Perspectives on Risk: How You Can Lose Money – Let's Count the Ways!

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Introduction: Risk – It Comes With the Territory

Investing, as many of us have unfortunately come to know well (with the "war stories" to prove it), is far from foolproof. It is an inherently risky endeavor in the sense that any investment, no matter how well thought out the thesis and no matter how attractive the future prospects seem to be, requires an investor to accept some degree of risk. The degree of risk that is accepted by an investor may vary wildly from extremely low to extremely high, depending on the nature of the specific financial asset and the circumstances surrounding it. Investments in very short-term United States Government Treasury bills and FDIC-insured bank deposits, for example, are generally and conventionally considered low risk and reside on one end of the risk spectrum per "prevailing wisdom," whereas other investments in, or perhaps more appropriately worded in this case, bets on highly speculative and risky securities such as microcap penny stocks, for example, reside on the other end. Most assets fall somewhere in between those two extremes, but the point is that <u>every investment, by its nature, includes some degree of risk</u>, simply because nobody knows with 100% certainty what tomorrow, let alone three years from now, holds for any given investment.

Alas, the future is uncertain. We'd bet that watching ten minutes of the evening news or casually thumbing through your preferred daily newspaper would be more than enough to fill you with anxiety, dizziness, nausea – you name the reaction, but it's likely unpleasant. Yes, it is obviously true that investing has, on average and over most timeframes, proven far more lucrative than not investing at all; if it didn't, why would anybody invest? Still, that fact probably has not provided much consolation to anybody who, for example, was heavily invested during the run-up to the 1929 stock market crash, in Japan in the late 1980s, or in U.S. subprime mortgage-related securities prior to 2008 and the onset of the Global Financial Crisis. In each of these as well as many other cases throughout financial history, extended periods of prosperity morphed into excessive optimism, the belief that "this time is different," the irrational overpricing of stocks, and the gross underestimation of risk. As you know, none of those stories ended well.

<u>A prudent, level-headed assessment of downside risk is essential to the long-term success of any investment program</u>. Debacles such as the three listed above are debilitating to the long-term returns of any and all who are heavily exposed at the time the bubble inevitably bursts, often impairing the wonderful process of compounding by which investments grow in value over time. It might take years or even decades for an investor caught on the wrong side of a bubble to recover; Japan's TOPIX and Nikkei-225 Indices, for example, have failed to come near revisiting their December 1989 peaks in the 26-plus years since. Although prolonged bull markets may occasionally seduce some investors/traders into thinking otherwise, <u>the future is uncertain and risk is ever-present, perhaps most so at the very times when risk is perceived by many to be lowest</u>.

So how do we grapple with this inconvenient truth and invest anyway, in spite of the uncertainty that the world brings? We certainly do not have a crystal ball in our office here at Moerus and because of that, we <u>do not</u> spend much time attempting to forecast and predict the future. Instead, we cope with investing's inherent uncertainties by spending an awful lot of time thinking about risk in its various forms, and how to mitigate its presence in our investment portfolios. In truth, we believe that uncertainty should not only be coped with, but also embraced as a source of opportunity to invest in well-financed assets and businesses at prices that we think are compelling relative to underlying, intrinsic values. But how do we think about risk, and how do we strive to mitigate the impacts that risk has on our investment portfolios?

A Roadmap of Risks

Fair warning! In the following pages, we hope to dwell quite a bit (some might say excessively) on what risk means to us at Moerus, and how we think about mitigating its presence in our investment portfolios. When it comes to risk as we view it, there is unfortunately a lot to talk/write about – numerous factors lurking in many different areas that can cause any investor to lose money in a hurry. The road to attractive long-term investment results is littered with investing's version of land mines, some better concealed than others, which can blow up portfolios. The successful avoidance of a few, or even most of them could nonetheless be rendered a moot point for investors who stumble upon one that "detonates." We hope to sensibly organize our thoughts on the subject by structuring the conversation in the following general order:

- First, we'll begin by explaining what risk does and does not mean to us, and why we define risk differently than do many others in the investment world.

- After defining the type of risk that we seek to mitigate, we'll move on to our first principle of risk mitigation: trying to reduce price risk by buying as cheaply as possible. Of course, "cheapness" is in the eye of the beholder, so we'll discuss how and why our valuation methodology differs from other approaches commonly applied today, and why we believe our approach to valuation contributes to reducing price risk. We'll conclude this section with an example of why cheapness and "buying right" matter.

- While buying as cheaply as possible is necessary in order to mitigate price risk, unfortunately it's not enough, by itself, to create what we consider a "margin of safety." It's a great start, but a host of additional risk factors, both internal to each individual business and external, must also be carefully considered.

- Even if each individual business or asset in an investor's portfolio has a risk profile that he or she considers to be manageable, other risks, which instead reside at the level of the portfolio, can conspire to wreck long-term returns. With that in mind, at this point we'll move on from risks facing each individual investment to those risks which affect the portfolio in aggregate.

- Finally, we'll explain what we mean by "knowing the neighborhood you're going to," and why and how we believe that an ongoing awareness of one's surroundings and healthy, informed skepticism help in mitigating the big, "unimaginable" risks that could strike.

The following discussion is admittedly a very lengthy read, but we believe that it's long for good reason. Risk is a topic that is incredibly vital to the ultimate success or failure of any investment program, but it is also complex and multidimensional. In our view, effective risk management requires a thorough, holistic approach that looks for any and all potential risks to the portfolio from a variety of angles. We hope that you find it informative.

Risk: What It Is Doesn't Mean to Us, and Why

Perhaps a sensible first step in discussing how we think about, recognize, and deal with risk in our portfolios is to ask ourselves the question, "What is risk?" in the first place. To us, this is not as simple as it might sound, as we view risk as a somewhat squishy, imprecise sort of idea which could mean a wide variety of things. Different investors define risk and think about how to deal with its presence in their portfolios in many different ways depending on, among other things, their specific investment philosophies, approaches, and constraints under which they operate. Simply put, in the investment world, "risk" means different things to different people. Before we dig into the details of what risk means to us, we'll begin with what it does not mean at Moerus.

Principal measures of risk that you have probably come across if you've studied traditional academic finance, and indeed which are used by many players in the investment community, typically rely in some form or another on statistical measures of volatility. In plain English and without digressing into the mathematical minutiae behind any of these measures (unnecessary, fortunately, for the purposes of this discussion), many of these statistics are, generally speaking, derived from measurements of historical movements in stock prices, sometimes extremely short-term in nature. The theory – again, we are admittedly oversimplifying things grossly – is that if Stock A's price history has consisted of a non-stop roller coaster ride of sharp ups and downs, while Stock B's price history has seen relatively stable, modest moves along a reasonably smooth path, then Stock A is deemed more volatile and therefore "higher risk" than Stock B.

In such a case, the fact that Stock A has historically been more volatile than Stock B is an objective matter of record. And for those who associate risk with historical volatility in stock price, Stock A is, by their own definition, indeed riskier than Stock B. We are quite certain that for many investors, this is a very sensible and appropriate way to view and measure risk. But for us at Moerus, we do not think about risk in terms of short-term share price volatility – that simply would not make sense within our framework of long-term, deep value investing. Why not? Much of the answer is linked to our investment approach, which we detailed in our first Investor Memo, but perhaps it would be helpful to briefly revisit some of these points, as they relate to how we think about risk.

At Moerus, we try to buy assets and businesses cheaply, with the goal of achieving capital appreciation and attractive risk-adjusted returns over the long term. "Cheapness," like "risk," means different things to different people, and we will dwell a bit on what it means to us shortly, but the key point we are hoping to make here is that from our perspective, we are buying interests in *businesses* and *assets*. The *stock prices* associated with those businesses fluctuate in value every day, some days more sharply than others. There are times when short-term *stock price* movements up or down may reflect a genuine increase or reduction in the long-term, intrinsic value of the underlying *business* in question; perhaps, for example, the FDA declines to approve a prospective drug that was considered crucial to the future prospects of a small biotechnology company that's essentially a "one trick pony." But in many cases, we believe that day-to-day *stock price* movements do not reflect changes in the fundamental, intrinsic value of the underlying *business* as much as they instead reflect a host of other factors, perhaps most notably investor/trader psychology.

How else could we make sense of countless cases in which, for example, a company's stock price declines in value by 20% in one day because its quarterly earnings per share (EPS) missed analysts' estimates by a few cents? Could this company's true value really be worth 20% less than it was yesterday? Maybe with the benefit of hindsight, market expectations had been irrationally optimistic, and therefore the stock was previously overpriced and such a decline is justified. On the other hand, maybe the 20% decline in the stock price was an overly harsh overreaction, and as a result the stock is now underpriced. Either way, in such a case either yesterday's or today's stock price misrepresent the long-term, enduring intrinsic value of the business – maybe they both do – but in any event, it is difficult for us in many cases to truly believe that the long run, intrinsic value of a business can change by so much overnight, because of something so immaterial to its long-term viability as its EPS over a *three-month* period falling a few cents short of analysts' expectations.

<u>Since day-to-day stock price movements do not, in our opinion, typically reflect commensurate changes in the fundamental value of our portfolio holdings, we believe it does not make sense for us to spend much time viewing short-term volatility as "risk" and trying to avoid or mitigate it</u>. Share prices will do what they have always done, zigging and zagging as market sentiment swings back and forth from excessive pessimism to excessive optimism, over and over again, with many starts and stops in between. This is simply a reality of financial markets, and <u>rather than focus on short-term share price volatility as a risk that we must mitigate, we often look to it as a source of compelling long-term investment opportunities that become available only fleetingly due to temporary turmoil and adversity</u>. For us, short-term volatility is a friend more often than a foe.

<u>Different Strokes for Different Folks</u>

Of course, there are certainly many players in the investment world for whom this is not the case. For day traders and other very short-term oriented traders, for example, day-to-day stock price movements are probably very important. But at Moerus, <u>we are long-term investors who typically invest with an intended time horizon of three-to-five years</u>, and in fact we are willing to hold positions for longer than that when we believe it is prudent to do so. Thus, while focusing on daily market price volatility makes sense for those with much shorter time horizons, it is much less relevant to us <u>other than as a source of opportunity to find longer-term bargains</u>.

Volatility represents a critical risk for another subset of investors: those who employ margin debt in their portfolios. During the good times, the leverage that margin financing provides can juice returns and make those who might merely be lucky seem very smart. But because leverage unfortunately cuts both ways, volatility can pose a grave threat to the capital of those who are invested on margin when market turmoil strikes, particularly because even temporary price declines, if sharp enough, could trigger "margin calls" and forced selling (often at the worst of times). This, in turn, pushes prices down further, triggering additional margin calls and yet more forced selling. This vicious cycle, as you surely know, has contributed to more than a few financial market meltdowns over the years. <u>We, however, do not employ margin financing in our portfolios</u>. <u>All else equal, when Mr. Market believes the sky is falling and businesses become available at depressed prices, we'd much rather be opportunistic buyers than forced sellers</u>.

Volatility also may be very relevant to investors who are evaluated and scrutinized by their employers and/or clients based on very short-term performance. For a portfolio manager whose assets under management, reputation, and career are closely linked to how he or she performs over the coming month or quarter, focusing on day-to-day share price fluctuations might understandably become somewhat of an obsession. These career-related factors, <u>which have nothing to do with investment fundamentals</u>, might even lead some managers to position their portfolios fairly closely to an index – after all, producing poor near-term results might represent less of a career risk if the index and "everybody else" produced similar numbers.

In a sense, such managers might (subconsciously or otherwise) lean towards mediocrity, but with the comfort of having a lot of company, while at the same time steering clear of less widely owned investments that could offer more compelling long-term value, but which could zig when the market zags and potentially expose them to the scrutiny and scorn that short-term underperformance can invite. At Moerus, however, we are unabashed, bottom-up, deep value investors who pay heed not to what others own or how any index is invested, but only to the individual opportunities that we find most compelling. The market will probably make us look stupid after some quarters and smart after others, but through all of these market-driven gyrations, we strive to maintain our opportunistic pursuit of assets and businesses priced at what we view as significant discounts to their long-term fundamental value, regardless of index, benchmark, and any other short-term considerations. Given this approach, volatility is not one of our primary fears.

In summary, risk often primarily means short-term volatility to many investors, which in many cases is perfectly sensible, given their particular approach, philosophy, and circumstances. But it doesn't make sense for us. Without even delving into matters such as our skepticism on questions such as whether measures of historical share price movements accurately capture the extent of risk looking forward – given the potential for dramatic changes in industry structure, capital market conditions, market psychology, technology and a myriad of other factors – viewing risk as short-term volatility simply does not make sense for us as long-term, bottom-up, opportunistic investors.

Risk: What It Does Mean to Us, and Why

We have discussed what risk doesn't mean to us. So, what does it mean? Our apologies in advance for revisiting an old value investing cliché, but as we alluded to earlier, at Moerus we buy stakes in businesses – we do not think of our investments as pieces of paper that go up and down in value every day. The *stocks* certainly do fluctuate in value every day (at least as their shares are valued by the markets), but if you've decided to invest, this is a reality that is uncontrollable and unavoidable, and thus something we do not worry about very much. Since we instead approach investing from the perspective of a long-term owner of a business, the risks that we are most interested in are not associated with the rolling stock tickers provided by the CNBCs of the world.

Instead, we are interested in identifying any and all fundamental risks to which a given business is exposed, which could potentially impact the returns that any such business could earn for its owners over the long run. Specifically, the risk that we are very focused on identifying and mitigating is a risk of permanent capital loss – in other words, any risk, which if it comes to be, can hurt or impair the business and diminish its value in a permanent way (for example, if a business is forced to declare bankruptcy, or if a management misstep erodes the value of the business in an irreparable way). Again, as we have discussed earlier and in our introductory memos, our objective is to buy businesses very cheaply so that over the years as these businesses grow their intrinsic values, we as long-term investors will be able to participate in that compounding of value (on a tax-deferred basis, we should add). Given this objective, we focus intently on any risk that could potentially impair the value-building ability of the business in a permanent way. This need not be a near total loss (as bankruptcy often is for stockholders), but anything that could materially and irreparably erode the ability of a business to compound value over the long term and generate attractive, time-weighted returns for us as business owners. Our goal is to steer clear of such exposure.

But specifically, how do we attempt to mitigate our exposure to the risk of permanent loss of capital? There are obviously many factors worth considering that vary on a case-by-case basis depending on the circumstances of each potential investment, but in the following pages, we would like to discuss our core principles of risk mitigation that we think about (even obsess over) every day, which apply to every investment that we consider for potential inclusion in our portfolios.

Principles of Risk Mitigation: Valuation Methodology and Price Risk

Our first principle of risk mitigation is simply to buy as cheaply as possible, but unfortunately it's not as simple as it sounds! Different investors think about valuation in vastly different ways. At a very high level, growth investors, who typically seek out the stocks of businesses that they believe have above-average growth potential, generally have less stringent pricing and valuation requirements than do value investors, who look for businesses that might not always have above-average growth potential, but which are trading at less than their intrinsic value. Even after narrowing the field to that of only those who consider themselves value investors, there are significant differences regarding what constitutes "cheapness" to whom, and on the specific methodologies of valuing businesses that are employed.

At Moerus, we consider ourselves deep value investors who believe in buying things cheaply. No surprise there. All self-proclaimed value investors believe that they are buying cheaply, at a discount to what the underlying business is worth (or its intrinsic value). But how do you measure what a business is worth? We believe that the specific valuation methodology applied – how the value of a business is estimated – can result in very different outcomes, with important implications for the risks to which an investor is exposed.

What We Don't Do: DCF

We discussed in greater detail different valuation methodologies, and how ours is different from many others, in our introductory Investor Memo, but to briefly revisit, many investors estimate intrinsic value through a discounted cash flow (DCF) analysis, which generally entails forecasting cash flows years into the future, before discounting those future cash flows to arrive at an estimated present value. While it is good financial theory, in practice getting it right requires that a number of the assumptions and forecasts used do not prove overly optimistic, including:

- Forecasts of cash flows years in the future.
- Forecasts of a number of variables, including future revenues, costs, capital investments, interest costs and taxes, which derive the ultimate cash flow estimates.
- In some cases, forecasts of macroeconomic variables (such as GDP growth, inflation, interest rates, etc.) that are used to estimate the many company-specific variables above.
- An estimated discount rate that is applied to estimated cash flows in future years.

We have no doubt that there are great investors who do DCF analysis very well and successfully. Our main concern with a DCF analysis-based valuation methodology is that it requires many assumptions, and even modest adjustments to these assumptions can result in material changes to estimates of what the business in question is worth. This could expose investors to meaningful downside price risk if their assumptions prove too optimistic. In other words, the business worth an estimated $40 per share that you bought for the seemingly "bargain price" of $30 might ultimately prove to be worth only $20, hardly a bargain, if the future turns out not to be as bright as your original forecast had implied. We prefer not to rely on forecasts.

Our Valuation Methodology: Asset-Based Conservatism

The Moerus approach to valuation, by contrast, does not place much of any emphasis on DCF analysis, and in fact typically involves minimal assumptions of the future. Instead of trying to forecast the future, we estimate the value of businesses by weighing heavily what we know today, here and now. Further, ours is typically an asset-based valuation approach that is often akin to liquidation analysis. In other words, what's a business worth today if it wound up its ongoing operations, shut its doors, liquidated its assets, and paid off whatever debt and other liabilities it owed? We try to arrive at this estimate using conservative assumptions of what the assets might fetch from a knowledgeable cash buyer in a "normal" environment, in which the sale is neither overhyped nor distressed or forced. We believe that in general, such an asset-based valuation methodology is a more conservative approach, one which mitigates downside price risk.

A couple of additional points regarding our valuation methodology are notable. First, given our asset-based approach and our preference for what is known here and now over trying to predict the future, the balance sheet is often the financial statement that is most useful in both our valuation methodology and our assessment of risk. This might sound unusual to many, and to be clear, this is not to say that we neglect to weigh the income statement (which tells us the earnings that a business has generated until that point in time and is often quite instructive). Still, in our experience the balance sheet is usually the most useful statement for our analysis, as it not only quantifies the resources and liabilities of a given business, but it also provides an indication of the quality of its resources. This is of particular interest to us from a risk perspective because in tough times, liquid assets – such as cash, tradeable assets, or assets which could easily be sold to ready, willing buyers – are often much more useful and provide much more of a cushion amid adversity than do illiquid, unsalable assets that do not have a ready, easily accessible market. So for us, the balance sheet is often a crucial place from which we can gain both *quantitative* and *qualitative* insights into the valuation as well as some of the risks facing a prospective investment.

Second, the conservatism embedded in our assumptions is of crucial importance to our valuation methodology because what a buyer is willing to pay for any asset often can vary considerably depending on capital market conditions and the availability of financing. Sometimes transactions fall through, or are not even proposed in the first place because adequate financing is not available to the buyer. A potential acquirer lacking enough internal resources might need to access external capital by issuing debt or new equity, and depending on capital market conditions, the financing might not be achievable at reasonable terms. If we were to value an asset based on comparable transactions that took place in a booming market, for example, when stocks were overpriced and debt was available at dirt cheap interest costs, we'd run the risk of grossly overestimating the value of that asset in the event that capital market conditions turn more fearful than greedy – see the 2009 Global Financial Crisis, or the past year-plus for energy and many commodity producers.

To provide one admittedly extreme example, in 2014 (after commodity markets had already started the descent from their peaks), Rio Tinto Group sold its Mozambique coal assets for $50 million. Rio Tinto had acquired those same very assets as part of their AU$3.9 billion ($3.7 billion) takeover of Riversdale Mining Ltd. in 2011, just three years before, only to write them down by $3 billion in 2013 before ultimately selling them[1]. Therefore, hypothetically assuming that there were comparable coal assets for any mining analyst to evaluate back in 2011, he or she could have valued those assets at 75%, 50% or even only 25% of the implied resource value that Rio Tinto paid, yet still would have wound up egregiously overvaluing the assets in question!

[1] Source: Bloomberg, "*Rio Tinto Exits Mozambique Coal Year After $3B Writedown*," July 30, 2014.

Our main point here is that in our efforts to mitigate downside price risk, we emphasize conservatism in that we are not looking to buy an asset that is for sale at large discounts to its value under only favorable market conditions, but under all reasonable financial market conditions, both conducive and hostile. Yes, it may be tempting to take liberties in valuing businesses and assets when the good times are rolling and when central banks are printing money, artificially depressing the cost of capital and thereby artificially inflating financial asset values. Nonetheless, we strive to employ a valuation methodology that's robust under a wide range of scenarios including, most importantly from a risk perspective, difficult times. In this regard, if we do our jobs well, we believe that this methodology often results in a "bedrock" (lower-bound) valuation, and that buying at a steep discount to such a bedrock valuation may provide a cushion against unexpected adversity.

In our view, a 30% discount to an asset-based, bedrock valuation provides better downside protection than a 30% discount to an estimate of intrinsic value that is based upon projections of future earnings or cash flows. Now, there are definitely times when a company's stock is so beaten down for whatever reason that we believe that it is extremely cheap on a future earnings or cash flow basis, even using draconian assumptions. Those situations are certainly of interest to us, and we can and do invest in such cases, but generally speaking, we believe that a balance sheet-based valuation approach provides better downside protection than earnings or cash flow-based approaches that attempt to forecast future unknowns.

At times, we have been accused by friends in the investment community of being excessively conservative or pessimistic. There is probably some merit to these accusations during the good times. But we look for opportunities that we believe are cheap not only in blue sky scenarios, but even in times of despair or disaster, where the market price is mostly washed out already. We believe that this mitigates downside price risk. Indeed, our approach may result in us missing out on opportunities to invest in businesses whose growth opportunities might be periodically underestimated by the market. But we are not confident in our (or anybody's) ability to forecast the future accurately, and lacking a crystal ball, we prefer to invest at deep discounts to what we believe a company's assets are worth today if they were liquidated, rather than potentially compromising on downside price risk while banking on our forecasting ability.

Price Risk: An Example of How Cheapness Matters

A simple point that nevertheless gets overlooked too often is that even a great, prosperous business can turn out to be a terrible, highly risky investment if proper attention is not paid to buying cheaply. The tech bubble that burst early in 2000 was catastrophic for investors who bought into interesting business concepts regardless of price and the economics of the business model, with many total or near-total wipeouts for shareholders as a result. But even those companies which have stood the test of time, remaining wildly profitable even now, have proven to be dismal investments for those who were seduced into buying at prices that baked in excessively optimistic forecasts that, in retrospect, egregiously overvalued the businesses.

Take Microsoft, for example. According to Bloomberg statistics, over its past 17 fiscal years (including the current one which wraps up this coming June 30) Microsoft has generated, in aggregate, around $950 billion in revenue and roughly $350 billion in EBITDA[2]. In its 2015 fiscal year, Microsoft produced over $93 billion in revenue and roughly $24 billion in EBITDA, as compared to less than $20 billion in revenue and less than $11 billion in EBITDA back in fiscal

[2] Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) is a measure of operating cash flow that is commonly used in the financial and analytical community.

1999. Sure, in recent years competition has dramatically intensified, profit margins have compressed, and growth has slowed significantly, but all things considered, the business has performed reasonably well, and needless to say, this is hardly a failure from a business perspective. Yet hypothetical investors who were unfortunate enough to buy Microsoft shares when the market opened for trading on the first business day of 2000 would have suffered a loss of 63% in the following year. Worse still, it would have taken them about 14 ½ years, until around July 2014, to dig out of the hole created by the bursting of the tech bubble to recoup the value of their original investment (assuming they reinvested dividends received along the way).

How can this be? In those days, Microsoft stock was trading at a valuation of over 20x revenue and over 40x EBITDA. Despite an underlying business that subsequently produced profits that most companies could only dream of, on the eve of the year 2000, Microsoft stock was a disaster of an investment waiting to happen because its valuation priced in expectations that proved to be unrealistically optimistic. While this may be an extreme example of overvaluation, it highlights the point that investors who pay up for a *stock* which has a very optimistic future already priced in leave themselves exposed to significant price risk even if the *underlying business* itself does not perform poorly, but is guilty merely of falling short of those lofty expectations that had been baked into the stock price.

In dwelling on this point a bit in the context of today's market, it is difficult not to wonder about the "FANG stocks" – Facebook, Amazon, Netflix, and Google (now Alphabet) – which roared to dizzying heights in 2015, skewing the returns of indices and arguably obscuring the lackluster performance of large components of the broader market. Maybe the FANG stocks will continue to perform spectacularly over the next decade. Maybe they won't. But what seems clear to us is that their current stock prices reflect an extremely bright future. Time will tell whether or not such expectations prove overly optimistic, but we believe that owning stocks at such elevated valuations exposes investors to significant price risk, even if the underlying businesses themselves continue to make progress in the years ahead.

At Moerus, we typically find ourselves investing instead in businesses where the current and near-term outlook is far more pessimistic. Our valuation methodology often leads us to investments whose value is backed by conservative, balance sheet-based assessments of the assets, with little to no value attributable to any expectations of a brighter future. By investing at a discount to such a draconian valuation, we believe that price risk is mitigated meaningfully, with much of it already reflected in the battered, discounted stock price.

From our perspective, "buying right," *i.e.*, as cheaply as possible, is our first principle of risk mitigation, as doing so successfully enables us to conceptually reduce price risk. To take it a step further, we view buying right as one of the most important requirements of successful long-term investing. Indeed, we subscribe to a general rule of thumb that for any profitable investment, we "make" a majority of the money when we buy and we "count" it when we sell. We suspect that this saying might sound odd, since sell discipline is a topic that we have been asked about many times. But in our opinion and given our conservative valuation approach, we view selling as a bit more of an art, whereas buying, for us, is a much more disciplined activity that sets the stage for potentially attractive long-term compounding. We believe that if we have done our homework and have bought correctly, it not only reduces price risk significantly, but can offer us the potential for considerable capital appreciation and compounding over time.

"Buying Right": A Great Start, but Not Enough

With that said, at this point we should make an important distinction. We have heard value investors often say that if you buy cheaply enough, you provide yourself with a "margin of safety." We partially disagree. We believe that buying as cheaply as possible is *necessary*, but not, by itself, *sufficient* in order to establish an adequate margin of safety. A margin of safety, to us, acts as a cushion to protect us against a permanent capital loss. Buying as cheaply as possible is required, and is indeed a major part of establishing that margin of safety, for the reasons that we discussed earlier. But buying a stock cheaply, in isolation, does not in any way provide guaranteed protection from the risk of a potential loss of 100% of the capital invested in that name. It is a good, even great, starting point to establishing a margin of safety, but cheapness is far from the only factor that we must address in our efforts to mitigate risk. In other words, a stock might be bought extremely cheaply, but result in a blow up and total loss anyway, for reasons that have nothing to do with the original buy price. In addition to our buy price and the ability to mitigate price risk by buying as cheaply as possible, we think about the other risk factors that must be addressed in three distinct buckets:

- Risk factors that are *internal* to the business.
- Risk factors that are *external* to the business.
- Portfolio-related and other considerations.

We'll begin with the first bucket of non-price related risk factors: those internal to each business.

Internal Risk Factors

Internal risk factors consist of anything inside the business itself that can hurt and inflict a permanent loss of capital on its shareholders. Again, individual risks might vary widely on a case-by-case basis, but some generic sources of internal risk that we always must assess and evaluate include the following:

- Balance sheet considerations.
- Capital needs – recurrent or otherwise.
- Inept and/or dishonest management.
- Inappropriate governance and/or the potential for self-dealing among control groups.
- Risks stemming from the business model.

In the following pages, we'll explore how we think about each of these internal sources of risks.

Internal Risks: Balance Sheet Considerations

We often talk about how we are focused on what is known in the here and now. Although rarely overnight, a given company or business could change dramatically over time. The following will probably sound like a familiar refrain by now, but we don't have a crystal ball and we don't spend much time attempting to predict the future. Instead, for any given investment we look to the information that we can learn from where we sit today, which can help us make a rational, reasoned investment decision. With that in mind, a company's balance sheet is often the first place where we turn, not just in our valuation analysis as discussed earlier, but also in our assessment of the financial risks that could face any prospective investment.

The balance sheet is very useful in assessing a company's assets and resources, how liquid or illiquid those assets might be, and how much debt and other liabilities encumber those assets. The strength of any company's balance sheet must be judged within the context of that company's business model and its individual circumstances, but in very general terms, we try to limit financial risk by favoring companies that possess strong balance sheets which are rich in high-quality, liquid, separable, saleable assets, and which are burdened only modestly by a relative paucity of debt and other financial obligations. As an aside, it is important to also identify any potential financial obligations and commitments that might not be found on the balance sheet itself. For example, future operating lease or capital commitments facing a business, contingent liabilities, and potential legal obligations might not be explicitly reported on the balance sheet due to accounting convention, but could nevertheless present more of a threat to the safety of equity holders than the debt that is explicitly listed in the financial statements. Because of this possibility, an appropriate assessment of the financial risk facing a company must "adjust" its balance sheet to reflect a more accurate picture of the value of its assets and liabilities.

The amount of debt on a company's balance sheet often represents a key financial risk. If a company is saddled with too much debt, its shareholders could bear the risk of material loss, regardless of how high-quality and valuable its assets might be. How much debt is "too much?" It often depends on the business: a given amount of debt might be more appropriate for a company with relatively stable cash flows than for one that is highly cyclical and subject to wild swings in profitability. But one red flag that we often see across different types of businesses is that during the good times, some management teams tend to get overconfident, extrapolate positive trends from the recent past into the future for budgeting purposes, and take on additional debt, either in the endless pursuit of growth via acquisitions or organic investments, or to help fund dividends or share repurchases.

Such elevated levels of debt might not seem overly burdensome when business conditions are favorable, but when the tide turns and conditions deteriorate, companies facing increased debt service and refinancing requirements might quickly find themselves forced to raise cash via asset sales or issuing equity or additional debt at the worst time, when market confidence has taken a hit and the capital markets fail to offer generous or even reasonable terms. Even if successful, selling assets at depressed values and issuing high cost equity or high yield debt securities are actions that typically are dilutive to the ownership interests of stockholders and diminish the ability of the business to compound value at attractive rates over time. Or even worse, highly indebted companies might eventually default on their debt service requirements and be forced into bankruptcy protection, where their liabilities are restructured but where common stock holders are often wiped out.

From a risk mitigation perspective, it is important to note that effectively analyzing the financial risks stemming from a company's debt load almost always requires a lot more than simply looking at the absolute amount of debt reported in the consolidated balance sheet and at static statistical measures of indebtedness such as leverage and coverage ratios, thereby determining whether the company is either "overleveraged" or "underleveraged." A robust examination of potential financial risk must be much more involved. Additional details that are of vital importance which must be considered include: the structure, nature, terms, and maturity schedule of the debt, where it is held, how it is organized (for example, is it recourse to the parent company or non-recourse?), and how onerous it is in the context of the nature of the underlying business.

Some of these considerations are very straightforward. For example, all else equal, debt that is due in six years is typically preferable to debt coming due in nine months, and debt with an interest rate of 3% is less onerous and less demanding of corporate cash flow than debt with an interest rate of 6%. However, assessing other debt-related factors can be much more subtle. The distinction between recourse and non-recourse debt is an example of one of those areas. Very generally speaking, in the event of a default, <u>recourse debt</u> allows a lender to go after all of a borrower's assets, not just the particular property or the specific asset pledged as collateral for the loan. On the other hand, <u>non-recourse debt</u> allows the lender to seize only the specific collateral, without being able to go after the borrower's other assets.

One example in which this distinction often comes into play is that of a conglomerate or holding company which has interests in multiple, structurally separate operating businesses, in the form of either controlled subsidiaries, affiliates or passively owned investments. In such a structure, debt might be held at the level of each separate, individual operating business, at the level of the parent company at the top of the organizational structure, or at all of the above. In general, if all of the debt in question is <u>non-recourse</u>, a default at the level of one of the operating businesses could not result in potential claims on other assets held by the parent/holding company, whereas in the case of <u>recourse</u> debt, it could.

Due to accounting convention, consolidated balance sheets often fail to distinguish between recourse and non-recourse debt. <u>In theory, from a holding company shareholder's perspective, non-recourse debt should be viewed as "less risky" than recourse debt, but in our experience, that does not always hold true in practice</u>. Many times, we've heard something along the lines of the following argument: "Here's a company that looks highly leveraged if you look at the consolidated financial statements, but most/all of the debt is held at the level of the subsidiaries, and it's non-recourse to the parent. So the parent company isn't really highly leveraged." There are often problems with this line of reasoning, including the following:

- If a parent company's principal assets consist of ownership stakes in highly leveraged operating subsidiaries, even if the debt held by those subsidiaries is non-recourse to the parent company, if one or more of those subsidiaries collapse under the weight of their debt and become a zero, this could nevertheless result in a meaningful, permanent reduction in the parent company's intrinsic value.

- The non-recourse nature of the debt could prove a moot point if the parent company, for any of a number of possible reasons, both economic and non-economic, decides to save the imperiled subsidiary by pumping fresh capital into the business. This would result in the debt being *de facto* recourse to the parent company, even if not so mandated by law.

Staying for a moment on the holding company theme, consider the opposite case: <u>a structure in which the operating subsidiaries have relatively clean, debt-light balance sheets, but where the parent/holding company is relatively indebted</u>. This could be particularly risky if the holding company's primary assets are its stakes in the operating subsidiaries, and if it does not produce much cash flow of its own. The holding company therefore is forced to rely on dividend payments from its subsidiaries to service its own debt. In such a case, investing in any of the operating subsidiaries – which often are also publicly listed on stock exchanges – could be a risky proposition.

The parent company, particularly if it has control, might be able to take measures that are overtly unfriendly to the subsidiary's minority shareholders, such as, for example, a questionable asset sale by the parent company to the subsidiary that effectively transfers cash and value "upstairs" to the parent. Or a seemingly more benign example might be the parent company insisting on higher than optimal dividend payments from the subsidiary, a scenario that might ostensibly seem fair since all shareholders receive dividends, but which might not be the best use of capital for the subsidiary (perhaps it earns high returns on capital and would be better served to reinvest in its business).

In summary, <u>we generally seek to mitigate financial risk primarily by focusing on companies with strong balance sheets, which have a wealth of high quality assets that are relatively unencumbered by debt and other liabilities. However, there is no uniform, cookie cutter approach to assessing financial strength – a more thorough, involved assessment of the financial position is required</u>. The assessment of financial risk is critical to our investment approach at Moerus, because given our stringent, conservative valuation criteria as outlined earlier, we typically find ourselves investing in businesses that we believe offer compelling long-term value, but which are going through periods of temporary adversity (if they weren't, they wouldn't be for sale so cheaply). <u>A business must have the financial wherewithal and staying power to make it through tumultuous periods in order to be around to compound value when conditions normalize and over the long run. Buying a deeply discounted asset is not enough – the asset must have the staying power to generate capital appreciation for its owners after the situation improves</u>.

<u>*Internal Risks: Capital Needs – Recurrent or Otherwise*</u>

An issue that is related to balance sheet strength is that a company's capital needs, both the magnitude of them as well as how recurrent those needs are, represent an additional form of financial risk. <u>All else equal, from a risk perspective, companies that do not have significant recurrent capital needs are preferable to those that do</u>. This issue raises two key questions: how will a business be able to finance itself, and how sustainable will those sources of financing be over time? While we generally find companies with a relative absence of recurring capital needs to be preferable, an important distinction should be made between whether these capital needs could be met <u>internally,</u> or if <u>external</u> capital must be relied upon.

For example, Company A operates in a highly capital intensive industry, which might require $1 billion in annual, recurring capital to reinvest in the business in order to continue operating on equal or better competitive footing. If, however, this company's business generates $2 to $3 billion per year in cash flow from operating activities, it can most likely meet its capital needs internally, without having to access external capital markets. All else equal, this is probably a <u>less tenuous situation</u> than that of Company B, which has about $300 million in annual, recurrent capital needs (a much smaller number in an absolute sense) but for whatever reason – perhaps because of the nature of its business model or because it is in a stage of its evolution in which heavier than normal investments are necessary – it cannot generate enough cash flow from operating activities or other internal sources to meet these needs, resulting in an ongoing reliance on external capital markets.

<u>The main issue is that companies with recurrent capital needs that cannot be financed *internally* by the business are inherently at risk of needing to access capital markets when conditions are most difficult</u>. A company might be able to steer clear of this risk, even without any glaring signs of trouble, as long as its industry and the markets in general are in favor, because it could meet those capital needs, for example, by accessing debt financing at reasonable terms, issuing new shares to the public at relatively high prices, and/or by finding willing and able buyers for the sale of non-core assets. However, <u>when we think about risk – our apologies for the repetitiveness – we try to</u>

intently focus not on the good or even normal times, but on the resilience that a potential investment may or may not have during difficult times, when conditions are not optimal. It might not seem to be a likely scenario after years of relatively benign conditions, but history over and over again has shown that the cyclicality of capital markets persists. We prefer companies that can meet their recurrent capital needs through internal resources because a reliance on external capital can come back to bite a business when the near-term outlook isn't as rosy.

Take today's example of high cost energy companies, which only a couple of years ago were able to secure abundant financing for their projects by issuing readily available, low cost debt or amply priced stock to eager buyers. The recurring capital needs of this very capital intensive business were not a problem when crude oil was over $100 per barrel and the industry was awash with external capital sources. However today, after the oil price has plunged and many of these companies are heavily bleeding cash, these sources of external capital have almost completely dried up, imperiling those which are the most highly leveraged and dependent on external financing.

Companies that can safely meet the recurrent capital needs of their business from internal sources, on the other hand, are much more insulated from the mood swings of the capital markets. This does not insulate them from the economic headwinds that at times face everybody, but it does prevent them from going, hat in hand, to the capital markets at the very time that they are most out of favor. Companies that can internally finance their needs are more likely to weather periods of adversity without being forced to take measures that are dilutive to shareholder value and to the ability of that value to compound at attractive rates over the long run.

Internal Risks: Inept, Self-Dealing and/or Dishonest Management

Another significant source of risk that is internal to any business concerns its management team. Even if a business has a strong financial position and is trading at an attractive valuation, its seemingly intriguing value proposition could prove nothing more than "fool's gold" if senior management is either incompetent or, worse still, takes actions that are in its own best interest, at the expense of shareholders. In our experience over the years, one of the unfortunate things that we have noticed about deep value investments – especially those whose balance sheets are very rich in assets – is that they sometimes attract the attention of bad actors who come in and use their positions to extract company resources for their own benefit, rather than that of all shareholders.

We have often gravitated towards companies with asset-rich balance sheets, and in such cases, particularly when those assets are mostly liquid, one of the key risks to be very aware of is that a successful investment outcome is often heavily reliant upon the management team and/or controlling shareholders for sound, shareholder-friendly decision-making that builds value rather than detracts from it over the long term. A thorough assessment and evaluation of the management team and any controlling shareholders is always imperative, as their decision-making can be terribly destructive to the value that attracted you as an investor in the first place. Examples of red flags to watch out for include the following two, among others.

First, a management team that, though well-intentioned, has performed poorly. A critical evaluation of management's skill as operators, investors and deal-makers often provides a qualitative sense of the risk that you are taking on by investing in a business that's under their leadership. This evaluation should not be determined so much from what management *says*, for example in meetings with them – after all, most senior corporate executives are seasoned, polished presenters and salespeople – but much more so from their *actions*, and more specifically their track record of either contributing to or detracting from value creation. Of course, a historical track record is backward looking, so a constant, ongoing evaluation of the performance of the business and management's strategic decision-making is essential as well.

Second, incentives for senior management, the Board of Directors, and/or controlling shareholders that conflict with the interests of all shareholders. Actions taken by management that result in value destruction for shareholders may often simply result from well-intentioned mistakes, but at times they might not be mistakes at all – there may be incentives in place for management to take such actions or not take others that might build value. Egregious executive and/or Board compensation is obviously a glaring warning signal, but there might also be slightly more subtle hints of the potential for trouble in how compensation is structured (beyond simply how much it is).

Extremely high fixed compensation, for example, is generally not considered ideal because it is not closely linked to performance. On the other hand, a compensation structure which includes a variable component that provides significant bonus payments to executives if a business generates growth in metrics such as revenue, cash flow, and earnings might seem reasonable enough. However, it could, in some cases, incentivize management to take on large, overpriced acquisitions that boost those metrics, but which also stretch the balance sheet and prove destructive to shareholder value in the long run.

Conversely, other compensation structures actually could encourage inaction and discourage value enhancing transactions from being executed. We once knew of a holding company whose CEO's compensation, for example, was in part determined by consolidated EBITDA, even though some of the businesses that contributed to those EBITDA figures were managed completely separately by their own respective management teams (two, in fact, were publicly listed). To our mind, this structure provided a disincentive to selling off the holding company's stakes in those businesses – which offered no synergies with the rest of the company and which could have provided significant capital that was much needed to reinvest in the holding company's promising core assets – because doing so would have reduced consolidated EBITDA and thus the CEO's variable compensation, even though it would have been, in our view, in the best interest of shareholders.

The pros and cons of each individual company's incentive structure must therefore be weighed on a case-by-case basis. Regarding management behavior and incentives, in the absence of glaringly egregious practices, there aren't necessarily any right or wrong answers. But it is important to:

- First, evaluate the historical record of decision-making and performance.
- Then going forward, carefully observe the overall stewardship of the company and the decisions made on an ongoing basis, considering whether they make sense and if they seem to be in the interest of all shareholders.
- Finally, consider whether seemingly sub-optimal actions (if any) are actually systematically encouraged by any incentive structures that might be in place. It is not always (or even often) obvious and visible, but if you begin to observe non-intuitive behavior that conflicts with the interests of all shareholders, you should begin to worry.

Internal Risks: Inappropriate Governance/Self-Dealing Potential for Control Groups

Risks that stem from poor corporate governance are somewhat related to the risks involving inept or self-dealing management in the sense that management incompetence or malfeasance, if it persists with any regularity, could not continue without being aided and abetted by the company's

Board of Directors and controlling shareholders (when they exist), either deliberately or via benign neglect. However, even businesses managed by extremely bright, talented, and ethical management teams may be hamstrung by poor corporate governance.

Controlling shareholders may and often do have other interests outside of the company in question that may or may not conflict with the interests of all shareholders. Returning to our earlier example of a financially leveraged holding company with a well-performing, separately listed operating subsidiary, shareholders of the subsidiary may be disadvantaged by decisions that might not be in the best interests of the subsidiary. The holding company might, for example, seek to improve its own balance sheet by selling assets to the subsidiary in a deal that might not make a whole lot of strategic sense for the latter.

Adding insult to injury, dual class share structures that allow for "super-voting" shares sometimes allow control groups to exercise material or even absolute control over businesses that is disproportionately greater than their actual economic interest in the business. Again, there are no absolutely right or wrong answers; supporters of dual class share structures might argue that they could be appropriate in the case of technology companies, for example, because they allow management to follow their longer-term strategic vision in a way that is more insulated from the market's pressure to deliver short-term results. But it is important to study any control group's track record of either creating or destroying value at the level of the company in which you are invested, as well as the structures which may or may not be in place that could enable shareholder-unfriendly behavior, in an attempt to gauge the extent of poor governance risk.

Internal Risks: Risks Stemming from the Business Model

Moving on to yet another way in which investors could get hurt, we believe that a heightened awareness of the sustainability and vulnerability of business models can help investors avoid a lot of trouble. A business model – or a plan by which a business is run, how it operates, generates revenue and earnings, etc. – plays a critical role in investment outcomes under various scenarios. In examining a company's business model from a risk-awareness perspective, it is critical not just to focus on how well a business model functions in good times or even in average or normal times, but also in difficult times and under less than optimal capital market conditions. Examples of business models that we often view with caution include the following:

Serial acquirers. A model that we generally dislike is that of a company that is a frequent acquirer of businesses. We have two main problems with this model.

- First, serial acquirers must continually finance these deals, either through: internally generated cash flow that might be better off reinvested organically; increased debt; or equity issuances which might dilute existing shareholders. Again, in normal times this might be doable without much trouble, but in tough times the capital markets become less available and more demanding, and issuing additional debt or equity at terms that are reasonable enough for the company may prove to be a tall order.

- Second, serial acquirers typically must employ increasingly complex accounting, and over time many successive acquisitions work to obscure both the underlying organic growth and performance of the business as reported in the financial statements, as well as any contingent liabilities that might be quietly acquired along with the target businesses, but which could suddenly make their presence known with the subtlety of an analytical hand grenade!

Business models that require continual access to external capital markets to function normally. We discussed many of the risks to which recurrent capital requirements expose businesses a bit earlier, but it's worth noting that certain business models have much greater such exposure than most. A now notorious example is the case of financial service companies (investment banks, brokerages, etc.) whose business models were generally predicated upon issuing and continually refinancing short-term commercial paper with the markets in order to finance their holdings. The ability to issue and roll over commercial paper quickly and on good terms requires a very strong credit rating. Again, such a business model functions most of the time without incident, but what would happen if something were to go wrong in the world and the credit ratings of many financials were to get downgraded? As you probably know, this in fact did happen, with catastrophic results: the newly lowered credit ratings precluded entire classes of investors from being permitted to buy the suddenly "higher risk" paper, these financial service companies quickly found themselves out of favor as fears grew in the capital markets, rendering them no longer able to support their inventory of assets, and some of these companies ultimately blew up. Witness the stories of Bear Stearns and Lehman Brothers, among others.

We find a model that requires recurring access to capital markets to continue the daily operations of the business, and in fact any business model that might not hold up under extremely adverse scenarios, to be very risky and often better off avoided. That does not mean that disaster will strike often, some of the time, or even relatively rarely. We, nevertheless, take comfort in investing in companies whose business models have the sustainability to make it through the worst of times without blowing up and resulting in permanent loss. Even if we don't think the darkest of days are ahead, we want a business model with a plan for making it through if they do arrive. Everybody (relatively speaking) will be fine in good times, but we search for survivability in the worst of times.

External Risk Factors

Unfortunately, buying at expensive prices and risks within the business itself are not the only ways that you can lose money in a hurry! External risk factors, another source of risk, consist of anything outside of the business that can nevertheless permanently damage its shareholders. Some generic sources of external risk that can jump up and bite a business include the following:

- Government intervention – official or by suasion.
- Industry structure.
- Industry/macroeconomic shocks.

External Risks: Government Intervention – Official or by Suasion

Sometimes an investment opportunity looks good on paper or even in reality, with a favorable balance sheet, valuation, business environment, industry structure, *et al.* These favorable attributes that such a business has going for it could nevertheless prove all for naught for investors if a government steps in and changes the rules of the game, either by official decree or by using the considerable influence that it wields over any business operating within its jurisdiction, thereby significantly reducing the attractiveness of the business.

There are certainly some governments which have proven more hostile to private business interests than others (Venezuela comes to mind as one example). However, even countries that have historically displayed reasonably responsible governance and cultivated a business-friendly environment are not immune to intervening in ways that harm the economics of a business. We have seen examples of this in generally business-friendly jurisdictions such as New Zealand, where a shift in the country's telecommunications regulatory regime in the mid-2000s – one which we'd argue was politically motivated – resulted in a meaningful deterioration in the economics and profitability of the telecom business in New Zealand (as an aside, many of the shareholders of the telecom companies conveniently were foreigners).

Given that even countries with otherwise quite reasonable and fair governance can sometimes behave in peculiar ways that are detrimental to investors, it is impossible to avoid this risk altogether. However, investing in companies that operate in industries which produce necessities – such as food and drugs, for example – despite the obvious attractions on the demand side, require a heightened awareness, depending on the circumstances and the country in question, of the potential for negative surprises coming from government intervention. Even reasonable governments can do unreasonable things when politics are involved.

External Risks: Industry Structure

An industry's structure represents yet another source of external risk. The structure and nature of the industry often plays a significant role in the returns, positive or negative, generated by a given investment. At Moerus, our deep value approach often compels us to invest in businesses at times when conditions are very depressed. Our general plan is to buy if the value is compelling, and wait. If the stock price declines, we are typically happy to buy more. As noted earlier, we are long-term investors who have a three-to-five year time horizon, and so waiting for conditions to improve is often part of the plan. However, after a multi-year holding period, we ultimately expect to generate an investment return that more than adequately compensates us for our years of "waiting" for the depressed situation to normalize and the latent value to ultimately be recognized.

What we try to avoid are industries with extreme ease of entry, which could threaten our ability to earn returns that are attractive enough to make a multi-year holding period worthwhile. While some degree of risk of easy entry exists throughout any investment's life, we believe that it is often less probable during the early stages of our holding period – usually when profitability is more muted – but it tends to rise over time if and as an industry's profitability improves. From our perspective, if a business that we invest in during a downturn starts to rebound, and our investment thesis begins to play out, there should ideally be at least some period of time that as owners, we enjoy the benefits of an improvement in business conditions before new competition is able to enter. We therefore prefer an industry structure that provides at least some impediments to new competition for at least some period of time. The number of players in an industry, its competitive intensity and the time and resources required for new competition to enter should be such that it cannot arrive very rapidly and easily. Ultimately, new competition should be expected, especially if the business turns reasonably profitable, but what we try to avoid are situations where the competitive intensity can increase markedly during our typical three-to-five year holding period. In our experience, the latter phases of a multi-year holding period – if business conditions revive, profitability recovers and market sentiment improves – are typically the ones that prove most rewarding for long-term shareholders, but an industry structure that provides ease of entry during an investor's holding period puts those lucrative, later years at risk.

External Risks: Industry/Macroeconomic Shocks

In our view, some industries are by their nature more prone to macroeconomic shocks than others, and they therefore require would-be investors to tread lightly and carefully before committing capital in these areas. For example, airlines tend to be relatively prone to macro shocks, with Brazilian airlines providing a particularly good example of that in recent years. In the late 1990s, Brazil began deregulating its airline industry. Many industry participants saw great opportunity in this news: Brazil boasted a population that was approaching 200 million, a rapidly growing economy, and relatively long distances required to travel across the country. All of this led, for many, to the general conclusion that Brazilians would presumably fly more and more over time. Indeed, the reduced pricing of tickets that resulted from deregulation, combined with growing income levels driven by Brazilian economic growth, stoked demand and resulted in increasing plane ridership. Many in the industry saw a booming growth opportunity, and over the years since then, they naturally began ordering airplanes at around the same time.

Historically, airplanes have typically been bought and sold in U.S. dollar-denominated transactions. Brazilian airlines, which generate revenue in Brazilian real (BRL), borrowed in U.S. dollars (USD) to match the USD-denominated assets (the airplanes) that they were ordering. Over time, the airplanes were delivered, the airlines compiled increasing USD-denominated debt loads, and as you probably know, the Brazilian economy subsequently began to roll over in recent years. Suddenly, there was significantly increased capacity, fewer people flying amid a slowing economy, reduced incomes and therefore less demand, and increasing numbers of empty seats to be filled – a terrible result for any airline. To add to airlines' misery, the value of the BRL tumbled, making their USD-denominated debt service costs more onerous. The result was a severe industry shock.

The point that we hope to highlight with this example is that <u>some industries are more prone to these kinds of macro-related shocks than others, and the levels of debt and currency mismatches that are typical in some industries can magnify the impacts of such shocks</u>. This is always something to worry about when investing in such industries; indeed, there is a long list of Latin American airlines that have blown up over the years for similar reasons. However, in this case the silver lining to the clouds hovering over the industry is that because there have been so many blow-ups over the years, the number of survivors in the industry that operate in the area is relatively few, and those that do survive are able to operate relatively profitably under normal conditions. The trick, of course, is having the wherewithal to survive the next downturn!

Portfolio-related and Other Considerations

So far we have discussed how we think about price risk as well as a host of other risk factors, both internal to each business and external. Alas, there is yet another category of risks that can cause investors pain. In addition to the many risks that every <u>individual business</u> faces, both internal and external, investors must consider, identify, and limit risks at the level of the <u>portfolio</u> as well as in other areas that are unrelated to the individual investments themselves. Sufficiently risk-aware investors should think carefully about the following four considerations, among others:

- Undue risk aggregation at the portfolio level.
- Risks that portfolio-level leverage impose on long-term investing.
- Mismatches between the time horizons of portfolio holdings and those of investors.
- Knowing the neighborhood you're going to.

Let's dig a bit deeper into each of these issues.

Undue Risk Aggregation at the Portfolio Level

Avoiding excessive aggregations of similar risk factors at the level of the portfolio mitigates the risks to a portfolio that arise as a result of a collection of similarly exposed investments, even if each individual holding, by itself, exposes the investor to seemingly benign risks. We think about avoiding undue risk aggregation at the portfolio level in very simple, straightforward terms: not having too much of something. But how much of something is actually "too much?" This is where things get squishier and more complex, because "too much" means different things to different investors, depending on their taste, degree of risk aversion and judgment, among other factors.

The ongoing, high-profile saga of Valeant Pharmaceuticals highlights some of the risk factors which we've already touched on that could affect any individual business:

- Balance sheet considerations (high debt levels).
- The need for recurrent access to external capital (to finance numerous acquisitions).
- Risks surrounding the sustainability of the business model (one built around many acquisitions and on raising drug prices, a politically and ethically sensitive area).
- "Buying right"/valuation questions (the stock price had already run from roughly $45 in July 2012 to around $250 in July 2015, just three years later).

Another part of the Valeant story, however, concerns how some investment groups had invested quite large percentages of their portfolios' assets in Valeant stock ahead of its troubles. To be clear, these groups included some very well known, extremely successful and well-respected investors, highlighting the point that the tolerance for aggregations of portfolio-level risk is not a matter of black and white but rather a very individual thing that depends on the investor's judgment and various other factors. While each investor should look within him or herself to consider what extent of portfolio risk aggregations make sense, we have a few generic comments regarding this issue.

First, when thinking about risk aggregation, it is important not to think in simple terms such as industry or geographic "categories." For example, an investor might have 20% of his or her portfolio invested in the insurance industry, which some observers might consider too much for their taste. This might very well be a fair conclusion, especially if the individual insurance companies owned share very similar exposures and operate in spaces within the industry that have similar dynamics. However, it might not necessarily be a fair conclusion after all. In our years of experience, for example, we've come to know insurers that are based in various jurisdictions such as the U.S., Japan, Norway, Sweden, the U.K., and Bermuda and others, which operate in different regulatory environments, with vastly different books of business, exposures, and dynamics. So while avoiding undue aggregations of risk at the portfolio level is imperative, it is important to be wary of standardized characterizations that could lead to erroneous conclusions.

We believe that mentally breaking down each individual business into its specific exposures is far more useful in accurately assessing portfolio-level risk aggregations. For example, what factors most affect the individual businesses that you own? Would higher inflation or higher interest rates, for example, prove particularly harsh for many of them, or are some holdings relatively more insulated? Although this, again, involves a lot of individual judgment to determine how much is too much, when a materially large percentage of a portfolio's assets would be impacted similarly by the same or similar factor, portfolio-level aggregations of certain risks may begin to become a concern.

Risks that portfolio-level leverage impose on long-term investing

We will confess to a prejudice of ours: we are not fond of debt, either at the level of the individual businesses in which we invest, or at the level of the portfolio. As we alluded to earlier, using leverage to invest is highly rewarding and looks and feels great when stocks are going up. Financial leverage can turn a 10% appreciation in a stock price into a 30% return and make you feel like a rock star. This sounds great, but what if you buy on leverage and the stock you bought starts falling? Therein lies the problem. Again, our mantra is to try our best to avoid situations where we can get hurt permanently – for example, by a loss of capital that we can't recover – and we therefore always try to think about things from the perspective of, "What happens if things get bad?" Considering portfolio leverage from that angle, we choose to avoid leverage because we believe that if things don't go according to plan, it can potentially kill a long-term investing program. Simply put, if one or more of your investments declines in price, financial leverage can force you to sell at what is probably the worst possible time, when you should instead be buying more.

Utilizing Cash as Opposed to Leverage in the Portfolio

This last point brings us to a corollary: instead of leveraging a portfolio, we would much rather hold some level of cash in it. Why? We think of our portfolios as having two broad pots of assets: in one is the cash which we use to invest, and in the other are the investments that we have already made. We buy when we think we see an interesting investment opportunity that is cheap enough, but we will also typically hold some amount of cash at most times in a portfolio's life, in the absence of sufficiently attractive opportunities that would otherwise compel us, happily, to be 100% invested. You simply never know with a high degree of certainty when bad things are going to happen, and because of this reality cash has, in our experience over the years, proven quite handy at times.

The way we think about investing is that we try to invest in a business when it is very cheap, and then we wait for the situation to normalize and for the fundamental value proposition to be recognized, either by the public markets at large or perhaps through a takeover or other value-crystallizing event. Importantly, when businesses trade at attractive enough valuations to catch our interest, it is typically because current conditions and the near-term outlook are so bleak that the skies seem unlikely to brighten overnight, or at least we do not expect them to. As a result of this, it is not uncommon that we invest in securities that continue to decline in value in the short term. All else equal, if something we buy gets cheaper, we'd like to buy more of it, and cash therefore represents a "rainy day fund" that affords us the opportunity to add to our positions if they get even cheaper and to establish new positions, whereas portfolio leverage might force us to actually sell at those times instead – a risk that would severely undercut a successful long-term investment approach.

We believe that holding cash in the absence of compelling opportunities is rational and simply a good practice that makes sense to us given our approach at Moerus, as it enables us to act quickly and decisively when investment opportunity knocks. This is a somewhat unconventional stance in the world of investment management, as many people feel that if you are managing someone else's money, you should generally be fully invested at all times. We disagree. We believe that being fully invested just to be fully invested, if it means sacrificing our pricing discipline by investing in situations that we consider overvalued, would be doing our fellow investors a disservice, exposing them to the considerable risks that not buying cheaply enough brings. On the other hand, holding cash provides us with "dry powder" with which we can opportunistically buy during market dislocations – maybe even the next version of the Asian Financial Crisis or the Global Financial Crisis, for example – whereas operating with leverage or with no cash whatsoever invites a heightened risk of becoming a forced seller. A final, vital point on the subject of holding cash: we believe that the key to getting the most value out of it, however, is to not be afraid to aggressively deploy it when market dislocations do occur and when compelling long-term opportunities become available.

Mismatches between the time horizons of portfolio holdings and those of your investors

Though this does not apply to individual investors, for portfolio managers who invest other people's money in addition to their own, risks are not confined to the individual investment holdings and the portfolio in aggregate. Specifically, a mismatch between the time horizons of portfolio investments and those of fellow investors can, like leverage, prove to be very disruptive to successful long-term investing. It is crucial for managers to make sure their investors' objectives are aligned with their own, and that both parties know and understand each other well.

This is especially true for long-term investors. Ideally, all investors in a portfolio share a similar time horizon and are willing to stand pat in the event of shaky market conditions and/or lackluster short-term performance. If, however, there isn't an alignment of objectives, a long-term investment approach could be negatively impacted by short-term asset flows from investors that go into and out of the portfolio, sometimes at inopportune times. In the depths of the Global Financial Crisis in 2008-2009, for example, widespread redemptions from frightened investors struck the investment management industry en masse, resulting in forced selling at depressed prices, which in turn exacerbated market price declines.

There is no way for portfolio managers to truly, completely insulate their portfolios from such risks, but they can mitigate it somewhat by working very hard in advance to make sure that they and their prospective investors understand each other's objectives, and that the characteristics of their investment approach are communicated clearly in advance, so that there are hopefully no unpleasant surprises from either side of the relationship. We believe that successfully getting portfolio management and fellow investors on the same page with regard to the investment approach and objectives not only reduces risk, but increases the probability of a successful and lucrative long-term investment program, which of course is in everybody's best interest.

Knowing the Neighborhood You're Going to

What do we mean by this odd, highly subjective title? We are global investors who invest around the world, but even for those who don't, the simple act of being very aware of your surroundings and thinking carefully and warily about "where you're going" – *i.e.*, the area in which you're considering investing – can save you more investment-related headaches and misery than you might think.

For the three of us (all long-time residents of New York City), the following analogy makes sense: imagine that for whatever reason, you have a commitment that requires you to travel to an unfamiliar neighborhood late at night. You know very little about the area to which you are headed – it might be a good, even great neighborhood. On the other hand, it might be a gritty part of town or even one that has a reputation (justified or not) for being fairly rough. Either way, you don't think that you'll run into trouble; the reality is that the probability of something bad happening to you is quite remote. Still, it would behoove you to learn about the area, look around, be aware of your surroundings, and even look over your shoulder for anything unexpected that might approach from behind. The likelihood of something very bad happening might be very slim, but maintaining a continual state of heightened awareness might help you see any such danger lurking in time to flee safely or to avoid it altogether.

Applying this analogy to the context of investing, a heightened awareness of your surroundings can help you identify and better prepare for the potential big, tail-type risks that might seem highly unlikely to most, but which could result in severe losses for those who are exposed. We believe that over the years investors and financial market commentators have shown a tendency to extrapolate current trends and the recent past into the future, and in part because of this bias, investment-related disasters, or at least the early stages of these disasters, strike when the broader market least expects it. The risks that inflict the greatest capital losses are often those that are largely deemed "unimaginable" by most at that point in time. In that type of environment, a few attributes might help in detecting major warning signals while many others continue to drink the Kool-Aid:

- An almost pessimistic predisposition.
- As noted earlier, a constantly heightened awareness and understanding of your surroundings.
- A healthy dose of skepticism on consensus views and the prevailing market narrative.
- A willingness and ability to look around for, and identify data points or information that does not fit that cheerful narrative.

An Example: Oil

The collapse in crude oil from north of $100 per barrel as recently as July 2014 to below $30 in early 2016 offers an example of how a healthy dose of skepticism, coupled with an awareness of potential signs of trouble in the "neighborhood" likely kept some of the more thoughtful investors out of harm's way (at least relatively speaking). Hindsight is 20/20, and during the first half of 2014, we don't recall many, if any, people forecasting a decline of over 70% in oil prices. Still, accurate forecasting (if there is such a thing) is often not needed in order to avoid the most dangerous, high-risk trouble areas. For example, those who took a critical, balanced look at the U.S. energy sector in mid-2014 (amid $100-plus oil prices) saw an enormous amount of drilling activity, abundant amounts of readily available financing, and many energy companies that were aggressively layering on debt to invest in projects that seemed very promising at those commodity price levels. Some companies, in fact, had piled on so much leverage that they were struggling to pay down their debt even in those heady days! Meanwhile, production growth was so robust that talk of American energy independence grew louder.

A level-headed assessment of the situation at the time might have included a couple of somewhat sobering observations.

- First, some excesses had begun to take shape in the form of significant amounts of debt issued by some companies whose creditworthiness wasn't exactly sparkling, even if the *status quo* of $100-plus oil were to continue.

- Second, given robust, growing American production, it did not seem like a shortage of oil would be in the cards anytime soon.

One did not need to forecast a dramatic decline in the price – the timing and magnitude of which would be, to us, an imponderable – to look around at the situation unfolding and wonder about whether oil producers would remain as wildly profitable as they had been. Keeping that in mind would probably lead one to wonder, further, about the yields and valuations of energy companies' bonds and stocks, respectively, in the financial markets, which had assumed that such profitability would, more or less, continue unabated. <u>Even without the benefit of accurate near-term forecasting, which we believe is virtually impossible to do consistently and therefore is largely a waste of time, merely looking around in the "neighborhood" could have been helpful in sensing trouble and perhaps steering mostly clear of the carnage that subsequently ensued in the oil patch</u>. In that sense, knowing the neighborhood where you're going can potentially save you some pain.

To Close…on a (Gasp!) Positive Note

After dwelling for so long on so many of the things that can possibly go wrong, a final few thoughts are probably worth making. Yes, we view a skeptical, pessimistic predisposition as helpful, almost necessary even, in order to look for dark clouds where seemingly most others see only clear skies. <u>However, such skepticism and pessimism *in isolation*, without being informed by careful, diligent analysis and an awareness of your surroundings, is insufficient, and likely even counterproductive to achieving favorable long-term investment results</u>. Uninformed pessimism can scare investors into a state of paralysis and inaction, exposing them to the risk of missing out on exciting investment opportunities that could potentially contribute to the long-term compounding of value.

After all, the potential for long-term appreciation of capital is, for us at Moerus, the reason why we invest. All investments involve uncertainty. Those who cannot tolerate any uncertainty should not invest at all (although that in itself entails risk, but we digress). We believe that investing at deeply discounted prices in businesses and assets that appreciate in value over time will prove better at creating wealth than not investing at all in the long run, temporary downturns notwithstanding. <u>And in our opinion, the first step towards achieving this goal of long-term compounding is to be extremely aware of and mitigate, to the greatest extent possible, any and all risks that could potentially, permanently interrupt that wonderful process of compounding</u>.

Summary Conclusions

- Investing is an inherently risky endeavor given the uncertainty of the future. Any investment involves some degree of risk. A prudent, level-headed assessment of downside risk is essential to the long-term success of any investment program, as many a fortune has been lost due to inadequate risk management. However, we believe that uncertainty periodically provides compelling opportunities to invest in businesses at bargain prices.

- The risk that many investors and academics tend to focus on often relates to short-term share price volatility. However, at Moerus we do not seek to avoid short-term volatility; this simply wouldn't make sense within our framework of long-term, deep value investing. Day-to-day stock price movements reflect factors (*e.g.*, market psychology) that we believe often have little to do with the fundamental values of underlying businesses. Rather than seeking to avoid short-term volatility, we often embrace it as a source of potential opportunities.

- The risk that we focus very heavily on is anything that we believe could materially and irreparably impair the ability of any business (and by extension, our portfolio of businesses) to compound value over the long term and generate attractive rates of return for its owners.

- We believe that effective risk management requires a thorough, holistic approach that looks for potential risks to the portfolio from many different angles, because the road to successful long-term investment results is fraught with dangers lurking in a variety of areas. In short, there are many different factors that can cause you to lose money in a hurry.

- Our first principle of risk mitigation is to try to reduce price risk by buying as cheaply as possible. Paying up for businesses based on optimistic forecasts of the future exposes any investor to significant downside risk if the future doesn't play out as expected or hoped. Even businesses that perform well might not protect the capital of investors from irreparable harm if they buy regardless of price. We strive to mitigate this risk by implementing a conservative valuation methodology that emphasizes the value of assets here and now over forecasts of future earnings or cash flows, which may or may not pan out. Finally, we try to buy at meaningful discounts to these intrinsic value estimates.

- Buying cheaply is a great start, but it, by itself, is not enough to create what we'd consider to be a margin of safety. There are many other risk factors that must be considered, including those internal to each individual business, external factors that could negatively impact a business in a permanent way, and risks that affect the investment portfolio in aggregate. While we dig fairly deeply into each of these areas, in general the common theme or goal is to construct a portfolio that possesses long-term sustainability even in periods of adversity, not just in good times. The objective is to build a portfolio which can weather difficult periods without permanently losing its ability to compound value over the long term.

- Knowing the neighborhood you're going to can often help you identify potential trouble spots, but blind pessimism that is not based on diligent, informed analysis could be counterproductive to long-term investment success. Investors cannot participate in the potential for meaningful compounding of value without accepting risk. However, such risk must be identified, managed, and mitigated to the greatest extent possible.

For those interested in reading more, we invite you to visit our website at www.moeruscap.com and to visit the Moerus Capital Management page on LinkedIn.

Many thanks – as always, your interest and curiosity are very much appreciated.

Sincerely,

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Michael Campagna, Research Analyst and Founding Partner

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