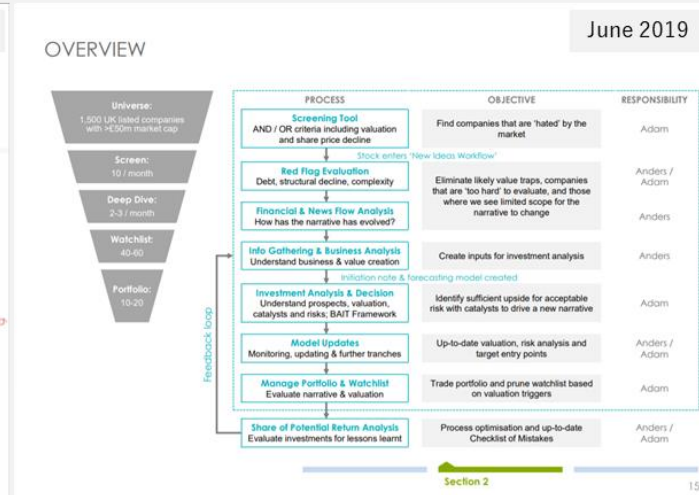
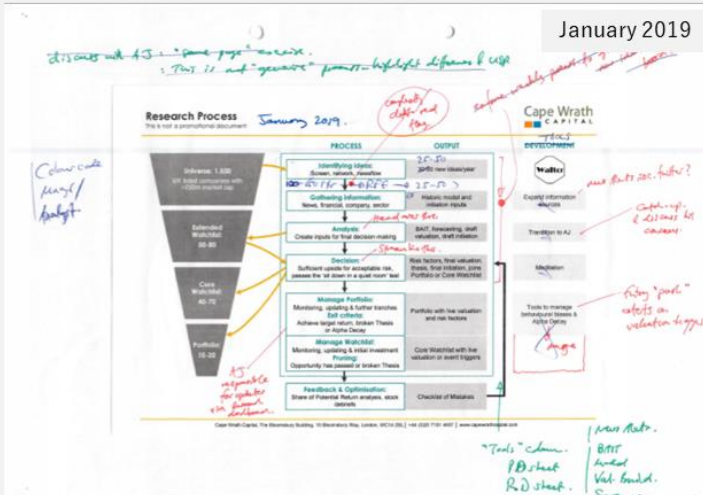
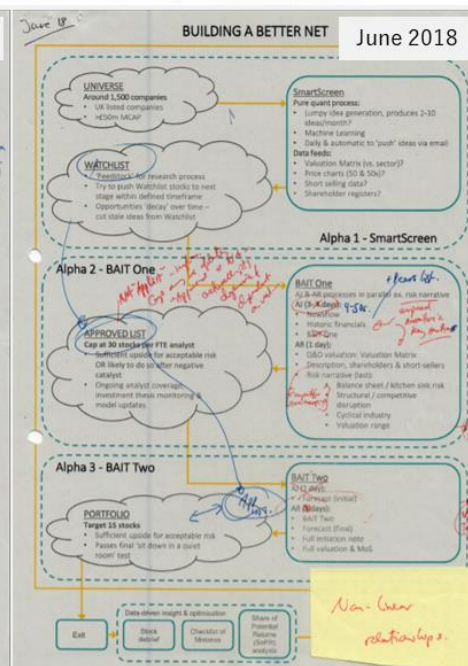
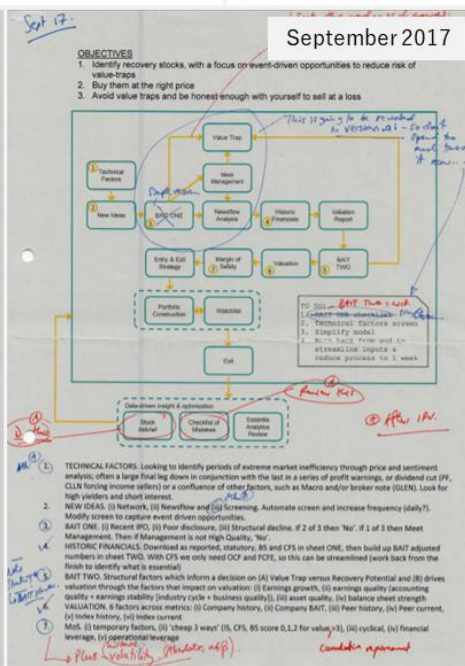
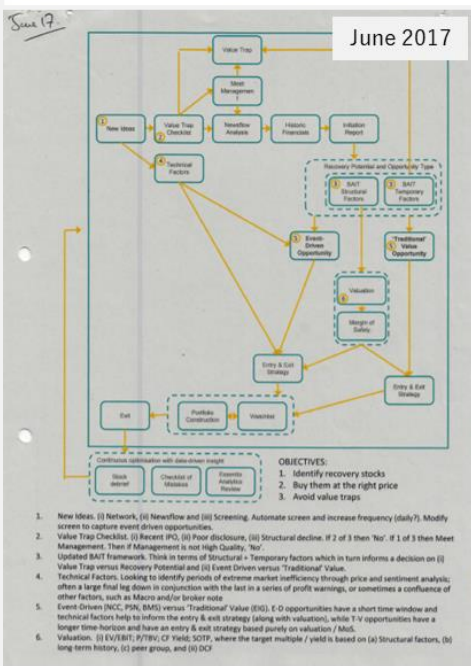
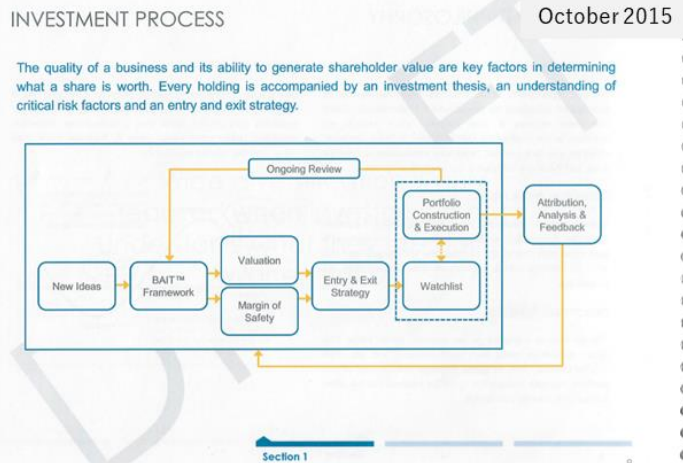
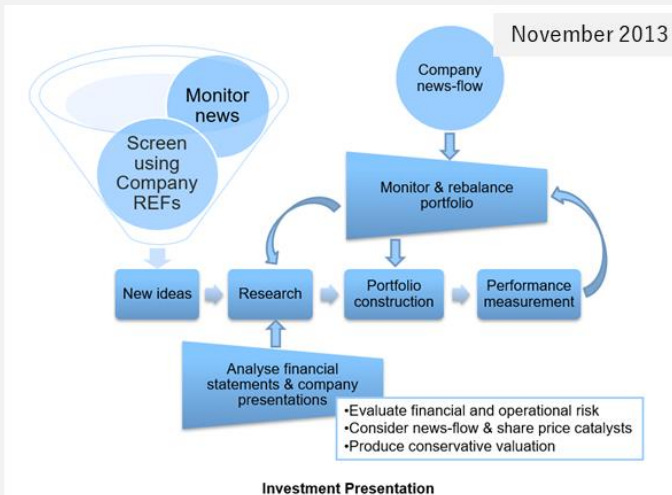


All models are wrong, but some are useful



All Models are wrong, but some are useful

Models help us to understand the World

Just as we use models to make sense of the World, so investors use a variety of formal and intuitive models to understand things like valuation, competitive advantage and investor behaviour. Stacking models in a structured way gives you an investment process. One consequence of using models is a tendency towards generalisation and simplification. This contrasts with the specialisation and the fluency with complexity required to make good decisions in the real world.

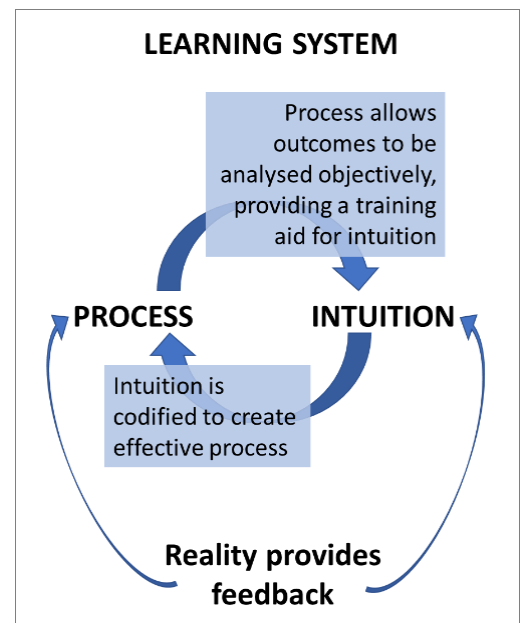
Our investment process does two things. Firstly, it mirrors our intuition. Here we use intuition to describe the 'good' side of gut instinct, versus the 'bad' side which is behavioural bias. In the heat of the moment it is easy to confuse bias for instinct and when this happens an effective process can help us to do what feels hard at the time but is ultimately right.

We see process as a codified version of intuition, but with some large gaps in those areas where the specific cannot be generalised and the complex cannot be simplified. We always aim to use process, but in these gaps we revert to intuition, and here the second function of our process is to play a supporting role by generating the information that intuition requires to work effectively.

Process and intuition improve with learning

How do you create a process that mirrors intuition? And how do you update that process as your intuition develops and the World changes? Our response is to use a 'Learning System', which improves both our process and our intuition over time by testing them against each other and against reality.

Intuition is difficult to assess objectively and impossible to back-test, which means that improvement is typically via the 'slow track' of direct experience, with the added hindrance of behavioural bias. But a process can be tested. Inputs, such as information and process stages, can be objectively assessed against outputs, such as decisions and performance. A process can also be back-tested to generate a range of alternative outcomes, which can be used to 'fast track' intuitive learning. The more closely that process mirrors intuition, the more useful these tests are as a training aid for intuition.



The development of our Red Flag Evaluation is an example of our Learning System in practice.

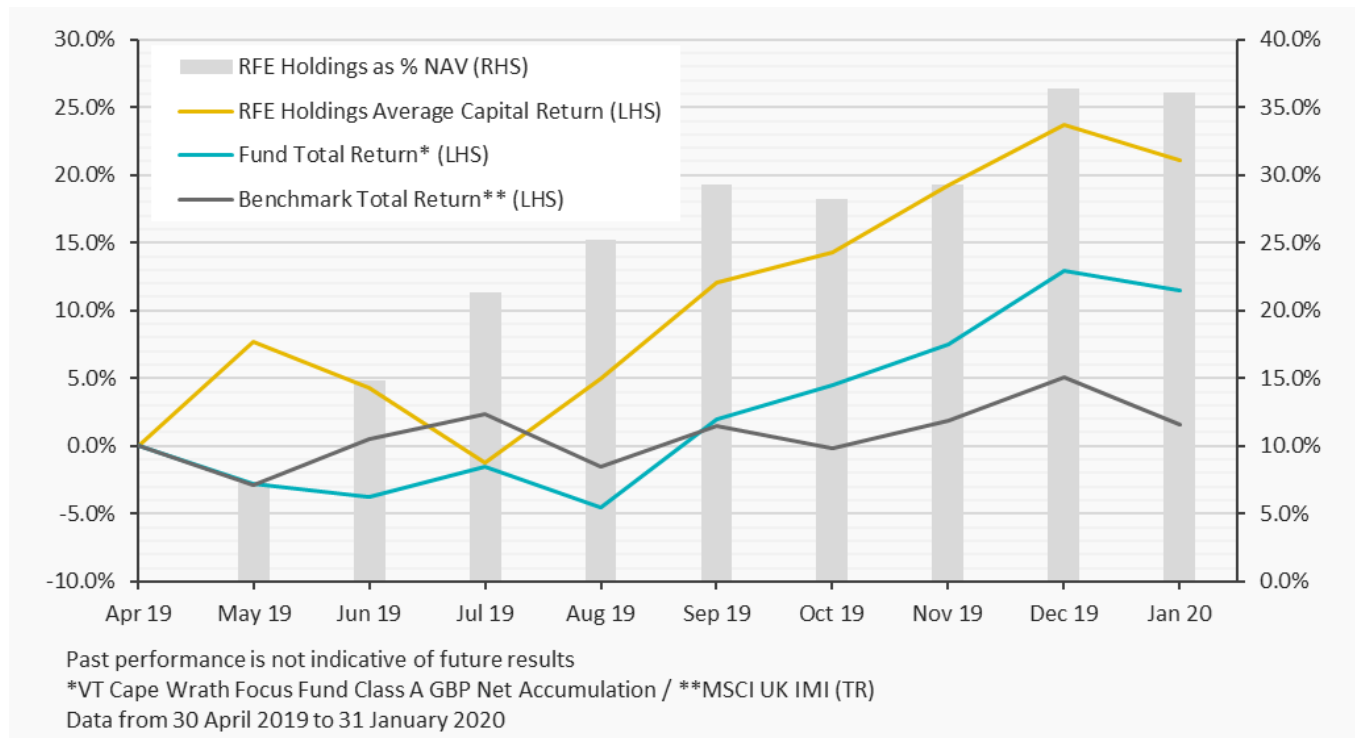
Red Flag Evaluation

Early in 2019 we identified our largest negative performance factors as stretched balance sheets and broken business models. Our valuation-based approach takes a linear view of risk, but some investment risks are non-linear (such as whether a company breaches its banking covenants, or not). With our strategy of adding tranches on price weakness (averaging down), buying non-linear risk was causing us significant pain. Conceptually, we needed to move from a position where we would buy any risk, given sufficient upside, to one where we would avoid some risks entirely, no matter how attractive the perceived value.

We implemented this change by adding a stage to our investment process, which we called the 'Red Flag Evaluation' (RFE). The back-test showed that applying the RFE over the 32 months since the Fund launched would have avoided seven losers and two winners. Avoiding these nine trades would have had a net positive impact of 19.7% on the Fund NAV.

Process drives performance

The RFE is having a positive impact on our returns. Over the 9-months from introducing the RFE to 31 January 2020, the Benchmark returned 1.6%, the Fund returned 11.5%, and the new ideas introduced under the RFE returned an average of 21.1%, having grown to represent 36.1% of the Fund NAV (from nil in April 2019). As we come to populate the whole Portfolio with ideas from the RFE (in the chart below, as RFE Holdings as % NAV tends towards 100%), the performance of the Fund will tend towards the performance of the RFE ideas. Given that the average holding period of RFE ideas is currently 4.3 months, we may be able to recycle our capital through more than one idea each year, thus compounding these average returns.



All models are wrong, but some are useful

Our deep-value investment style looks for alpha in Mr Market's changing narratives and behavioural mis-steps. We look for a target return or a catalyst, and the faster it occurs the more times we can compound the proceeds. If implemented successfully, this approach has high portfolio turnover, in contrast with the 'Buffett-style' of buy-and-hold investing.

Cape Wrath Capital exists to deliver investment performance, and our process is our most powerful tool for delivering that performance. Whether we succeed or fail depends on our capacity to learn and our appetite for change based on what we have learned. Process and intuition are only approximate models of reality and because they cannot be perfected, they can always be improved. In the words of George Box, 'All models are wrong, but some are useful'.

Adam Rackley

Cape Wrath Capital

February 2020

