DUE DILIGENCE QUESTIONS

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WHY DUE DILIGENCE QUESTIONS?

At White Loch Capital Management we want to be able to exploit opportunities across both our Compounders and Workouts framework. We want to be like the proverbial Swiss Army Knife, with many tools in our tool box for analysing different opportunities. Therefore, we believe a document like a checklist or scoresheet is too ridged for our investing framework and cannot adequately encompass the different opportunities that we want to exploit in the market.

The purpose of this document is to have a list of thought provoking questions that will help guide us through the stages of a deep dive analysis and will help provide a structure to our research process. It is by no means an exhaustive list of questions and we fully expect the list of questions to evolve over time. Although this document is intended to guide us through a through deep dive of a business it can also help lead us to killing an idea very quickly. Our goal is to find one foot hurdles where the investment thesis is easy to understand and the due diligence process is easy because company disclosures are great and management are willing to talk with us. What we want to avoid is having to dig through footnotes to try untangle opaque accounting and poor disclosures.

Our due diligence framework starts at Idea Generation and the pitfalls that come with certain sources of ideas. We want to quickly reduce the biases that come with certain sources such as halo effect, likening tendency and paying more attention to confirming evidence than confirming evidence. Next we consider the financial statements looking for any glaring "no's". After the financial statements we will examine the Moat of a business, Growth potential, Management and then do an Industry analysis. Next, we want to whittle down the investment thesis to the few key drivers of value (KPIs) in this thesis. Then, we consider the value of the business and if it is offering a margin of safety and any Catalysts that will unlock value. Finally, before pulling the trigger we re-examine any biases that may be clouding our judgement.

In Appendix 1 there is a list of some of the resources we use to source ideas and use during the investment research process. In Appendix 2 there is a graphic visualization of our investment frameworks.

IDEA GENERATION

Before we start doing due diligence on an idea we want to first examine where our idea came from and the pitfalls that come with different sources. We think that the internet has been both a blessing and a curse for investors. On one hand it has never been easier to: connect with other investors; share ideas; run screens and get data from all around the world. However, at the same time there has never been more: noise; group think; information overload and false information. We need to be selective in the information we consume and we must also recognise the biases that may come with any source. We will go through some of the ways we source ideas and briefly cover some pitfalls to be aware of.

Screens

Screens can be used to narrow down a large universe of stocks by searching for companies with desirable characteristics like ROE, gross margin or insider ownership. Some investors follow a quantitative strategy like Joel Greenblatt's Magic Formula where the investor will follow a formula of systematically buying and selling companies with certain favourable characteristics without studying the underlying businesses. However, we are not trying to play that game. We are looking for companies that are either high quality business that can grow and compound for a long period of time and that we can buy at a discounted to intrinsic value – our compounders - or companies that trade at massive discounts to intrinsic value with a catalyst to unlocking that value – our workouts. For our purpose screeners can be useful in curtailing a list of potential research candidates, for us screeners are at best a starting point. However, screeners rarely produce any contrarian idea because everyone can screen easily. Moreover, often companies that screen extremely cheap are at a cyclical peak and are overearning. If anything we like ideas that "screen badly", where for whatever reason the company looks very poor on a screen but deep research shows that it's actually a good investment.

Investment Newsletters

There is a plethora of great newsletters on the internet, many of which are free. Many newsletters will give stock picks which can be a great way to source ideas. However, we muct be cognisant of the incentives of the authors. Authors have the incentive of getting as many readers as possible and don't necessarily "eat their own cooking" when it comes to their stock recommendations. We view everything we read in newsletters with scepticism, especially newsletters where the author often self-promotes and has apparently recommended many 100 baggers yet fails to make the Forbes rich list. We will do our own research on businesses that sound interesting.

Fund Letters, 13Fs & Gurus

It is possible to "clone" investment "gurus" and find out what they own from 13F fillings, Fund letters and podcasts. This can be the source of truly remarkable ideas, to think that we are investing alongside the world's best. However, we think that this is the source of ideas where the most negative biases come from and lazy thinking. Firstly, not all investment managers have the same mandate or strategy. For example Seth Klarman and Michael Burry, undisputable greats of investing, use a lot of hedging, basket buying and a whole array of other techniques outside of our circle of confidence. For all we know an investor could have bought a stock to cover a short position. Moreover, we can clone an investor's investment position but we cannot clone their conviction. Any idea we get from a fund letter or investment "guru" must be extra diligently researched and made our own,

QUESTIONS

- Is the source of the idea making me lazy on my due diligence?
  - Solution: We put the idea on a watch list and forget about it for a while, hopefully forgetting the source of the idea, then we can look at the idea with a fresh point of view
- What are the incentives of the person sharing this idea?
- Does the source of the idea have skin in the game?
- What is the track record of the source for ideas of this nature?
  - Some investors have had fantastic track records within certain types of industries and not others
- Does the source of the idea have a similar investment philosophy to us?
- Are there investors we respect publically against this idea?
- Would we be comfortable holding this stock if source of the idea sold?
  - We ask ourselves if Buffett publically announces a large short position on a stock we own would it sway our conviction? The answer should be no, but it definitely would make us re-examine our work.
- Have we actively sought out disconfirming evidence?
  - Solution: We actively highlight any disconfirming evidence we find because we are likely to discount it.
- Is this idea in our circle of competence?
  - We don't suddenly gain competence in the semiconductor industry just because an "expert" recommends a semiconductor stock to us. We are quite happy to pass on ideas we don't understand even if industry experts are saying it's a once in a generation opportunity
- Is the investment thesis talking about multiple and being "relatively undervalued"? We eschew ideas where the thesis is purely based on that a company should trade at X because its peers trade at 2X. Firstly we think that it is very difficult to find two exactly comparably businesses. Secondly, we think there is as good a chance that the peers should trade at X as that the idea should trade at 2X.
- Does the investor have an activist position ?
  - Our process is that we try to forget the source of the idea and try to totally make it our own, the exception to this is when we find an investor we respect - with an excellent track record and similar invest philosophy to us – with an activist position in a business and we think the activist has a good chance of unlocking value. Then the source of that investment idea is critical to the investment thesis.

BALANCE SHEET

The balance sheet plays a big part in determining downside risk. For us a strong, robust, balance sheet is an unnegotiable requisite. We actively avoid binary outcomes and don't feel comfortable underwriting the large liquidity risks of companies with high debt levels. Anything multiplied by zero is zero.

QUESTIONS

- What are the levels of debt like?
  - Debt/EBITDA
  - Debt/Equity
  - Interest coverage
- How is the debt structured?
  - Is the debt non-recourse?
  - Is the debt backed by assets eg mortgages?
  - Who owns the debt?
- Does the company have large pension liabilities?
- Are there off balance sheet items?
- What are the lease term structures like?
  - Should the leases be counted as debt?
  - IFRS often doesn't include lease liability, do adjustments need to be made to the debt?
- Can the business survive off the cash generated from operations?
  - If no: Can it raise debt?
  - If no: is there appetite for an equity raise and how value destructive would and equity raise be?
- Is working capital growing fast than revenue?
  - Is cash actually going to come out of this business?
- Who owns the debt?
  - If a parent company or insider owns the debt should it might be consider more similar to equity than debt?
- Has the value of equity being growing? – Without share issuance?
- Is depreciation and amortization reasonable?
  - If aggressive the book value of the company could be higher than stated and management is purposely depressing earnings to shield from tax
  - If weak the company could be inflating earnings and write downs might be on the way
- How has the balance sheet evolved over time?
  - Is debt growing?
  - Has cash been sitting on the balance sheet for an unreasonable amount of time?
  - Are customers paying the company? Are accounts receivable growing?
  - Have management got a good handle on the inventory levels they need? Has the company had to write down inventories in the past?
- Is there unreasonable amounts of goodwill?
  - When looking at debt ratios we subtract goodwill
  - If goodwill is too large it is a warning sign of bad capital allocation and potential empire building
- What is the company's ability to refinance?
  - Do they have multiple potential lenders?
  - If a lender was to demand their money back could a company easily find another source?
  - How long do they have their current lending facilities in place for?
- If a low probability – high impact, event like Covid was to hit could this company survive a quarter with highly reduced or no revenues?
  - What about a year?
- How does the business account for inventories? LIFO adjustments needed?

CASH FLOW STATEMENT

In the cash flow statement we can get an idea about how cash is moving through the business and we can get an idea about how management are allocating capital.

QUESTIONS

- Does net income turn into cash?
  - Cash conversion ratio over time
  - If cash conversion is substantially less than 100% this is a red flag and we want to dig in to see what income isn't turning into cash
- Is net working capital growing faster than revenues
  - If yes: Will it reverse?
  - In the company's relationship with its suppliers and buyers who has the power? Are supplier able to demand long term trade credits?
- Is the company investing more in capital expenditure than depreciation and amortization?
  - If yes: The company could be looking to grow internally? Is it likely that this growth capital expenditure will earn its cost of capital?
  - If no: Is this company purposely running down the businesses and giving money back to shareholders? Should more money be invested into growing the business?
- What has share count done over the last 5 years?
  - Has the company been diluting shareholders?
  - Has the company been buying back shares? – was it a good use of capital?
- Is stock based compensation reasonable?
- What is the company investing in?
  - Are they investing in organic growth?
  - Have they been acquiring businesses? – What was the return on investment?
  - Is the company investing in marketable securities? Is this justified?

INCOME STATEMENT

The income statement is the financial statement where management have the most freedom for manipulation and often many items are up to the discretion of management. We take everything with a pinch of salt in the financial statement and we often go through the footnotes to see the assumptions made by management. We want to see clear disclosures that make sense to us. If we think that management are being purposely opaque and disclosures are poor it can lead to a quick "pass" from us. However, we think that compared to the other financial statements the income statement provides the best opportunity for an enterprising investor to dig into the footnotes to aim an informational or analytical edge. Often this comes in the form of business transformations or recognising the cyclicality of earnings. We particularly like to find Good co/ Bad co situations where a bad segment is completely distorting the income statement and hiding the good segment.

QUESTIONS

- Has the company got a history of being profitable?
  - If not: when will the company likely be profitable?
- What is the current margin structure?
  - Where could the margin structure be in 5 years' time?
  - Could there be a reversion to the mean in margins?
  - What are gross margins like? If gross margins are high and current net margins are low could we see the business cost cutting to increase profitability or will the company reach a certain scale where it is highly profitable?
- Does the company have a money losing segment that is optically depressing earnings?
  - If yes: Is that segment a young growth business or an old dog that should be killed off?
- Are earnings at a cyclically high or low point poised to revert to the mean?
- Is there a business transformation at play that is temporarily depressing earnings?
- Are operating expenses reasonable for that type of business? Eg should a commodity company be spending a lot on marketing?
- Are there trends in the expenses?
  - Ever increasing marketing or R&D spend?
  - Are there expensive that could be capitalized?
  - Expenses that are expensive over time like Depreciation, is their assumed life time fair?
- What does the variable/fixed cost structure look like?
  - High variable costs means the effects of economies of scale are lessened
  - High fixed costs leave the business vulnerable to down turns/black swans.
- Are there a lot of 'unusual costs'?
- Does the company have a history of taking write downs and impairments?
- Are their frequent accounting changes?
  - If there has been recent accounting changes how has that affected the income statement?
  - If the business is selling a subscription how are revenues being recognized? Over the life time of the service or upfront recognition?
- Is the business properly accounting for warranties, doubtful accounts and returns?
- Does the business disclose all relevant segments?
  - Is the business hiding some segments?
  - If yes: Good reasons or bad reasons?

MOAT

Capitalism is brutal and if there is profit to be made then people will try and get to it any way they can. The idea of a protective moat for a business is analogous to a protective moat around a castle from intruders. A company has its own moat (competitive advantages) to protect its business. When it comes to moats it is useful to have some mental models about what has worked in the past.

Network effects

- Does the incremental user add to the company's moat?
- Are there already existing networks?
- What are the benefits of this network vs competitors?
- Does this network have win-win relationships or are some of the stakeholders forced to use the network?
    - If one or more of the stakeholders are unhappy in this network there is room for competitors to come in and satisfy everyone
- Is this likely to be a winner take all market?

Differentiating brand

- Does the Brand translate into higher margins?
    - If not: when will it?
    - Does the brand actually have value?
        - Would we pay more for a Sony TV vs an LG TV? (If no, brand value = $0)
- How often are consumers interacting with the brand?
    - Is there consumer habit?
        - Consumers of Coke are engaged and consume the brand on a regular basis vs Sony where customers might only engage with the brand a few times in their lives and are unlikely to have a strong connection to the brand.
- What does the brand signal?
- Is the brand stronger today than it was 5 years ago?
- Is marketing spend justified?

Critical niche products with low cost relative to the end product/service

These companies are generally niche manufactures of highly engineered products that generate massive amounts of cash. They tend to be found in industries like autos, aircraft manufacturing, chemicals and commodities. These businesses often provide a mission critical product/service with a small relative cost to the finished product. Examples, WD40, small aircraft components (Transdigm), all have almost no competition and incredible high margins but don't always have huge reinvestment opportunities. Moreover, they are often well known by the market and it is rare to find them at a discount to intrinsic value

- Is there competition?
- If they are a monopoly is there threat of regulation?
- Are they abusing their power as a critical component?
    - If they are engaging in Win-Lose situations eventually the other party will find an alternative.
- Are margins high?
    - If no why not? Eg keeping competition out (long term greedy)
- Are there opportunities to grow in core or adjacent markets?
    - Can they roll up smaller competitors?
- What is the company doing with the cash?
- Barriers to entry?
    - Small TAM?
    - Regulatory?
    - Technological?

- Does it have win-win relationships?
    - If no: stakeholders on the losing end will find a way to get round this company

Lowest cost producer

- Margins are likely to be razor thin, so can they keep growing the top line?
- Why is this company able to have lower costs than competition?
    - Good management?
    - Technology?
    - Zero based budgeting?
    - Lower wages?
    - Lower quality product?
- If the company cutting expenses is it killing the business in the process or is it improving the company's moat?
- Is the industry experiencing a price war or is this the company's decision?
- Is the business dependent on commodity prices?
- Is there a threat from low wage countries?
- Do consumer want to consume the brand or are forced to due to financial circumstances?
    - Often it is better to have the aspirational brand than the low bid.
- Are there other differentiators in the industry other than price?
    - Is it worth pursuing the low cost producer model in this industry or would a value-add differentiated model be better?

Natural monopolies

Some companies like railroads, mining and commodities, utilities etc can be natural monopolies where do to physical constraints there is no opportunity for new entrants.

- Threat of regulation?
- Threat of substitute?
- Capital allocation?
- Does society want this business to earn an economic profit?
    - If no: Society will find a way to replace this monopoly?
    - If no: is this company on a path towards being a favorable member of society?
    - When we come across companies that we think society actively distains earning an economic profit – oil? – we need to include a huge "fade rate" in our valuation models. Often we just avoid completely.

Technological based moat

- Do we have expertise in this field and do we fully understand the technological advantage this business has?
- What stops competitors from developing this technology?
- Does the company have the necessary patents?
- Does the company operate in markets where patent law is upheld? China?

Economies of scale shared

Arguably the strongest of all moats. When a company grows it often starts benefiting from economies of scale, often companies will let these benefits translate into margin expansion. However, the economies of scale shared model suggests that instead of letting its margin expand a company should let margins stay low and gives the increasing margin back to its customer – via lower prices, better service, better product etc. A great example of this is Costco, they have openly said they will only ever mark up prices on products by 15% and any extra savings they get on buying in bulk they will give back to the customers via lower prices. Once at scale it is almost impossible to compete with, even Amazon cannot take market share from Costco.

- Are customers benefiting as this company grows?
- Does the business have a high net promoter score and satisfied customers?
- As revenues grow is the company letting margin expand or are they investing in their moat? (long term greedy)
- What is this company's moat and how can they use the economies of scale to widen that moat?

GROWTH

When we see that a company is growing we look at if that growth is creating value. We define value creating growth as a return on invested capital that is greater than the cost of capital. ROIC > Cost of Capital – value creating, ROIC < Cost of capital – value destructive, ROIC = Cost of Capital value neutral. Therefore, to understand if growth is value creating it is important to define our Cost of Capital.

A note on cost of capital: We define the Cost of Capital as the amount of return we require in order to give away our money today, regardless of where interest rates are (though that would come up as opportunity cost) adjusted for risk. If we take a waiter who perhaps struggles to pay his rent, what return would he require to give away his capital today? He certainly wouldn't care where interest rates were. He would imprecisely calculate his opportunity cost, which would include paying his rent, putting food on the table and buying something nice for his spouse. For him it is painful to give away his capital today, therefore he might require, 20% or 30% return on his capital. The value of current cash for the waiter is very high. On the other hand a money manager at a big fund would have a completely different Cost of Capital. Firstly it is not her own capital, and it doesn't affect her own spending. Secondly it is her job to maximize risk adjusted returns, therefore, she rationally will want to be fully or close to fully invested in the market giving current cash very little value. For the money manager she might use the federal funds rate as her opportunity cost, therefore, having a very low risk adjusted Cost of Capital – perhaps 5%. The Cost of Capital is completely personal and dependent of an imprecise opportunity cost that includes ill-defined non-financial opportunities such as buying a car or going on holiday. Finally we discount the cash flows from an investment using a weight adjusted Cost of Capital + Cost of Debt, discount rate, then subtract the initially amount of money laid out. Any positive number would indicate an investment earning its Cost of Capital.

$$NPV = -C_0 + \sum_{i=1}^{T} \frac{C_i}{(1+r)^i}$$

QUESTIONS

- How long can growth continue?
  - Does this company have a large TAM?
- Is the market fragmented?
  - Can the company use value creating acquisitions to consolidate the market?
- Has the company got a history of growth?
- Is the company growing where they have expertise or are they growing in unrelated areas?
  - Is there growth just for growth's sake or is there a clear strategy?
- Is the company growing the right areas of the business?
  - Is the company pumping money into a low return business when it should be growing a different area of its business?
- Does management have a long term vision?
- Is there a company mission?
- Can we picture this company in 5-10 years?
- Has the company got a good track record of spawning businesses? Spawner DNA Eg Amazon, Web services, logistics, retail etc. Gentex Started off a fire protection company, moved into rearview mirrors, aircraft windows, surgical lighting etc.
- Are there easy high return investments available?
  - Usually organic including factory optimization, increasing factory utilization?
- Is the company still producing cash during this growth phase?
  - Will the company need to raise capital to grow?
- Is growth widening or shrinking the moat?
  - Is the company investing in hard to replicate assets like expertise, patients, and brands?
  - Is growth going to lead to economies of scale?

MANAGEMENT

Management is an incredibly important topic but it is much nuanced. Often we rely on intuition and gut-feel. Buffett has often cited three main characteristics you want to see in management: Trustworthiness, Competence and Energy. A caveat to this is that if they don't have the first trait "Trustworthiness" we definitely don't want them to be competent and highly functioning. When assessing a company we determine how important management is, there are fantastic businesses that it would be hard for even the most incompetent sloth to destroy – Coke, Maotai. Then there are some companies that all they have is a great leader – early Amazon, Walmart, Microsoft. For businesses other than the Cokes of world, we think about management incentives and shareholder alignment. "Never, ever, think about something else when you should be thinking about the power of incentives" – Munger.

QUESTIONS

- Is management aligned with shareholders?
  - Large inside ownership?
  - How is their performance judged?
  - How is their bonus structured?
  - Is the board aligned with shareholders? – Ownership?
- Does management talk about the importance of its shareholders?
  - Do they use words like "long term partners", "owners"?
- Have management been returning cash to the shareholders?
- Do management actively buy shares in the open market?
- If the company is underfollowed, how are management seeking to solve this problem?
  - Tradefairs?, Investor events? Are they too focused in this area?
- Is compensation fair?
- Does management have a history of diluting shareholders?
- Do management have a long term vision?
- What are disclosures like?
  - Are there parts of the business we wish we knew more about or that management don't talk about?
- Is Management Empire building?
- Has the CEO got a good team around him/her?
- Are there different share classes?
  - If yes: does one class have extra voting rights or are the shares structured to insure that management have control even if they have less than 50% of the outstanding shares?
- If there are large cash balances how do management justify it?
  - Is this managements own play fund?
  - Will cash ever come out of this business?
- Have previous acquisitions been value creating?
- Are management critical of their own performance or is everything always rosy?
- Does management deliver on their promises?
  - Have we looked back at what management has said and seen if it turned out like they said it would?
- Has management been purposely shrinking the business to focus on higher ROI parts of the business?
  - This can often lead to massive outsized gains in share price if the market has missed it.
- Is management willing to try and fail? – Amazon fire phone, New Coke
- Is management fanatical about the business?
- How do employees view management? – Check glassdoor.com

CAPACITY TO SUFFER

What really enables us at White Loch Capital Management to take a long-term view is knowing that our businesses will be around for the long-term. We look for businesses that we believe are robust to shocks and have the ability to deploy capital during a crisis when its competitors are conserving their cash and are in survival mode. Capacity to Suffer is not a line item on the balance sheet nor can it be found in any quantitative measure. Capacity to Suffer is really a confluence of both qualitative and quantitative factors that come together to make a robust company that will be able to survive if not thrive in a crisis. We think that a quick, high-level view of a business with the Capacity to Suffer is one which has: a strong balance sheet; an Owner-mind-set CEO that has a long-term vision; an adaptive culture that can evolve as the environment around it changes and a business with high pricing power and gross margin.

QUESTIONS

- Does the business have a robust balance sheet?
- Does the business have enough liquidity to not only survive a market down turn but to take advantage of it?
    - How much cash is on the balance sheet?
- Is there potential for this business to face iniquity constraints in a time of tight credit markets?
- Has this business had a history of adapting to a changing environment?
- Has the business and management survived a recession?
    - How did they act during a market downturn?
- Does management have a long-term vision?
    - Is management more focused on quarterly earnings or a long-term goal?
- What is the culture of the business?
    - Does management place a high value on culture?
- Is the business structured so that management can survive long enough to implement their vision?
    - Is there an impatient board or impatient group of investors?
    - Is it likely that management will stick around? – Why?
    - Is management the founder? – Founder-mind-set?
- Does this business have pricing power?
- Is this business filling a need?
    - Are the stake holders better off because of this business?
    - Are consumer captive and happy or captive against their will?
- Does this business have high gross margins?
    - If a well-funded startup was to enter the industry and lower prices, how would this company react?
        - Could it cope with low price competition?
- Is there threat of regulation that could seriously impair the company?
- Is there threat of substitution that could seriously impair the company?
- Is this an industry that is likely to be dramatically different in 10 years' time?
- What is the biggest threat to the industry?
    - How is the company prepared or preparing for the arrival of this threat?
- Is annual market share turnover high in this industry?
    - If yes: why is this company immune to losing market share quickly?

INDUSTRY FORCES

Generally we want to be macro aware but macro desensitized. However, we feel it is important to know what environment a business operates in. A good heuristic is generally the more that macro and industry forces drive the outcome of a business the further we want to stay away. However on occasion we find businesses that operate in extremely favorable market conditions and this can lead to outsized returns on capital for a long period of time. Porter's five forces still remains a good standard for industry analysis.

QUESTIONS

- Where is the economic profit earned in this industry?
  - We will conduct a value chain analysis to see if we can find who holds the most power and where economic profits are earned along the value chain.
- Do suppliers hold a monopoly in the industry?
  - If supplier were to raise prices could the business pass those prices through?
- Can the company easily switch supplier?
- Could the company effectively vertically integrate its business?
- If any one supplier was too suddenly disappear how would this business cope?
- Where are the suppliers located?
  - Are there complicated supply chains?
  - Is it possible to "near-shore" supply chains?
  - Is IP being put at risk due to manufacturing in countries that don't respect IP law?
- Has the company had to halt production in the past?
- In some ways labor is a supplier. Does the workforce hold power over this company?
  - Unionization?
  - Has there been strikes?
- Are wages rising faster than the company is able to pass on those costs?
- Do consumers have a lot of choice in the market place?
  - Why do consumers choose this product?
  - Is there consumer captivity?
- Is the product or service essential to the customer?
- Can the customer easily switch to an alternative?
- What is the competitive landscape?
  - Fragmented?
  - Big lazy players?
- Is the company top one or two in the industry or is it likely to be in the future?
- Could a well-funded start-up come in and lower prices making everyone unprofitable?
- If we were given a billion dollars today could we set up a business to effectively compete with the business?
  - Warren Buffet with a billion dollars probably still couldn't compete with Coke
- How much market share changes hands every year?
  - If there is consumer habit and very little market share changes hands every year this could be a very powerful moat in itself for incumbents
- Is there regulation stopping new entrants?
- Is this company good for society?
  - ESG is mainly marketing however we believe that society has a way of rejecting things that aren't good for it - tobacco, diesel.
- In an ideal world would this company exist?
- Does the business seek win-win relationships with its stakeholders?

KPIS

There are four types of information: Knowable and important; Knowable and unimportant; Unknowable and important; unknowable and unimportant. We want to purely focus our energy on the first bucket. First we find it useful to invert the problem, what is unknowable? For this exercise we try to rid ourselves of hubris and understand that macro events are unforecastable. We try to look at what is really driving the business (or investment thesis) forward. For example with Coke it might be to maintain operating margins and returning cash to shareholder, trying to predict whether growth rates will be 1.5% or 1.6% greater than GDP is redundant. For a SaaS company we might look at metrics like ARPU and churn rate. In liquidation cases we will be looking for speed in legal proceedings and accuracy of the balance sheet. We think it is essential to identify the two or three key drivers of growth and ignore the noise. We like to write down an investments "North Star" and only focus on that. For long dated securities (Compounders) we give a lot more wiggle room to our business and can tolerate more volatility. For short dated securities (cigar butts, commodities and liquidations) if the KPIs are starting to move in the wrong direction we probably want to get out quickly.

QUESTIONS

- What drives the value of this company?
- Is management looking in the right place, talking about the right metrics?
    - We want management to have the same "North Star" as us.
- Is management using a lot of terms like 'non-GAAP adjusted EBITDA"?
    - We want to partner with management who treats shareholders like partners and part of that means giving shareholders a clear insight into the business and being open with shareholders
- How is management investing retained earnings and does it improve our KPI metrics?
- How does this KPI metric help build the company's competitive position?
    - For compounder the KPIs should be linked to the moat
- How is management's track record of improving these KPIs?
- Does the company's vision fit with these KPIs?
    - Does management's vision of the business fit our own?
    - How will our KPIs look if management's vision is achieved?
- In 10years time what do these KPIs look like?
    - Are KPIs likely to improve or deteriorate over time?
    - What is the current trajectory of the KPIs?

PRICE/VALUE

Price is what you pay, value is what you get. Value is not some metric or ratio, a high PE stock could be a bargain and a low PE stock could be overpriced, we define value as the future cash flows attributed to the holder of a security (stock, bond), discounted back to today's value of money. A holder of a security can be paid cashflows in a number of ways, dividend, share buyback, coupons, debt maturing, takeover, liquidation, selling the security. With debt securities cashflows aren't very difficult to calculate and there is no guessing other than default risk. For an equity security we need to use our brains a bit more and we need to be really humble when making assumptions. Once we have calculated the cashflows we expect to receive from an investment then we must discount them back to the present value. We do this by discounting using our weighted average of cost of capital + cost of debt. After we have discounted those cashflows back to the present value we want to buy them for less than they are worth – **Margin of Safety**. Margin of safety is the discount to the present value of cashflows that we require to feel comfortable owning a security.

QUESTIONS

- What is the price to sales ratio?
  - Price to sales can be a useful indicator of value for unprofitable growth company with uncertain cashflows.
- Are earnings currently depressed so it looks expensive on a PE ratio?
  - Most investors use a multiple to value a business, if we can find why the multiple is uninstructive then we might be able to generate alpha.
- Are earnings currently inflated?
- Are one off items distorting value?
- How certain are we of future cashflows?
  - How long will we need to wait for those cashflows?
  - How much is a black box with a $1,000,000 inside that will never come out worth?
- Are earnings being translated into cash?
- Is share count growing or shrinking?
- Why is there a mispricing?
  - Illiquidity?
  - Turn around?
  - Unfollowed?
  - Forced sellers?
  - Industry or market sell off? Baby out with the bathwater?
- Why will this mispricing reverse?
  - Catalyst?
  - Spinoff?
  - Share buybacks?
  - Growth?
  - Take over?
  - Getting included in an index?
- What is our edge in this investment?
  - Informational?
  - Analytical?
  - Behavioral?
- How much is being reinvested in the business?
  - How much is growth cap ex vs maintenance cap ex?
  - Does this business need to run a hundred miles an hour to stay in the same place?
- Can the business keep or increase its margin structure?

CATALYST

If we have a company that we believe we can buy at a discount to the present value of its future cashflows what will reverse this undervaluation?

QUESTIONS

- Is the company growing in a value creating manner?
  - Value creating growth is often a catalyst on its own
- Has management acknowledged the undervaluation of the shares?
  - Do they have a plan to reverse the undervaluation?
- Is there a strong possibility of a spinoff of a business so that the market can fully value the whole business?
  - Why do we believe management will do a spin off?
  - Are management incentivized to do a spin off or are they incentivized to oversee a bigger company?
- Will management increase dividends?
- Will management repurchase shares to close the valuation gap?
- Is this company likely to be a new addition to a big index like the S&P500
- Who is the marginal buyer of the shares?
- Who is selling these shares?
  - Are there forced sellers?
- Is the management attending conferences and investor events?
- Is this company an acquisition target?
- Will this company be bought at a fair price for shareholders?
  - Management incentives?
  - Is there a large owner that could take the company private below intrinsic value?
- If it's a liquidation, when will this liquidation happen?
- Does the company have an undervalued business segment?
  - Some research has shown that a segment needs to get to at least 30% of revenues before the market prices it in
- Is there an activist involved in the company?
  - Is management cooperating? Board seats?
- Is this company about to dual list or relist to a bigger exchange?

BIASES

We believe there are three ways an investor can have an edge: Informational – information is universal these days. Analytical – seeing the information differently to everyone else. Behavioral – behaving in a manner that gives us an investment edge, might include longer investment horizon, patience, risk tolerance etc. The first two ways are really hard but the third way is slightly less hard and totally within our control. After we have found an investment opportunity and compared it against its opportunity set we try to identify any behavioral biases impairing our judgement and to make sure this investment is compatible with our EQ/temperament. If we accept that Total IQ = IQ*EQ where EQ<1 then we can see that we need to align our investment strategy with our EQ. What does it mean to align our investments with our EQ? Everyone has their own personality, risk tolerance, circumstances etc, these are the factors that drive our investment philosophy. We believe that the ultimate test is the sleep test, if we can't sleep comfortably while we are invested in a certain business we either need to reduce the position size or more likely we need to exit the position. It is crucial for us that we align our investments with our temperaments and no matter how good an opportunity is if it doesn't pass the sleep test we don't proceed.

- Would we be comfortable holding this stock, at its current weighting in our portfolio, during a 50%+ drawdown?
  - If no: why?
  - If no: do we need to reduce the position size or exit?
- Can we sleep soundly at night holding this stock at its current weighting in our portfolio?
- Do we truly understand this business? Is it in our circle of competence?
- Do we find ourselves only thinking of the upside?
  - Have we fully considered all the disconcerting evidence?
- Have we tried to mentally kill this business?
  - Have we tried a red team/blue team analysis?
- Are we over optimistic?
- Have we been sold on a charismatic CEO?
- Has someone we know or admire bought this stock?
  - Liking/loving tendency?
  - Social-proof tendency?
- How is our mood?
  - Stressed?
  - Have we got a large cash position and desperate to put it to use?
  - FOMO?
  - Stress mis-influence tendency?
- Have we slept on the decision?
- Do we love this company?
  - Are we consumers of the product?
    - If yes how is that affecting our judgement?
- Does this look good because it is new?
  - Shiny new object?
- Did we spend a long time researching and now have sunken cost bias?
  - We want to be like Daniel Kahneman– no sunken costs.
- Do we not like this company because we think our current companies are better?
  - Endowment bias?
- Have we spoken out publically about liking this business?
  - Inconsistency avoidance tendency?
- Has this stock been recommended to us?
  - Authority mis-influence tendency?
- Does this stock look good because recently our portfolio has been doing poorly? Or have we been researching lots of really bad businesses and this business only seems great compared to those dreadful ones?
  - Contrast mis-reaction tendency

THANKS FOR READING

White Loch Capital Management is a **fictitious** fund based in Scotland. The fund serves as a vehicle for the author to express and clarify his thoughts. Moreover, the fund will help keep the author accountable and will employ inconsistency bias to help the author stay true to his investment philosophy. Investors must be on guard for getting caught up in the excitement and folly of current market trends. So often investors experience style drift or begin to lower their standards, the hope is that writing will keep the author honest to his investment principles.

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Appendix 1: Resources

Gurus/Funds –

Terry Smith - https://www.fundsmith.co.uk/

Warren Buffett - https://www.berkshirehathaway.com/

Guy Spier - https://www.guyspier.com/

Monish pabrai - http://www.chaiwithpabrai.com/

Michael Mauboussin - http://michaelmauboussin.com/

Bill Brewster - https://www.thebusinessbrew.com/

Jake Taylor - https://orphanira.com/jake/

Tobias Carlisle - https://acquirersfunds.com/

Joel Greenblatt - https://www.gothamfunds.com/principals.aspx

Carl Icahn - https://carlicahn.com/

Bill Ackman - https://pershingsquarefoundation.org/

David Einhorn- https://www.greenlightcapital.com/

Connor Haley - https://www.altafoxcapital.com/

Matthew Sweeney - https://www.laughingwatercapital.com/

Ian Cassel - https://microcapclub.com/about/microcap-experts/

Chris Mayer - https://www.woodlockhousefamilycapital.com/blog

Adam Mead - https://meadcm.com/

Francois Rachon - http://www.givernycapital.com/en/

Christian Ryther - http://www.curreencapital.com/

Sean Kirkwood - https://srk-capital.com/

Brian Feroldi - http://mindset.brianferoldi.com/

Bill Miller - https://millervalue.com/–

Jeremy Grantham - https://www.gmo.com/

Aswath Damodaran - https://aswathdamodaran.blogspot.com/

Howard Marks - https://www.oaktreecapital.com/insights

Morgan housel - http://www.collaborativefund.com/blog/authors/morgan/

Nick Sleep - https://igyfoundation.org.uk/wp-content/uploads/2021/03/Full_Collection_Nomad_Letters_.pdf

Lauren Templeton - http://www.templetonandphillips.com/firm-professionals

Vitaliy Katsenelson - https://contrarianedge.com/

Tom Gayner - https://www.markel.com/markel-corporation/for-investors

Prem Watsa – https://www.fairfax.ca/

Scott Miller - https://www.greenhavenroad.com/

Adam Wilk - https://www.greystonevalue.com/

David Waters - https://alluvialcapital.com/

Wayne Jones - http://www.ganescapital.com.au/

Yaron Naymark - https://www.1maincapital.com/

Dan Roller - https://marancapital.com/

Martin Versfeld - https://www.rowancapital.co.za/

Bill Nygren - https://oakmark.com/

William Posten - https://www.oakhavencapitalpartners.com/

David Barr - https://www.penderfund.com/

Podcasts

The investors Podcast - https://www.youtube.com/c/TheInvestorsPodcastNetwork

MOI Global - https://www.youtube.com/user/manualofideas

MicroCap Club - https://www.youtube.com/channel/UCzX4HLkD7eXBgzVwHMZlhmg

Good investing - https://www.youtube.com/channel/UC5Z-C01O2VlpeD1rMs_HS2Q

Excess returns - https://www.youtube.com/channel/UCPYvx_y92dvI1PSdiho0ALw

Wealth Track - https://www.youtube.com/user/WealthTrack

Meb Faber show - https://www.youtube.com/channel/UCKvWzzrVUA_DSCoKXL6GU2w

The Knowledge Project - https://www.youtube.com/user/farnamstreetblog

The business brew - https://www.youtube.com/channel/UCBywIfdQy7Nyb2RfRb_Z0eg

The Acquirers podcast - https://www.youtube.com/user/Tobycarlisle

SNN Network - https://www.youtube.com/user/SNNWire

Real Vision - https://www.youtube.com/channel/UCBH5VZE_Y4F3CMcPIzPEB5A

Pender Funds - https://www.youtube.com/channel/UC7Htya6_hQdlKDiC4Kn6Txg

Websites

https://www.gurufocus.com/ - great resource for getting a quick overview of a business. Also has some good articles

https://www.dataroma.com/m/home.php - Shows the holding of many ‘gurus’

https://www.valueinvestorsclub.com/ - great online investing club

https://www.reddit.com/r/SecurityAnalysis/ - good discussions on investments and has links to all the latest fund letters

https://finviz.com/ - Good screening resource for US listed stocks

https://seekingalpha.com/ - has good write ups about stocks

https://www.sec.gov/edgar.shtml - Has all SEC fillings

https://roic.ai/ - fantastic resource for a company’s financial information

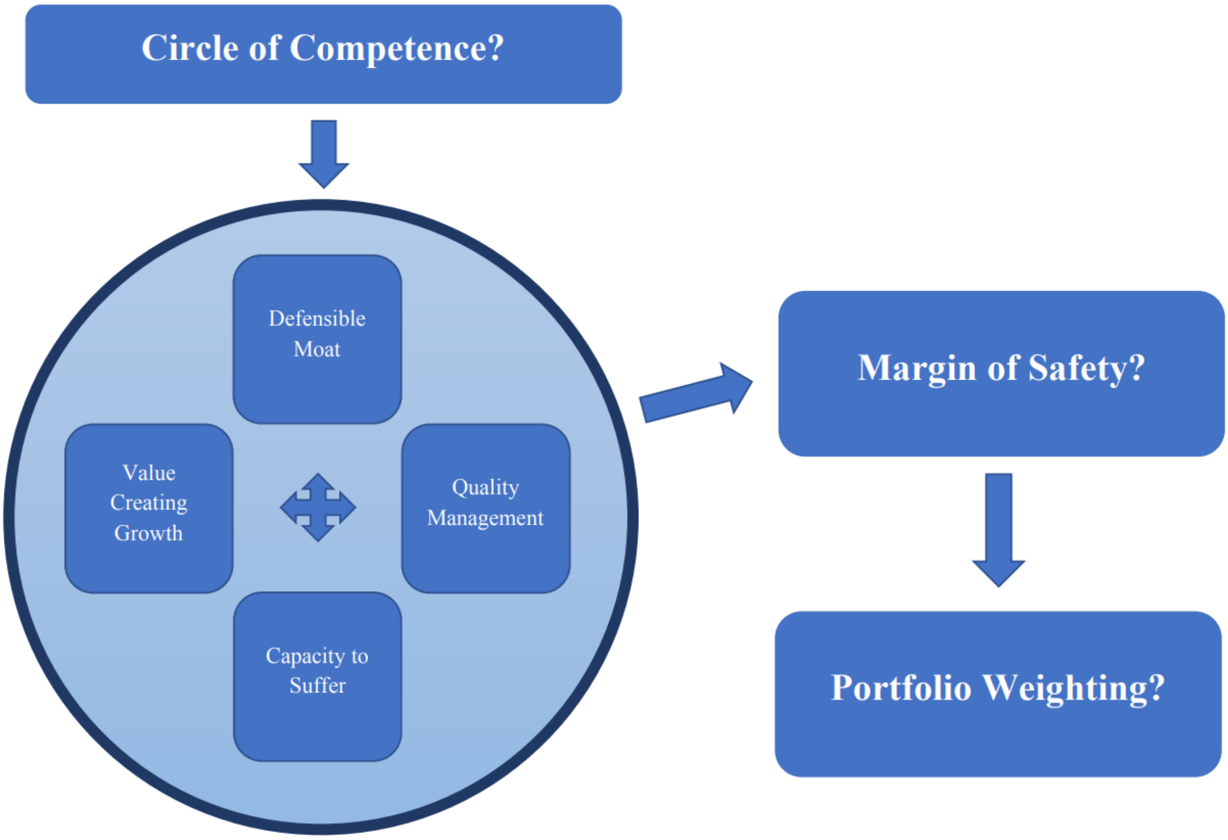
tikr.com – Another screening tool

https://thecobf.com/forum/ - Value investing forum

https://www.ivey.uwo.ca/bengrahaminvesting/resources/ - has a whole load of great value investing resources

Appendix 2: Investing Frameworks

WLCM'S COMPOUNDERS FRAMEWORK



WLCM'S WORKOUTS FRAMEWORK