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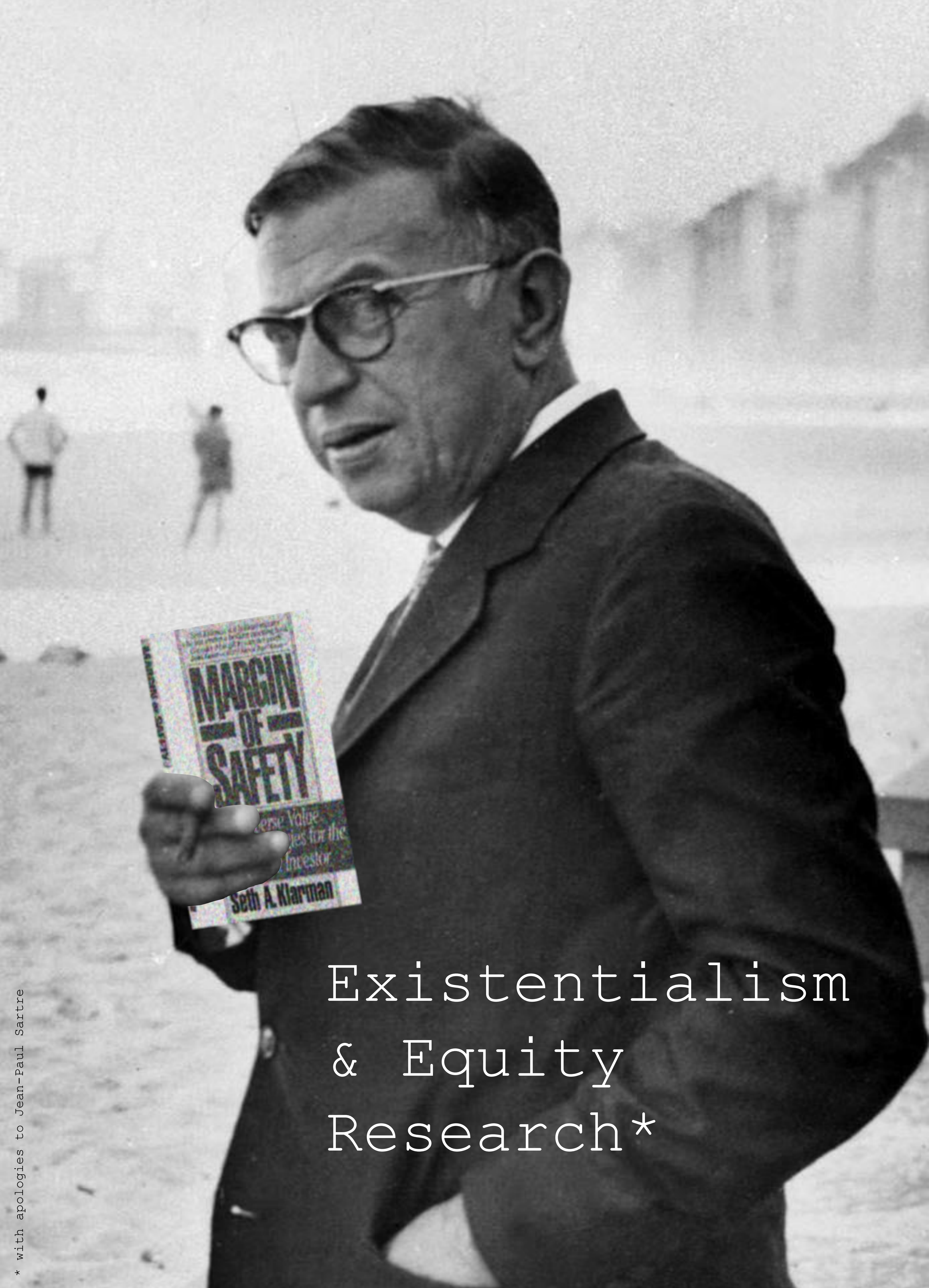

Existentialism & Equity Research*

* with apologies to Jean-Paul Sartre

Sartre meets Seth Klarman

Existentialism (and investment) involve developing a mental framework for understanding and interpreting 'truth', in a world that shapes and is shaped by the power of human choice. The challenge faced by the philosopher / investor is to develop their framework based on what can be inferred about causes from a study of effects. Without a complete knowledge of causes (e.g. what factors and relationships will move the share price, and by how much), the framework will always be incomplete; we are trying to hit a target when we can only see its shadow.

Philosophy for grown-ups

Philosophy is fun, but if you're interested in the real world, I recommend swapping your Bertrand Russell for a copy of Ben Graham.

How is the investor's mental framework developed? They have a thesis about how the world works; test it in the market to win or lose; try to decipher what the outcome means for the thesis (which is not always clear); adjust the thesis and test again.

By contrast, the philosopher lacks a real-world measure (like investment performance) as a basis for testing and revising their theory; instead they use thought experiments and value judgements.

It's natural to become less flexible in one's thinking over time, and also to have a preference for simple narratives, as opposed to multi-factor explanations. But these tendencies are at odds with the complex and changing relationship between cause and effect in the real world. While this conflict does not obviously penalise the philosopher's thought experiments, it can be catastrophic for the investor.

An investor hopes to make fewer mistakes over time. This requires intellectual humility and a willingness to adapt. When Stanley Druckenmiller was 25 years old, he was promoted to Head of Equity Research at Pittsburgh National Bank, ahead of a team of older and more experienced analysts. The Director of Investments took this tough decision because he recognised that the senior members of his team bore too many scars from the 1970s' bear market (it was 1978) to make the right decisions when the next bull market arrived (markets eventually turned in 1982). The Director's willingness to adapt meant passing the baton to the next generation.

We have a thesis about how the world works…

We are often drawn to businesses that face challenges. Pearson (PSON) is an education-focused publisher and technology provider which we first looked at in October 2016. Pearson's challenge is its large exposure to print textbooks, which are in structural decline.

Our decision always comes down to valuation, and in October 2016 we saw Pearson as expensive at 761p, versus our approximate value of 706p. But we also saw three catalysts which would bring the shares down towards our 543p initial target entry point (we always look for a margin of safety).

This was the conclusion of our analysis:

Conclusion

PSON enjoys market leadership in the attractive and growing OPM (Online Programme Management) market (including MyLabs and REVEL), however 50% of revenues are in the challenging courseware market where OERs (Open Education Resources), increasing student use of rental, growth in digital, and cut-price imports are all putting pressure on revenues and margins. PSONs restructuring plan is aligned with structural changes in the industry, however the re-alignment will be capital intensive and may offer sub-economic ROI, while the exit from working-capital intensive physical book market is not yielding net benefits to working capital (as one would expect).

Management quality is suspect. 2018 targets of £800m+ EBIT may be achievable, but only with short-term fixes. PSON is currently trading above fair value, however a number of negative catalysts may play out over the next 12-18m to put it into BUY territory (below 543p), such as:

- 50% dividend cut
- £2-3bn intangible asset write-downs and further restructuring
- Management change / acceptance of significance of structural vs. cyclical factors

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Test it in the market to win or lose…

Although these three catalysts played out over the next four months, we didn't buy the stock. The closest we got was on 18 January when the price troughed at 552p, a couple of percent above our initial target entry point. The share price has since rallied to 647p, 20% above our initial target entry.

Try to decipher what the outcome means for the thesis (which is not always clear)…

There are numerous interpretations, but broadly:

1. Our catalysts and initial target entry point were both correct. Even if 552p marks the low for the cycle, we were right not to buy at that price because the valuation did not compensate sufficiently for the risks that existed at that point in time.

2. Our catalysts were right but our initial target entry point was wrong. Our broad range of possible valuations for Pearson, from 883p to 559p (with our 706p approximate value being in the middle), illustrates how much uncertainty there is around our initial target entry point.

3. Our catalysts were wrong but our initial target entry point was right. Although our catalysts played out over the short-term, we were wrong to believe that these would trigger a buying opportunity; in fact there are further catalysts, which we did not anticipate, that will play out over a longer time period to provide an attractive entry point.

4. Our catalysts and initial target entry point were both wrong. There are further catalysts that will play out over a longer time period, and if we had factored these in to our analysis we would have arrived at a lower initial target entry point.

Valuation is the most important part of our analysis; but it is also the most difficult. This would incline me to reason #2, followed by #4. There is a risk that this analysis simply ends up reinforcing natural biases. For example, when the news-flow is at its worst, there is a tendency to believe that there is still more bad news to come, and vice versa; the points of maximum optimism and maximum pessimism mark the top and bottom of the cycle respectively. Thus, when Pearson experiences negative news-flow, there is a temptation to re-base our pessimism (and initial target entry point), as suggested by #4.

Adjust the thesis and test again…

At present the lessons learned feed-back in to our process via a 'Checklist of Mistakes'. For example, if we accept that our catalysts were right but our initial target entry point was wrong (#2), then we might adjust the process such that realisation of our catalysts, combined with sufficient proximity to our initial target entry price would provide a trigger to purchase the stock. Or we might consider using standard deviation to measure the size of the market's response to an event, and compare this with our own assessment of the event's significance.

Over time we will improve our feedback loop with a more data-driven approach, thus providing a measurable path of improvement, while always keeping an open-mind about improving the process of improvement itself.

Adam Rackley

Cape Wrath Capital

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