Owner's Manual

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The greatest threat you face to your investment performance is from you.

Why an Owner's Manual?

The Owner's manual's main job is to communicate our investment philosophy. The Owner's Manual serves two other purposes. It keeps management accountable as our investment philosophy is out in the open and if we are in clear violation of the Owner's Manual then we should be held accountable. Lastly the Owner's Manual serves as a road map for Management to stay focused on what we promised to do and so that if we veer off track we can look back at our founding principles.

Our Goal

Our goal is to achieve the highest possible risk adjusted return over a long period of time. To achieve our goal it is very important that our temperament and personality is aligned with our long term outlook and with our investment philosophy. Whilst there will always be: other managers who out preform us for periods of time; there will be fads and bubbles that will try to persuade us to chase the thrill of the gamble but it would not behove our investment returns to chase these fads and trading businesses like Pokémon cards. Most investors never achieve great returns even if an investor picks the right fund they almost seem destined to buy at the top and sell at the bottom, settling for a dismal return. Peter Lynch returned an astonishing 29% annual return during his reign at the Magellan Fund. However, according to Fidelity Investments, the average investor lost money during this period. How can this be possible? The reason why investors cheat themselves out of great returns is they let their human nature take over and are far too active in the market. We must have iron discipline to dismiss the call to action in the markets. We feel more than ever the markets have more power to call our system 1 thinking into action. These days we are bombarded with news reports, social media and false prophets opining on whatever is "hot". We most hold firm in our beliefs because the day will come when you are staring at a 50% meaningless mark-to-market loss, or a period of underperformance in comparison to some irrelevant index, it will happen. We must take a long term view as business owners and use any fear from weaker market participants to our advantage. We must be fearful when others are greedy, we must be greedy when others are fearful. We want to maintain our long term mind set and stay true to our beliefs during our periods of inevitable underperformance.

Generating Alpha

We believe that there are generally three ways to generate above average returns in the market. First an investor can have an informational edge, this is where the investor gets some information that is not generally recognized by the market. With insider knowledge being illegal and the internet making almost all information available to everyone, getting an informational edge is very difficult these days. It can still be obtained for example by scuttlebutt or digging through weird and off the beaten path resources. Ted Wechsler has talked about subscribing to niche trade publications and industry magazines as a way to gain unique insights to keep up with trends the market is generally missing. Second an investor might have an analytical edge, this is where the investor is able to see something in the information available to the market that others don't see. This might look like spotting a trend before the market does, being able to predict how certain factors will affect a certain business better than others. This usually means outsmarting the army of PHDs on Wall Street, it is a difficult edge to obtain and usually needs some sort of specialisation. Finally an investor may have a behavioural edge. This generally means being able to control one's own behaviour and take advantage of other investors' irrationality. We think this is the most obtainable edge for us and that our temperament is very suited for exploiting behavioural irrationality in the markets. This means being buying the stocks we like when there is blood in the streets and people are fearful. People panic, its human nature, and therefore we stay rational during inevitable down turns and scoop up the stocks we like at a discount. We are also able to patiently wait till those businesses we like get to a price that we feel comfortable with the risk reward distribution. We also want to hold business for a long time 5-10 years and see ourselves as business owners. This is far from the norm in the markets where in 2020 the average stock was held for less than 6 months. The market has become a casino where speculators are trading in and out of stocks and chasing the latest fad. This is great news for us as we are able to see through the madness and prudently buy business that will compound our wealth over time. This means that we have to be extremely patient, we need to let our business compound and we can't let the constant call to action risk disturbing that compounding. Our portfolios are like a bar of soap, the more we play with them the smaller they get.

Investment Philosophy

How we think about stocks

Stocks represent part ownership in a business and that is how we treat them. We do not think that they are little pieces of paper that should be traded on a daily basis. We acquire businesses with a private owner mind set the same way we would approach buying a farm or any other productive asset. We think that the constant bombardment of changing prices for an asset whose value fluctuates very slowly is doing a disservice to investors and we do not pay any attention to the daily or weekly moves of stock prices, we focus on what the underlying business is doing. When we, or anyone else, owns a stock they own a piece of a business alongside their business partners (the other shareholders), so we find it crazy the way many investors trade in and out of businesses. If you bought a convenience store would you be looking every day at what it is worth? Phoning up agents every day to see what people would pay for the business? Would you also be going to the convenience store down the street to buy your groceries? Of course you wouldn't so why would we do it with our partial ownership in the businesses we own through shares? We take this mind set very seriously, if we 5 shares of Coke, we should still act as if it is our business, we drink Coke not Pepsi, we should seek to consume the products of the business we own and help our businesses anyway we can, which also includes being active shareholder. Just like if you owned the local convenience store you wouldn't go to your competitor to buy your snacks.

Our ideal holding period is forever.

What business do we want to own?

We want to be a Swiss army knife with many tools in our toolkit and we look globally to find those opportunities, this freedom gives us the greatest chances of finding the best businesses. However, there are some important caveats, we MUST stay within our circle of competence, and we need to understand the business and the environment it operates in. This quickly disqualifies business that need specialised knowledge, many businesses in industries such as biotech and healthcare fall into the "too hard pile". We need to have some idea of where the business will be in five years' time. We also want our businesses to operate in a relatively stable environment, this means that we consider the threats from regulation and disruptive technology as low or we at least think we have some incline on where the industry in heading. We are not ESG investors however we like to believe that society will eventually reject things that are harming it, so we like to think about the purpose of the company in society and if it is bringing win-win relationships to its stakeholders. This means we generally avoid industries like oil and tobacco. Moreover, we avoid businesses that are treating its stakeholders poorly, such as business that treat employees as replaceable and those that take for granted "trapped" customers. We think that if stakeholders' needs are not getting met eventually competition will enter the market to fill those needs or regulators will step in. As we said we believe society will eventually reject what is not good for it like the body rejects a foreign object. We also don't want to invest in black boxes of money, where the money is there but it is not coming out. If a box has 20 million dollars in it but there is no way of getting that money out what would you pay for it? We think zero. This means we want to see some catalyst for unlocking value and that can come in many forms. We generally put our businesses into two groups, Workouts and Compounders.

Investment Philosophy

Why do we think opportunities exist in the market?

We do not believe markets are efficient. We believe that the stock market is a large open outcry auction of stocks where participants are playing multiple different games, the interconnectedness of markets are convoluted beyond imagination; human bias, herd mentality and emotions are running amok and it is a complex adaptive system that by definition cannot be figured out. This is part of the reason why it draws in so many of us, including us, we find it fascinating to continue learning, it is a game that cannot be completed. We do not believe that we have or ever will solve the markets, nor do we believe that we can predict what markets can do in the short run, we cannot do most things. What we believe we can do predict where certain businesses are likely to be in 5-10years time, and ever-so-often our expectations do not match the markets expectation and that is when we act.

How do we value a business?

The value of a business is all of the cash that can be taken out of the business from now until judgement day discounted back to the present value of today's cash using a weight cost of capital (the required return for the investor) and debt (the cost of any debt held by the business). So as an investor how do we get cash from a business? There are a number of ways, first the simplest way, the business during the course of its normal operations will generate cash (hopefully), then management has the choice to reinvest it back in the business with the purpose of generating future returns greater than the cost of the capital (hopefully) or management can return the money to shareholders via dividends or share repurchases. Next the business could be sold and the proceeds returned to shareholder. The business could be liquidated and funds returned to the shareholders. The key here is that the money is returned to shareholders eventually, if the money isn't ever going to come out of the business then no matter how good its technology is or how much cash is sitting on the balance sheet, the value of the business to a shareholder is zero. This is why we do not compromise on needing a catalyst and good management. We will typically discount the cash flows that a business will generate by 10% a year (this is our cost of capital). Then we want to see that the price at which the business can be bought at today is half that of our calculated value 5 years out (margin of safety). This gives us a roughly 25% rate of return if our calculations are right (which they rarely are), and even if we are only right by 60% then we will happily take the 15% annual rate of return.

Margin of safety

When we analyse a business we try to estimate the value of that business by predicting the cash that will come out of the business. But this is by no means a precise measure and at the best of times we only have a mosaic like picture of the business. So we need to have a Margin of Safety when buying a business, this means that the price we are willing to pay for the business is well below the value that we think it is worth. A good analogy is that if the maximum load bearing weight a bridge could take was 2.5T would you be willing to drive a 2.4T truck over it? Of course you wouldn't you would be scared that there were miscalculations somewhere, you might be comfortable driving a 1.25T truck over it, a 50% margin of safety.

Investment Philosophy

Workouts

Workouts are where we are looking to exploit an inefficiency in the market using a 1-5 year outlook (short term… For us). These opportunities come in many different flavours some that we do feel confident exploiting and others that we avoid because we have no competence in those areas. We will hunt across all market caps, but we think that the vast majority of the market inefficiencies are in the small cap range where there is less analyst coverage and the businesses are too small for institutions to hold. With Workouts the role of management is less important for us than with Compounders however we still want to see that management has the shareholders' best interests in mind and we are wary of a controlling owner in the Workout space as they might have no incentive to unlock value for shareholders. We have seen many highly undervalued small cap businesses with controlling managers who treat the business as their personal bank account, never unlocking value for the shareholder – these are especially prevalent in China and Japan.

We like to look at spin offs, sometimes the market can be inefficiently pricing one part of the spin off, usually the unloved part. Though this area is usually well combed over ever since Joel Greenblatt shed light on the opportunities that can found here. However, undervalued businesses can be found here especially if there is a lot of forced selling because the spin off business is too small for the big institutions to hold.

Bankruptcies can be a space for enterprising investors to sift through, where panic selling has led to the share price to plunge below the claim on assets owned by the equity holder. However, we would need to see a huge margin of safety and are very cautious about long drawn out legal proceeding, often by the end of these long slogs any assets you thought you had claims to might no longer be there. This is not our area of expertise but never say never.

We like to look for highly undervalued businesses, with strong balance sheets where we see a catalyst to unlocking value. So let's break this down a little more, here we again need to understand the business, we need to understand why the stock is so undervalued (forced seller, obscurity, etc.). We still require the business to have adequate balance sheet strength, we feel that when a business is overly debt burdened its future is often not in its own hands and liquidity can kill it a lot faster than solvency. We have no skill underwriting liquidity risk. A key question we focus on is how we realise value, we don't want to be buying a black box of money with no way to get the money. Catalysts are usually in the form of growth the market isn't pricing in, dividend pay-outs, share buybacks, activist investor, spin out, change in management, the list could go on, and there are many different catalysts.

One of our favourite type of workouts that we look for is what we call a "Bad co/Good co" which is where the business might have a no growth legacy business that currently accounts for the majority of its revenue, but it also has a smaller faster growing business that we think has a bright future. The market often values the whole business as just the legacy business and ignores the newer faster growing segment. What we hope to happen here is that eventually the Bad co will be sold and the Good co can be properly priced and might even turn into a compounder.

Things we won't do: we will not chase fads; we do not chase momentum; we do not invest in nonproducing assets like gold or bitcoin; we don't invest because we see some pattern in a chart; we won't test the edge of our circle of competence and we don't short. We are not bashing these types of investing, we just have no competence there. We want to stay firmly in the centre of our small circle of competence.

The real test we have with all of the businesses we own is the sleep test – Can we sleep soundly at night owning these business.

We must see a clear path to unlocking value.

Compounders

Compounders are great businesses that will continue to grow and compound our wealth for a long time. When we think about Compounders we think in decades and our ideal holding period would be forever. This is our preferred method of compounding our wealth, make one decision to buy an outstanding company at a fair price and sit on our asses while the businesses compounds. Ideally our portfolio would consist only of compounders, maybe eventually they will, but they aren't many fantastic businesses and very few that ever become undervalued. So when we see a business that we are confident is a Compounder and is undervalued we swing and we swing hard. In the mean time we distract ourselves with the workouts and research.

We do not share the ultra-short term thinking that plagues the market, when we buy a compounder we look at it as a marriage. First we want to do very diligent research on the business maybe even own a very small position to feel invested in the business, this is analogous to the dating phase, trying to figure out if you see a long term future. Then once we feel comfortable we will buy a large position in the business thinking about how the business will look like in the decades ahead with the intent of owning it forever, like a marriage the intent is forever. However, like a marriage things can go sour or something a lot better can come along. Now you don't leave a marriage for something that might be just a little better there are risks involved in switching, you already know the business (partner) you are involved in and you have a good understanding of it (them). However if something a lot better comes along that you are equally as confident about then it only makes sense to make the switch, however the intent entering into buying a business (marriage) is never to have to make that switch.

What do we mean by a great business? It is really a business that can earn high returns on its unlevered incremental capital employed for a long period of time. The capital employed in the business is all of the current assets (inventories, cash and accounts receivable); all of fixed assets (factories, machinery and land) and any intangible assets that the business needs to operate. So we look at how much the business needs to invest in future and what return it will get on that growth. Growth is a much nuanced concept, to explain the growth we are looking for we will use an example of four savings accounts, A, B, C and D. They all start the same £1,000 in the bank earning £100 a year in interest. Lets say that as an investor we require a 10% return, that will be our cost of capital. All four bank accounts have a starting return on invested capital (ROIC) of 10%, matching our cost of capital and therefore not generating any economic return. The investor for bank account A puts in another £1000, and the annual interest goes up to £180. So here the investor might think that the bank account is returning more to the investor (there is growth) but actually bank account A now only has a ROIC of 9%, below our cost of capital. The investor in bank account A as they put more money in the worse the outcome is (this is value destroying growth). The investor for Bank account B also puts an additional £1000 the account and the annual interest goes up to £200. Here the investor is in the same place, she might feel that there has been growth but there hasn't, the ROIC remains at 10% (Value neutral growth). The investor in bank account C takes out an 8% loan for £1000 and puts it into the savings account and gets annual interest of £200. So the investor has still only invested £1000 of her own money into the account, yet is getting £200 in interest, however the loan needs a payment £80, so she only has a claim on £120 interest. Bank account C has a 12% ROIC which is great they are creating more value for the investor however there are obvious risks attached to the loan, what about if the interest suddenly dropped to £0 just for one year (Levered growth). Finally the investor for bank account D puts in an additional £1000 and gets an annual interest payment of £300. Now his investments are returning more money, he has an ROIC of 15%, this is great the more money he puts into his savings account the higher the interest rate (value creating growth)! We want to focus our attention on the value creating growth companies, those analogous to bank account D.

We will look across all markets and all sizes to find Compounders but we must stay within our circle of competence, really understand the business and stay within jurisdictions where we feel that the interests of the businesses and investors are protected by a solid rule of law. The rule of law is a really important factor for us, we will invest in European, North American and a lot of Asian countries where we feel we have a good grasp on the political system. The fact we have a lot of experience in China and our Principal has lived for an extended period of time in China has convinced us foreign investors have NO rights or claims to any assets in China and therefore will not invest in China as a foreign investor.

We don't compromise on our requirement for good rule of law.

Buying a business is like a marriage.

Compounders Cont.

We prefer looking to the smaller end of the markets as we feel this is where businesses will have the longest runway for growth and the law of large numbers in not yet inhibiting the growth of the business. We have found the mid cap range to be fertile hunting ground where we usually find well established businesses with long run ways and competent management. We want to find Compounders that are overlooked by the market due to obscurity, the size is too small for investors or the country/sector the business operates in is currently unloved.

For Compounders we place a great deal of value on management. When we buy a business we want to know that management has the shareholders' interests in mind and is competent enough to grow the business in a value creating manner. We are very cautious of empire builders, especially from founders, who just want to build the biggest business they can even if that means destroying value and taking on copious amounts of debt. We think some key signs of good management is insider ownership, low levels of debt, strong cashflows and a well-defined vision for the business. We look for insider ownership because we want management incentives to be aligned with us and for them to eat their own cooking. We feel like we can give the business a lot of leeway if we know that management truly has the best interests of the business in mind and is working tirelessly to implement the business. We think low levels of debt is usually a sign of a robust business that can survive the cyclical nature of business, and a sign that management is not empire building and is keeping the business strong. We look for strong free cash flow that is matching what we see on the income statement. The income statement is easily manipulated, cash flows less so. Therefore we want to see healthy cash flows from operations with reasonable amounts for investment back into the business. Finally we like management to have a long term vision that the business can work towards and also something for investors to track, a north star for both the business and the investor to focus on.

We also want Compounders to have strong competitive advantages that will stand the test of time and allow our businesses to earn a healthy economic profit (a moat). A company's economic moat can come in many different ways and are infinitely nuanced so it is important for us to have a few models in our mind about what worked in the past and what is likely to work in the future. We think that certain brands make for good moats, but only if consumers are consistently willing to pay more to consume that brand, we consider the Coca-Cola brand a moat: we do not consider LG TVs brand a moat. We also think Network effects are a good moat, where the incremental user adds to the value of the whole network – Social media platforms, market places. We like to look for Spawners, which are companies that have innovative DNA that have a good track record of starting new business lines and continually extending the runways of their businesses. We like businesses that have a technological advantage that we understand, usually backed by patents. Finally we will mention the Economies of scale shared is a great model, as the business grows it employs economies of scale but instead of increasing its profit margin it pumps the extra profit back into the company growing its moat, perhaps by lowering the cost of the product or service making it very hard for new entrants to compete.

As you can see for us to buy a Compounder a lot needs to be in place and these truly great businesses are rare to find, so when we do we buy big and hope we aren't dumb enough to sell along the way. The test for a Compounder is if the market was to shut for 10 years could we sleep soundly owning these businesses.

Capacity to Suffer

We want all of our businesses to have the capacity to suffer. The world is an unforgiving place where the law of entropy marches incessantly and the competitive nature of business can be brutal at the best of times, we want businesses that can survive if not thrive in the harshest of environments. We want to hold the best businesses for long periods of time and to do so we need businesses that will survive. More importantly we as the investors need to understand the stochastic nature of business and markets to be able to hold the businesses through the inevitable noise. The legendary Berkshire Hathaway has been on a journey to becoming more than an 18,000 bagger (that means turning £10,000 into £180milion). However it has been by no means a smooth ride for Berkshire, you would have had to hold on to the stock through multiple large draw downs. This is true for all businesses it will not be plain sailing, wars, financial crashes, pandemics will continue to get thrown at us and we need to be confident our businesses will thrive in these environments to hold on to them during the inescapable drawdowns. So what gives businesses capacity to suffer? We think a few key tenets are: strong balance sheet; management with an owner mind set and a strong competitive moat. We love to see management taking actions that will benefit the business in the long term but make the business suffer in short term because we know that management who is being evaluated on a quarterly bases (which is the vast majority) won't be able to follow suit this is a strong competitive advantage. We don't want to own the Ferrari that looks great during the short periods of smooth roads but will crash at the first pothole; we want to own the Land Rover that will look boring during the periods of smooth roads but will survive and when the bumps in the roads come along, as we know they will, it will trundle past the burnt wreckage of the Ferrari.

Berkshire Hathaway Largest Losses Since 1980	
1981-1982	-19%
1987	-37%
1989-1990	-37%
1998-2000	-49%
2007-2009	-51%

Volatility/Risk

We do not agree with the view that risk is volatility, though we do see how volatility can induce greater levels of irrationality and folly both to the upside and downside (greed and fear). We define risk as the chance of permanent loss of capital and not some little Greek symbol or mark-to-market gains. This view requires us to remain level headed and not to get swept away in the heated emotions of the markets bipolar swings between lust and chastity. We will not engage in the Keynesian beauty contest that the market engages in, hoping to flip overpriced "hot" stocks onto the next greater fool. We do not try to predict where the market is going to go and do not try to time the market, if we see something sensible to do we will do it regardless of the macro environment and if we don't see anything sensible to do we will do nothing. We try to keep focused on what the business is doing and what are the few key performance indicators that will really tell us where the business is going.

We want to focus on the underling business and ignore the noise.

INVESTMENT PHILOSOPHY

We want our businesses to take advantage of crises.

How we view the macro environment

We want to be aware of the macro environment and following the trends with in industries but we also need to be desensitized to it so that small changes make no impact on our thesis but large smack you over the head with a two by four changes will change our thesis. We think it is relevant to focus on industry trends and focus a lot on what competitors are doing and reading trade magazines. However we do not try to predict future macro trends.

Leverage

As part of our capacity to suffer criterion we eschew excess amounts of amounts of leverage and want to see that the business can generate enough cash from its business operations to sustain itself. We do not feel comfortable underwriting liquidity risk as even small amounts of debt can become a problem if there is suddenly no access to debt. We also don’t want business to be reliant on dilutive equity raises of capital. We have also had experiences in the past where excess debt in the business has violated our sleep soundly test and has forced us to sell early leaving massive gains on the table (we captured a 3x instead of a 30x because we sold not being comfortable with the leverage). Having said all that we some businesses make sense to have some leverage in them especially if it is long dated.

Diversification

We are concentrated investors typically holding 5-12 businesses. We feel comfortable with this level of diversification as we can get to know our businesses intimately. We would rather put more money in our first best idea than our fiftieth best idea. We agree with Buffett when he said “wide diversification is only required when investors don’t understand what they are doing”. Moreover, we only feel comfortable owning businesses that we know intimately and we have some idea of where the business will be in 5-10 years’ time, sadly we don’t have the brain power to do that with 50 businesses, but we do think we can get to know 12 businesses fairly well and be able to sleep soundly knowing that our money is in the hands of honest management. This suits our temperament, we just wouldn’t enjoy holding thousands of businesses that we don’t understand.

Hedging

We believe that we have no ability to predict what markets will do, and we select businesses that we believe will survive or thrive in all environments. Therefore we feel no need to hedge, we feel that if we were to engage in hedging that it would be a net negative to the fund’s performance over the long term due to our lack of ability. A lot of the businesses we own are either located or do a lot of business in countries where there might be perceived currency risk, however we believe that our businesses have the pricing power to raise prices to mitigate the effects of currency depreciation. This is also why our capacity to suffer criterion is so important to us, we think our businesses will come out the other side of any crisis in better shape.

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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