality:

1. **Financial Strength**: A subjective factor that varies by business model and market participant, but we generally take this to mean that the company has a financial position that is conservative and a business model that is not reliant on continuous access to capital markets for survival.
2. **Above-average Margins**: Businesses that have monopolistic market positions, resistance to competition, and strongly growing revenues and/or earnings typically have higher margins than their peers and are widely viewed by most market participants as being higher quality than competitors. These measurements typically include Return on Invested Capital, Return on Equity, and Gross or Net Profit Margins, amongst others.
3. **Business Consistency**: This too is measured in various ways, but generally focuses on a business’ “demonstrated” track record of success: repeatability of cash flows or earnings, growth prospects, and insulation from competition (oftentimes referred to as a “moat”) that provide stability for the earnings generation ability of a company.

We don’t disagree at all that these attributes are empirically attractive and worthy of the “high quality” description, but we always come back to the fact that employing this approach generally does not result in a non-consensus viewpoint. As such, we tend to think that the quality premium is reflected – thus, the higher the *quality* of the company, the higher the *price* that needs to be paid for the shares. At Moerus, we strive to identify divergences between what the market consensus view is and what we view as reality over the long term; said differently, we are looking for situations where others think a company is of low quality, but where we identify underlying value.

Expectedly, this results in our portfolio oftentimes consisting of a collection of companies that the market would deem to be low quality – or even junk. This is an observation we often hear from prospective investors, as nearly all investments we make are in companies facing significant

uncertainty and challenges. We believe, however, that this is a feature and not a bug. If the market didn't incorrectly view these companies as low quality, the valuations would not be attractive and thus we would not be buyers. To us, it is easy to say that you are in search of high-quality companies to invest in, but if the market agrees completely, then we believe that excess return potential has been eliminated, as the positive attributes have likely already been priced in.

Quality: Magnificence or Mirage?

Importantly, we believe that something many investors may not fully appreciate is that *retrospective quality* is not reflective of *prospective quality*. Past performance is not a guarantee of future results. While companies deemed high quality by the market over the past decade (think the Magnificent 7) have been superlative achievers in all three main aspects of our earlier definition of "high quality," this may be changing in the future. We believe that we may be at an inflection point today as a result of the unprecedented AI-driven capital expenditures. Today's mega-cap tech companies are viewed as some of the highest quality companies in market history (at least, that's the impression we get given current multiples), viewed – rightly – as having had strong financial positions, enviable margins, and irreplacable monopoly positions in their businesses. But what if this changes? Looking backwards, these are high margin, capital light businesses with net cash balance sheets – i.e., squarely high quality. But what happens if they transform into asset-heavy businesses with more commodity-like margins and significantly more leverage? What happens when technology changes and what was once a monopolistic position suddenly becomes obsolete? There are four reasons to wonder if we are at an inflection point today:

First, many market participants point to the persistently strong and growing profit margins of many high-quality companies as support for their valuation multiples. Additionally, the argument is made that current Price/Equity ratios are not that excessive relative to history. Both arguments rely on accounting profits reflecting reality. One major thing to consider is the massive portion of Other Income contributing to today's earnings growth of mega-cap stocks. A recent Wall Street Journal article highlighted that Other Income accounted for 71% and 66% of Alphabet and Amazon's Q2 profits, respectively, which was attributed mostly to massive mark-to-market gains from the revaluation of equity holdings, including SpaceX and Anthropic^{iv}. These one-time uplifts are effectively being laundered through the high-quality reputations these companies enjoy and may be being viewed as repeatable earnings by the broader market at first glance. This contribution is so significant that the WSJ also estimates that the combined contributions of Other Income from Alphabet and Amazon accounted for ~15% of *all earnings* for the S&P 500 in the second quarter.

Second, there is a singular trend driving market-wide earnings today across a range of industries. The massive capital expenditures by AI hyper-scalers has been a key driver of earnings growth of the market, inflating earnings across semiconductor manufacturers, construction, electricity generation, and many other industries. As the hyper-scalers commit ever larger amounts of capital to build out compute infrastructure, we worry that the market is conflating these one-off surges in capital expenditure as durable long-term earnings power for many of the companies receiving these expenditures as revenues. This is being seen across the entire supply chain for industries even remotely related to the AI buildout.

Third, there is an accounting quirk that is making market-wide earnings seem even stronger than their already historic levels. Because of accounting convention, every dollar spent is being credited to the downstream companies selling goods and services as revenue today, but only a fraction of the corresponding spending is being recorded as a cost for the purchasers. This is because revenues are accounted for immediately on the income statements of recipients while expenses are depreciated over several years by the hyper-scalers. As a result, the market as a whole is likely showing inflated

earnings. Said a different way, the benefits are accounted for today while the full accounting for the costs is not seen until future years. Layer on the circular nature underlying the financing of many of these purchases and the increasing utilization of off-balance sheet financing structures, and the reality may look significantly different than what the accounting numbers show. Simplistically, to us, the high-quality companies of the last decade are taking actions that may result in an erosion of quality into the future.

Finally, in a fascinating paper titled *Rules of Relevance*, Carlyle Group estimates that the profit implied on the \$2.5 trillion of hyper-scaler compute backlog leaves only an estimated \$375 billion of net economic value, implying roughly 15% of total profit on the nominal contract base for the providers of compute over the life of the contracts^v. They also note the alarming divergence between Free Cash Flow and Accounting Earnings occurring. This doesn't strike us as consistent with the impressively high margin businesses that companies like the Magnificent 7 have enjoyed over the past decade. If these companies are entering into structurally lower-margin businesses in a big way, what does that imply for their future profitability?

Price is What You Pay, Value is What You Get

Price versus value is a basic tenet of investing, but it appears to us to have been somewhat diminished in stature over the past decade. At the very least, the market seems willing to put more faith in valuing earnings far in the future over earnings today, with many investors demonstrating a willingness to pay ever higher multiples for the chance to own a high-quality, high-growth enterprise – even if the real profits are not expected until well in the future. Where does this leave price conscious investors? Simple, it leaves us focused on the same thing we have always been focused on: fundamentals – what *you pay for a stock* in relation to what *you get in underlying corporate value*. We strive to buy companies at discounts to their current value, based on estimates that are anchored in the here and now, not valuations reliant upon lofty predictions or expectations of future profits, no matter how certain they may appear or how large the market opportunity may seem. Don't get us wrong, we love to own high-quality companies with strong balance sheets and attractive growth prospects; we just steadfastly refuse to pay the premiums required when the market appreciates their high quality and prices it in.

To be clear, we do not think that the market is irrational or that we are smarter than other investors. To the contrary, we are no more intelligent than the rest of the investment community. Our “edge” comes not from having *superior information*, but rather from using that *same information in a superior manner*. While much of the market is focused on the treadmill of estimating near term earnings, speculating as to who will win AI, and predicting the timing of the reopening of the Strait of Hormuz, we are focused on looking for investment opportunities that are attractive over the long-term regardless of what future precipitates. We often say that our crystal ball is cloudy. In reality we believe that no one is able to consistently and correctly predict the future. As such, we focus on what we know, not what we think will eventuate. To find these opportunities at discounts to Net Asset Value, one needs to be willing to look for companies where their high-quality nature is obscured. This can be the result of a variety of factors, but often stems from the earnings variability of a company facing issues and the market's muted or low expectations for the business. With short timeframes, many investors completely write off entire countries and sectors they perceive to be on a downtrend, avoiding these companies in the pursuit of high quality. This is precisely where we believe we can find the most compelling investment opportunities: where others aren't looking.

Asset-Based Investing in an Earnings-Focused World

At Moerus, we search for high-quality businesses (despite being viewed as low quality by others) at discounted prices relative to what we believe their net assets are worth – without attributing any

value whatsoever to forecasts of earnings or cash flows, visions of the future which are far too often seen through rose-colored glasses. This is where our investment approach stands in stark contrast to most others. In their pursuit of quality, most other investors seem to subscribe to a primacy of the Income Statement approach, which in our view is overly reliant on extrapolation of current earnings trends, as if the company will just remain as a strict going concern. We take an approach more akin to that of a creditor, seeking to appraise the assets and liabilities of a company based on what we believe are conservative estimates that a rational, arms-length buyer would pay for the assets, not based on the current or future earnings-generation ability of the business.

One implication of this approach is that, at the risk of stating the obvious, such opportunities do not come easily or often – alas, there is usually “a catch,” or something “wrong” which pushes others away and drives pricing down to the unusually attractive levels which pique our interest. Common examples of what might be “wrong” include, among others, a challenging short-term outlook facing a company’s relevant industry or geography, or a company-specific misstep or hiccup that results in share price declines. For traders and investors with short time horizons, this near-term uncertainty and turmoil oftentimes rules out any such investment. But our long-term focus allows us to look past temporary rough patches that render a company, industry, or geographic market out of favor in the broader market, as they often prove to be interesting sources of longer-term investment opportunity – provided that the turmoil is indeed temporary and the potential investment has the staying power and wherewithal to survive tumultuous times and thrive if, as, and when the situation normalizes.

While most investors look at companies through the lens of a “going concern” model, we are much more attracted to businesses that have fallen out of the “going concern” sphere and are potentially more likely to experience Resource Conversions (significant transformations of their asset bases). Resource Conversions can include the sale of a division, the sale of the entire company, a significant share repurchase program, or a host of other capital transformative activities. The main driver here is that the company trades at a discounted-enough valuation that there exist alternative avenues of creating value – beyond just the broader stock market recognizing the value we see in the business. We believe this differentiated viewpoint is key to our success. Looking at companies beyond the traditional going concern model allows us to make investments in attractive situations that may end up being less driven by overall market trends. This has been consistent with our experience since founding Moerus. We have experienced a decent portion of our investments having been acquired by a third party, typically the result of a take-private transaction by management, a competitor, or a financial buyer. This also has the added benefit of having the potential of performance patterns that are less driven by the broader market.

Treasure Amongst the Tailings

The phrase “treasure amongst the tailings” is an idiom derived from the mining industry, meaning to find something of immense value hidden inside what others have discarded as worthless waste. Mining waste piles (tailings) often contain missed gold and other critical minerals of significant value. In summary, we believe we can find value by looking where others are not. This is partly a function of the broader market having a different time horizon and looking for companies where the consensus is that they are high quality. However, what has been high quality in the past is not necessarily high quality in the future and vice versa. Further, what is deemed low quality *today* might actually be high quality that’s just “having a bad day.” We believe that transient factors that obscure the quality of our investments can be a key driver of adding value to a portfolio over the longer term.

The traditional “high quality” approach has certainly worked historically, but quality is very much in the eye of the beholder. When investors are all in agreement that a company is high quality, valuations generally reflect these opinions, so the risk may be to the downside if reality doesn’t match

expectations. We believe our differentiated viewpoint allows us to appreciate quality that others don't see. An added benefit is that we also believe this approach results in generally lower downside risk, as market expectations are typically not priced into "low quality" issues and, thus, if they disappoint on fundamentals, there may be less price risk baked into the valuation. To paraphrase Benjamin Graham: the more enthusiastic the public grows about a stock, and the faster its advance as compared with actual earnings growth, the riskier a proposition it becomes. In paying a premium valuation, you may become a hostage of fortune, as you are reliant on the stock market itself to validate your thesis.

Today's markets certainly feel to us like they are pricing in high expectations for the high-quality companies dominating most indices. While this is in no way a market call, as we don't believe anyone knows what the future holds, we do think this is an opportune time for investors to take a look at their portfolios to make sure they have adequate diversification – we would argue, given the outsized impact from AI on the markets (well beyond the Magnificent 7) that this diversification include exposure to non-AI factors. This is where we believe a portfolio like the one we manage can contribute. By looking beyond consensus, searching for opportunities where others are not, and having a truly differentiated viewpoint, we believe that we have assembled a portfolio of attractive opportunities that the broader market does not recognize as high quality. These securities tend to have much more attractive valuations, which we think is a key contributor to upside potential and downside protection. To quote General George S. Patton: "If everyone is thinking alike, then somebody isn't thinking."

ⁱ <https://am.jpmorgan.com/us/en/asset-management/adv/investment-strategies/etf-investing/investment-ideas/jqua-why-invest-in-quality-factor-etfs/>

ⁱⁱ The Nifty Fifty refers to a group of roughly 50 large-cap blue-chip stocks on the New York Stock Exchange (NYSE) that dominated institutional investing in the 1960s and 1970s.

ⁱⁱⁱ The Magnificent 7 are a group of seven dominant U.S. mega-cap technology and growth companies: Nvidia, Alphabet, Apple, Amazon, Meta Platforms, Microsoft, and Tesla.

^{iv} <https://www.wsj.com/finance/stocks/the-121-billion-in-one-time-gains-boosting-big-techs-profits-5d2201da>

^v <https://www.carlyle.com/global-insights/research/rules-of-relevance>

About Moerus Capital Management

Moerus Capital Management was founded in 2015 and is a 100% employee-owned organization. We run a global, deep value investment strategy that utilizes an opportunistic approach that results in a concentrated portfolio of securities in developed, emerging, or frontier markets where we see the most attractive long-term opportunities. The investment team led by Amit Wadhwaney, Portfolio Manager and Co-Founder, has worked together for more than 15 years and has experience investing in most countries around the world.

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