NEVER MIND RULES OF THUMB

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PLEASE DON'T INVEST IN OUR FUND

The investment industry likes rules of thumb. Phrases like 'we invest for the long-term in high-quality businesses' are taken as a given. No fund manager ever told her client 'we buy crap and flip it quick.'

Right?

Well. Yes and no.

There are times when doing the right thing and *appearing* to do the right thing are quite different (I'll leave the topic of ESG for another Broadside). So, if you are a fan of received wisdom, here are some reasons why you shouldn't invest in our fund.

X Rule of Thumb #1 - "Our favourite holding period is forever"

This is from the Berkshire Hathaway 1988 Chairman's letter to shareholders. I have copies of every Chairman's Letter going back to 1965. I've dragged my wife to Omaha, eaten peanut brittle, queued outside the Century Link Centre at 6am and washed down dinner at Piccolo's with a root beer float. But the Rule of Wrath is that our favourite holding period is the one that maximises annualised returns. This is the difference between a quality growth investment style and a value one.

A quality growth investor buys companies with long-term earnings potential. Their returns come from holding companies that compound. If they get the initial call right, then after that the best course is to do nothing. In a former life I managed an equity fund in this way.

But as a value investor, if I am targeting a 60% upside to fair value, then I would rather achieve that return over a shorter period than a longer one. My returns come from achieving fair value on an investment, then recycling that capital into another opportunity. With effective stock-picking, the faster the wheel spins, the better the annualised returns.

This perspective informs our attitude to management meetings at Cape Wrath Capital. Previously, as a quality growth manager, I would meet with management several times a year. The prep was forensic. Before the meeting, you prepare detailed questions and review previous questions and answers. After the meeting you discuss how management answered the questions, as well as what they said. You consider the dynamic between the CEO and CFO. You consider their personality types. You write detailed notes. Then after a couple of years this work starts to pay dividends. You know these people well enough to infer, to read between the lines.

This is great if you have very long holding periods. But if your holding period is less than 18 months, the incremental benefit of meeting with management is usually negative when netted against the opportunity cost of the time required to prep sufficiently for a meeting to get anything meaningful out of it. And so, we rarely meet management. Another Rule of Wrath.

Rule of Thumb #2 - "We only buy quality"

We buy companies that have suffered a capitulation event and where we see an opportunity for a narrative shift. Before making an investment, we consider over 90 different factors, including capital allocation, margins and RoIC, working capital trends, changes in accounting policies, use of factoring, management change, industry and competitive environment, and insider ownership. These factors build a picture of the quality of the business. But 'quality' is not what we are solving for - we are looking for risk-reward asymmetry. Quality plays a part in that, but only in a supporting role.

Rule of Thumb #3 - "We target low volatility"

Markets show a positive correlation between long-term returns and short-term volatility. An investment that promises one without the other should be approached with caution.[1] If you have a long-term investment horizon, then volatility measures the potential for a portfolio to inflict emotional (rather than financial) trauma.[2] If you want to maximise long-term returns while moderating the emotional journey, there are better ways.[3]

Our high conviction, deep-value strategy takes the form of a concentrated portfolio of significantly-more-volatile-than-average securities. We have fantastically supportive investors who get all this. But they are rare beasts. More often than not, we have found that being OK with volatility in theory, and being happy to buy a fund with extremely volatile returns are very different things. In practice, high volatility means that over periods of a year or less, you are as likely to find the VT Cape Wrath Focus Fund at the bottom of the performance league tables,[4] as you are to find it at the top. This is a Rule of Wrath. However supportive the longer-term numbers may be, many potential investors find inconsistent short-term performance hard to stomach.[5]

If this message appeals to you, then you're in an exclusive club. Most of our industry likes the idea of differentiation in *principle*, but find it less appealing up close when things get sweaty. And that's fine. The last thing anyone wants is a travelling companion who thought they were on a different journey.

If you like what differentiation looks like in *practice*, it would be a pleasure to share this journey with you. Otherwise, please don't invest in our fund.

Cape Wrath Capital

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1. *https://www.ft.com/content/055bf6d2-70fb-4ed0-b97a-36f412e1aff7*
2. *https://en.wikipedia.org/wiki/Loss_aversion#/media/File:Loss_Aversion.png*
3. *https://www.r-bloggers.com/2020/06/fooled-by-randomness/*
4. *https://citywire.com/funds-insider/sector/uk-smaller-companies/i601?periodMonths=36*
5. *https://www.institutionalinvestor.com/article/2bsu74xt0041lcl5qmnsw/portfolio/career-risk-is-one-of-the-biggest-enemies-of-alpha?zephr_sso_ott=qeVPXu*