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VT CAPE WRATH FOCUS FUND

BEHAVIOURAL VALUE EDITION

2016 onwards

Haynes

Fund User Manual

EVERY MANUAL BASED ON A COMPLETE TEARDOWN AND REBUILD

July 2024

Fund User Manual

Behavioural Value Style

> *The investor's chief problem, and even his worst enemy, is likely to be himself.*
>
> Ben Graham

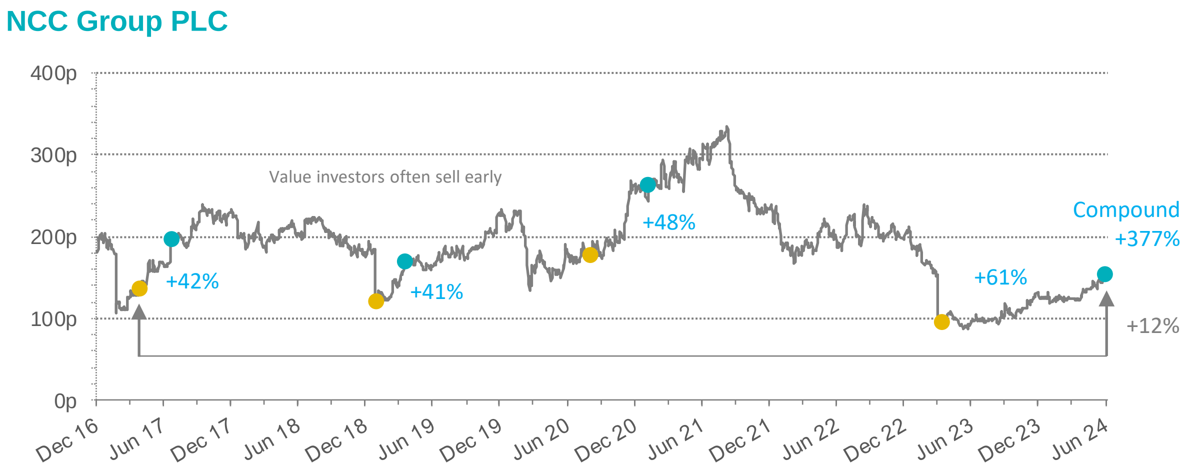
> *Win or lose, everyone gets what they want from markets. Some people seem to like to lose, so they win by losing money.*
>
> Ed Seykota

I've read the books, travelled to Omaha, queued outside the Century Link Centre at 6am, listened to the OGs and drunk the root beer float. I loved every minute of it. One principle of the Buffett approach is that buying a share is buying a piece of a business, and you should own that business to benefit from the long-term compound earnings it generates. Buffett's approach is widely emulated. But not by us.

We look for turning points in other people's emotional narratives and analytical journeys. Every time a company has some bad news or a profit warning, the investors' conviction takes a pounding. Sometimes you get to the point where that conviction collapses entirely. That's a Capitulation Event. The types of stocks that find their way onto our New Ideas list have typically fallen, 70%, 80%, or even 90% from recent highs.

Some of the stocks we buy are labelled 'turnarounds'. But the chance of a turnaround succeeding within our 12-month average holding period is vanishingly small (and as Buffett said, 'turnarounds seldom turn').

Down this rabbit hole, things are not always what they seem. For example, a failed turnaround may be a better investment than one that succeeds. Investors in the IT services business, NCC Group, who waited seven years (March 2017 to May 2024) for a turnaround which never happened, made a 12% return. But over that same seven years we made a 377%[1] compound return on the stock, consisting of four episodes with a 26-month cumulative holding period, exiting each time NCC hit Fair Value. Our initial episode in 2017 returned 42%, a proxy for our returns if the initial turnaround had succeeded.



We are interested in what's happening in the real world. But, in this Plato's Cave, we make money by being interested in *what other people think* is happening in the real world. The latter, being more capricious than the former, is easier to profit from.

We describe this approach as 'behavioural value investing'. Mauboussin argues for behavioural as the most persistent of the four sources of alpha (behavioural, analytical, informational, technical).[2]

To have longevity as an investor, it helps to have a style that fits your personality. I am the contrarian child who relishes the moment when the adult says 'You were right and I was wrong'. The behavioural value approach allows me to be that child. Psychotherapists call this 'transference and repetition'.

Concentration, Co-investment & Capacity

I enjoy reading accounts, chewing over narratives, and weighing up risk & return. Most ideas are discarded along the way. In the end we are left with just a handful. I can't build conviction in enough stocks to satisfy the industry idea of a diversified portfolio. We look for 20-25 (on this point alone I side with Modern Portfolio Theory). I don't think too much about how indices are performing. Our default is cash rather than the benchmark.

I created a regulated fund structure so that others could co-invest while I managed my own money, using the behavioural value strategy that I had developed to fit my personality. 100% of my investable assets are in the Fund. My earnings come primarily from the returns on my investment in the Fund, rather than fees charged to co-investors. If a manager gets fat, it should be from eating their own cooking.

Every strategy has a capacity. It may be in the millions, or it may be in the billions. For a high-conviction, UK, deep-value strategy we believe that size will start to impact performance at £200m. Therefore, we have a soft close at £100m and a hard close at £200m.

If you're in the fund *business*, £100m is laughably small. Fortunately, money is low on my list of motivations. Money will help with the food and shelter bit, but at the top of Maslow's Hierarchy is self-actualisation. Money won't help much with that. But what will is coming to the office each day to be the contrarian child.

Ethical Decisions ≠ ESG

Conscience and common sense are increasingly driven out by regulation and compliance. Too often, ticking a box has replaced the need to think for oneself, and the nuance of ethical decisions is outsourced to service providers who treat it as a data problem. Ethics is not a data problem. And if ESG is actually nothing to do with ethics, then it's hard to see the point of it without resorting to cynicism.

There are areas where we will not invest no matter how attractive the risk/return (palm oil, spread betting, defence in some cases). There are areas where we struggle (tobacco). And areas which score poorly on ESG (oil & gas), where we are happy to invest. When considering negative externalities, moral authority requires consistency. Banning palm oil would have a positive impact well beyond the rainforest, not least by throwing a spanner in the works of the ultra-processed foods industry. But banning oil & gas would lead to the immediate collapse of almost every aspect of society.

Government policy, public sentiment and investor sentiment mean that ESG risks are investment risks. But the overlap between ESG, investment risks and *ethics* is most evident in questions of governance.

In May 2022, we published 'The Siren Call of Subjectivity'[3] which included some work we had done on the legal services business, Ince Group.

> *It's rare that having started a deep dive on a stock, the stench is so bad I don't bother finishing it. But that was the case recently with Ince Group, the legal services business. I had concerns with cashflow, accrued income, and deferred consideration, but the odour became overwhelming when I got to related party transactions and executive remuneration. In 2021, the company made payments to companies controlled by the CEO and his family members which totalled £688,000. In the same year, Ince took £2.1m in government COVID support and made 147 roles redundant, while the CEO received a 'one-off short-term incentive' of £500,000, on top of his normal salary and profit share incentive. As Peter Drucker said, "Culture eats strategy for breakfast".[4] If the atmosphere at the top smells like entitlement, it might be unsurprising when our due diligence throws up the instance of Ince employees being refunded their bill and being told to "never come back" after inappropriate behaviour at a Cardiff restaurant.*

Those restaurant guests included the CEO, Adrian Biles. Within a year Ince Group had filed for administration. Our comments at the time are on LinkedIn.[5]

User Experience

A successful owner of this fund will need to disengage the natural desire for social proof.

We believe that to achieve long-term outperformance, it is helpful to accept above average volatility. Alpha is persistent when it is hard to access. With our approach, this is for behavioural reasons.

The behavioural value style may deliver long periods of modest underperformance, punctuated by short periods of extreme outperformance. This means that an owner of this strategy may often have the nagging sense that they have made a mistake, whilst very occasionally feeling like a hero. The exception is during market crashes (October 2008, March 2020), when the owner may feel like they have exited an aircraft strapped to a bomb. This is the moment when the *unsuccessful* fund investor sells, for just as the behavioural value strategy profits from capitulation events, so the *owner* of a behavioural value strategy may find that the best entry point is at the moment of greatest uncertainty.

Adam Rackley

Investment Director

1. (1.42) x (1.41) x (1.48) x (1.61) - 1 = 377%
2. 'Behavioral inefficiencies may be at once the most persistent source of opportunity and the most difficult to capture' https://macro-ops.com/wp-content/uploads/2019/02/Who-Is-On-the-Other-Side.pdf
3. https://capewrathcapital.com/wp-content/uploads/2022/06/The-Siren-Call-of-Subjectivity_May22.pdf
4. It has since been pointed out to me that Peter Drucker never actually said this (thanks Mia)… but you get the idea
5. https://www.linkedin.com/posts/adam-rackley-5973735a_how-reading-accounting-footnotes-can-save-activity-7054897289420525569-scSI/?utm_source=share&utm_medium=member_desktop