Graham & Doddsville

SPRING 2023

An investment newsletter from the students of Columbia Business School

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/ Editors

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Welcome to Graham & Doddsville

Meredith Trivedi, Managing Director of the Heilbrunn Center. Meredith leads the Center, cultivating strong relationships with some of the world´s most experienced value investors and creating numerous learning opportunities for students interested in value investing.

Professor Tano Santos, the Faculty Director of the Heilbrunn Center. The Center sponsors the Value Investing Program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry´s best practitioners. The classes sponsored by the Heilbrunn Center are among the most heavily demanded and highly rated classes at Columbia Business School.

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CSIMA Columbia Student Investment Management Association

We are pleased to bring you the 47th edition of Graham & Doddsville. This student-led investment publication of Columbia Business School (CBS) is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA). In this issue, we were lucky to be joined by three investors who have plied their craft across geographies, asset classes, and market cycles.

We first interviewed **Daniel Bakalarz** and **Alex Furmanski,** founders of Unison Asset Management. We discussed their path to investing and the dangers of emotionally investing. We also dig into their long positions in CDW Corporation and Elevance Health.

Next, we interviewed **Chuck Bath**, **Austin Hawley**, and **Varun Gupta** from Diamond Hill Capital Management. We discussed the firm's five-year investment outlook and their long ideas on Martin Marietta Materials and SS&C.

Finally, we interviewed **Matthew Sweeney**, founder and managing member of Laughing Water Capital. We discuss Mr. Sweeney's small-cap value strategy and a potentially undervalued stock that he believes is being overlooked by quants.

We continue to bring you stock pitches from current CBS students.

In this issue, we feature the winner of the 2023 Artisan International Value Stock Pitch Challenge, Bryden Nugent ('23), for his long thesis on Simpson Manufacturing (NYSE: SSD).

We also feature the winners of the 2022 Neuberger Berman ESG Investing Challenge, Jose Alvarez ('24), Tanay Dixit ('24), and Benjamin Hui ('24) for their long thesis on Trex Company (NYSE: TREX).

You can find more in-depth interviews on the *Value Investing with Legends* podcast, hosted by Tano Santos and Michael Mauboussin, Head of Consilient Research on Counterpoint Global at Morgan Stanley Investment Management and adjunct faculty member at Columbia Business School. Recent interviewees include Scott Hendrickson, Bill Nygren, and Angela Aldrich.

We thank our interviewees for contributing their time and insights not only to us, but to the whole investing community.

G&D Editors

26th Annual CSIMA Conference

Mason Morfit


Cliff Asness


Tom Gayner and Tano Santos


Lauren Taylor Wolfe and Michael Mauboussin

Artisan International Value Stock Pitch Challenge

David Samra and Bryden Nugent '23 with the Artisan Challenge judges and Meredith Trivedi

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SAVE THE DATE

Value Investing Executive Education

London

Date: September 13-15, 2023

1 Birdcage Walk
Westminster
London SW1H 9JJ

Registration will open on May 15th!

Pictured: Professor Tano Santos

For inquiries, please contact: valueinvesting@gsb.columbia.edu

Unison Asset Management

Daniel Bakalarz

Alex Furmanski

Daniel Bakalarz is Managing Partner and Co-CIO. Dan has over 20 years of equities investment experience, on both the public and private sides. Prior to Unison, he spent a decade managing Rote Capital, a Family Office based in Miami. Before that, he was at JPMorgan Chase's Chief Investment Office, where his team was responsible for investing and managing the bank's on-balance-sheet private equity portfolio. From 2003 – 2007, Dan was an equities trader at First New York LLC, a NYC-based hedge fund. He holds an MBA from Columbia Business School and a Bachelor of Arts Cum Laude from Tufts University.

Alex Furmanski is Managing Partner and Co-CIO. Alex has more than 20 years of professional investing experience. Prior to Unison, from 2011 – 2017, Alex was Managing Partner and Founder at Safe Harbor Investment Partners LLC, a private investment partnership focused on investments in public equities. From 2005 - 2011 Alex was Senior Associate at Khronos LLC, a private investment partnership based in New York. From 2003 – 2005 Alex was an Investment Banking Analyst in the Global Healthcare Group at Merrill Lynch. Alex earned a Bachelor of Science in Economics Cum Laude with a concentration in Finance from the University of Pennsylvania's Wharton School in 2003.

Editor's Note: This interview took place on April 14th, 2023.

Graham & Doddsville (G&D):

Thanks Dan and Alex for being with us today. We're really excited to talk to you and we think our readers will really enjoy this chat. Could you walk us through your background and how you became interested in investing?

Alex Furmanski (AF): Great. I'll go first. I was born and raised in Bogota, Colombia. My entrepreneurial and business streak started early on in my life. My first business was started at age eight, with my older brother and a friend. We bought tops, which I don't think are extremely popular here in the States, but they definitely were in Latin America. We bought them wholesale and then resold them at school.

My father is also an entrepreneur. He had started a flexible packaging company out of college. So, by the time I got to Wharton, I had a fairly good understanding of businesses and what made them tick. What I hadn't really spent too much time doing was thinking about how to value businesses, and my years in college were actually very productive in that regard. After graduating from school, I did the traditional Investment Banking Program at Merrill Lynch in their healthcare group in Palo Alto.

This was 2003, so it was right after the dotcom bubble had burst. The NASDAQ had gone down 80% from peak to trough so there was a lot of hurt. The office Merrill occupied at the time had two floors and one sat completely empty. It was an interesting time to get started in the world of finance. My time at Merrill provided me with a solid foundation and a fairly good understanding of how the Wall Street machine works.

After two years there, I moved to the buy side where I worked for a family office in New York for six years. I had the opportunity to work on both direct investments and fund selection. I was exposed to a wide array of strategies as well as some of the best managers and minds in investing. That really helped solidify my investment philosophy. By 2011, I was married and felt it was the right time to go out on my own and combine my passion for the business world and the stock market.

So, I moved down to Miami and started the predecessor to Unison, which was called Safe Harbor Investment Partners (SHIP) with

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$2,000 to draft the legal documents for SMAs. A handful of friends and family members had entrusted me to manage part of their money. I set up the operation with extremely low overhead to ensure staying power.

Starting any business feels very much like a roller coaster and SHIP didn't disappoint. You need thick skin to go out on your own. The good thing is that as time passes, it becomes easier and the wins and losses become less pronounced. In terms of my journey as a professional investor, it evolved from emphasizing traditional statistical cheapness, to one that's more focused on quality, similar to the journey that Munger and Buffett went through. I learned the hard way that quality wins out and that time is the friend of good businesses.

Daniel Bakalarz (DB): I was also born and raised in Colombia. As a matter of fact, Alex and I have known each other since early childhood. We went to preschool together and we've been close friends ever since. We liked to quip that the master plan for Unison was conceived at the playground during recess. I grew up in Bogota during the '80s through the mid '90s, which was just an incredibly tragic period for that country. This was at the height of the drug cartel's power, and Colombia was consistently ranked as one of the most violent places in the world. Because of this, my mom moved our family to Miami in the mid-90s and my dad, who was an entrepreneur, stayed back to run his business. So, I did my last three years of high school in Miami, and then I got my B.A. at Tufts University.

I grew up with aspirations of being an entrepreneur. I still think the best way to make a mark in the world is to build a great business. The second best is to fund great businesses. In part, the reason I got pulled into investing was circumstantial. I was at Tufts throughout the dot com craze and a close friend of mine, who had come to the United States with not much more besides the shirt on his back, opened a brokerage account with some money he had earned working various odd jobs. In the span of less than two years, I witnessed him go from a few thousand dollars in his brokerage account, to putting money down for a new BMW Three Series, to having to go back to his family for financial help. And just seeing those events transpire made me incredibly curious about markets.

I thought, "How did that happen and how did it happen so quickly?" I started reading about it. I started paying closer attention to the markets, and I've been hooked ever since.

My first job out of college was at a hedge fund. I was a U.S. long-short equities trader at First New York. I was there for about four years. I got to a point in that job though where I felt I wanted to explore different areas of financial services, particularly within investing, so I decided to get an MBA. I went to Columbia Business School from '07 to '09, and then spent the next four-plus years of my career at JP Morgan. First, as part of an MBA rotational program where I had an opportunity to work across different lines of businesses and roles throughout the firm, and ultimately placed in their Chief Investment Office, which is the group responsible for managing and investing the bank's excess cash balances. I was part of their private equity team. And in 2012, with the onset of the Volcker Rule, which disallowed merchant banking-like activities at large banks, our group's mandate shifted to one of pure risk management. I took that as an opportunity to move on and pursue what had clearly become my passion, which was investing, particularly in equities. I packed my bags and moved back down to Miami and with the help of extended family and some close friends, I formed Rote Capital, which is a family office that I ran for

> *"I learned the hard way that quality wins out and that time is the friend of good businesses."*

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nearly a decade.

About three years ago, Alex and I, who had kept in very close contact throughout those years as we were both growing and developing in the world of investing, began having exploratory conversations about becoming partners. Fast forward, we joined our portfolios under Unison Asset Management, and the rest is history.

G&D:

Any key lessons or takeaways that stand out from your careers?

DB:

In terms of lessons, I'll go beyond my time at Rote, JP Morgan, and Columbia Business School, to my first job as an equities trader. In hindsight, I still think those were the most formative years of my career.

Markets have this way of finding your own weakest personal trait and exploiting it against you. And this weakness typically expresses as either "FOMO" or fear. Buying as stocks are going up or selling when they're going down. And they're inexorably damaging because they trap you into a myopic mindset. So, if you bought an investment because it went up, you will be the first to panic when it inevitably goes down.

"The key lesson was this: emotion is an indicator of bias, and the more emotional you feel, the less you should trust your judgment."

Fortunately, I experienced a very heavy dose of that early on in my career. At our desk at the hedge fund that I worked for, we traded frequently. On average, we were opening and closing eight to ten positions daily to make dimes and quarters. For perspective, it wasn't unusual to turn more than one time the value of our portfolio during a single trading session. For comparison, at Unison, we do less than 15% of that on a yearly basis. Because of that experience, in a short period, I effectively encountered thousands of times the emotional experience of buying, holding, and selling a stock. I did it so many times that I developed proficiency in recognizing when emotion was influencing my decisions.

The key lesson was this: emotion is an indicator of bias, and the more emotional you feel, the less you should trust your judgment. The experience really taught me how to distill my own emotion from judgment. And just as importantly, I learned how to make volatility work for me and not against me. I know a lot of investors today, many of them in the later stages of their careers, which have not yet learned how to make friends with volatility.

G&D:

That's great. As your careers have progressed on the investing side, what investors have made the biggest impact philosophically? Have there been any important investing mentors in your lives?

DB:

I'll speak for Alex and myself when I say Buffett, Munger and Klarman, whom I think provided the first clear articulation of the three concepts that are fundamental to the way that we invest.

The first one is the Mr. Market analogy, which really gets to the heart of the idea that in the short term, the fundamentals of a business and its stock price are 0% correlated, but 100% correlated in the long term. Second, there's the concept of margin of safety. In other words, risk is not inherent in an investment, but rather relative to the price paid. And third, that uncertainty is different from risk. In fact, when big uncertainty drives asset prices to low levels, they often become less risky investments.

On a personal level, I do have several managers and peers that have been memorable throughout my career. I'll give a shout-out to a few. Larry Wein was the first PM I ever worked

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for. He taught me how to be an "optimistic skeptic." Paranoia certainly pays off on the downside, but optimism makes you money. Norma Corio at JP Morgan. She was the firm's treasurer before she came to co-manage our team. She really hammered in the importance of consistency over striving to be number one in any given year. And the math here is super compelling. Morgan Housel framed this idea well. If your investment returns are in the 50th percentile every year, you will end up in the top 5% to 10% over a 20-year period. PIMCO used to call this "strategic mediocrity," which is just a great way to describe it. But it really gets to the counterintuitive thing about managing money, which is that it's a negative art, meaning returns are oftentimes better if you avoid mistakes rather than pursue excellence. And then one more is Craig Fountain, who's a good friend of mine, he was a peer at JP Morgan. And he really showed me how to be relentless at due diligence, while making best friends with the person that you're interrogating. Interviewing is a skill, and he's one of the most skilled that I know. I still use parts of his template when doing due diligence on a new opportunity.

AF:

I think several people have had an important influence on my career, but really when I boil it down, it's the knowledge of the best minds in investing and business that have had the largest impact. What I would say is if you haven't been lucky enough to have a great mentor, avail yourself of all that is freely available on the internet.

"If your investment returns are in the 50th percentile every year, you will end up in the top 5% to 10% over a 20-year period. PIMCO used to call this 'strategic mediocrity.'"

G&D:

That's a good segue into Unison. It'd be great if you could give our readers an overview of your firm, your strategy, and dive a little bit deeper into why you landed on the name Unison.

AF:

Daniel and I each managed our own portfolios for over a decade before uniting under Unison. We had both operated as one-man bands and realized that it's very hard to do everything on your own. By the time we combined, we had reached the point in both our careers and friendship where we recognized that the value of our individual experiences and conviction in our approaches could be leveraged for greater benefit through a partnership. And the name Unison was chosen because it implies a sense of harmony working together towards a common goal, which in our case is to compound capital over many years while prudently managing risk.

G&D:

Another interesting dynamic to touch on is that while you share an investment philosophy, you also have two somewhat contrasting styles. Could you talk about what that looks like in practice?

DB:

There's this general belief that having two CIOs running one portfolio strategy can obfuscate decision-making. And in our case, it's the exact opposite. We think the best way to produce any sort of clarity is through an open conflict of ideas and principles, between people who hold each other with respect and with high regard. And there's really no limit to this degree of clarity when neither person minds who gets the credit. In a nutshell, that describes the nature of my relationship with Alex.

People are surprisingly good at fooling themselves. There's Mark Twain's famous line, "It ain't what you don't know that gets you

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into trouble, it's what you know for sure that just ain't so." And that points to how knowledge can be an illusory target that can lead you astray.

Think back to the geocentric earth model. For centuries people thought the Earth was at the center of the universe. If bad information can entrench itself on such a large scale and in the minds of even the most knowledgeable people, imagine the harm it could cause for a portfolio manager whose ideas aren't being challenged. Ultimately, Alex and I act as each other's guardrails in our pursuit of this kind of absolute knowledge.

While we share the same investment philosophy, there are many areas where we juxtapose and it's how we end up complementing each other. In a past life, I am certain that Alex was a credit trader because he is remarkably talented at thinking about what can go wrong in an investment. I was probably an angel investor because I enjoy thinking about what can go right.

It's funny because this filters into the kinds of stocks that we each like to follow. Historically, Alex has been attracted to more mature companies, and I've always followed younger, more disruptive businesses. We've always felt that by joining these skill sets, we get the luxury of covering a broad and diverse territory for ideas.

G&D:

Describe your investment philosophy at Unison. What are the companies you're looking to invest in?

DB:

Our approach is straightforward. We use a private owner mental model to find good businesses with durable competitive advantages. We look to buy these businesses at reasonable prices, and we hold them for as long as they stay great, which could be anywhere from five years to never selling. For us, the term "good business" has a very specific meaning, and we define it as companies that can reinvest their capital at above-average rates of return for long periods of time. And I can get into what that means in just a second. What our record has shown is that if we can buy these companies at good prices, our returns will be attractive over a full market cycle, which we define as from the end of one recession to the end of the next recession.

Said differently, when a company first makes it onto our radar as a prospect for the portfolio, there's two questions that we're fundamentally trying to answer: The first one is, "how good is this business?" And the second question is, "how much is this business worth?" We determine this by building a discounted cash flow model. And as we're systematically working through those questions, our research centers on breaking down the essential components that underpin all businesses: (1) The economics of the products it sells (2) The values of the people that manage it (3) The strength of the balance sheet that supports it (4) And the depth of the moat that protects it.

> ***"In a past life, I am certain that Alex was a credit trader because he is remarkably talented at thinking about what can go wrong in an investment. I was probably an angel investor because I enjoy thinking about what can go right."***

G&D:

How do you approach analyzing each of those pillars as you evaluate a business?

DB:

A big part of it centers on proper framing.

Consider that the average half-life of a company is 10 years and it's gotten progressively worse. In the 1960s, the average member of the S&P 500 Index lasted about 60 years. That number is now down to 12 years. With that

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context in mind, Alex and I always begin at the end. Our default is that all businesses, even the great ones, are in terminal decline. It's like all living creatures, we begin to die from the moment that we're born. Alex and I will not debate that for a second. Instead, we'll spend our time figuring out this rate of decline. I've heard Bruce Greenwald refer to this as a "fade rate," which is the time it takes for a business's competitive advantage to wither away.

Of course, some businesses are going to have negative fade rates throughout parts of their lifetimes, which may translate into a hundred-plus-year moat. Still, we operate under the premise that eventually no company escapes this basic law of averages. Along those lines, our framework necessarily becomes pragmatic. If we can predict, with a high degree of probability—more than 85 percent—that a company will be in the same or stronger competitive position three years from now then, definitionally, it's a good business. Five years, and it's a great business. And I can get into why those specific numbers in just a second. But the point is that we are perpetually updating our beliefs about the company, the industry, and normalized rates of return every time we discover new pieces of information.

And those numbers, three and five years, there's a few ways we'll think about this. Most pointedly, in our career, we've observed that the market is good at discounting earnings six to 12 months into the future. In other words, we don't think that we will beat the market in predicting Apple's next couple of earnings prints because, at that timeframe, the market is just better than us. However, we've noticed that dynamic progressively starts to break down three years out, and essentially disappears beyond year five. Alex and I are convinced it's because investors are wired and incentivized to think short-term. So, by underwriting investments over five-or-more year periods, we're inherently creating an investment edge because the parameters we use end up being ignored by most other market participants.

G&D:

Any examples of a mistake here or a business that you sold because it no longer passed that test? What metrics or frameworks do you use to monitor whether or not a business is still great?

DB:

Carter's [CRI] is a vertically integrated discounter of children's apparel that we purchased about two and a half years ago because it checked all the marks: A good business, run for shareholders, trading at a reasonable price. The problem that came shortly thereafter is that top-line growth was not meeting our expectations. And if there was ever a time for a baby clothes discounter to shine, it'd be now, in an inflationary environment, coupled with the most widely forecasted recession ever, where we'd expect consumer behavior to shift in favor of lower-priced non-differentiated goods. When that didn't come through, we were quick to sell our position. It's an example of how a decision can sometimes be made easy because of point-in-time data that distinctly disproved our thesis.

> ***"Our default is that all businesses, even the great ones, are in terminal decline."***

Many times, the circumstances will be far more ambiguous. Meta Platforms [META] is a company that both Alex and I have owned in our portfolios since before Unison. And for the greater part of that period, this company had the holy trinity of investing, as Jeff Gundlach calls it, which is earnings growth, multiples expansion, and share buybacks. But all of that was suddenly put into question at the end of 2021. Between Apple's new user privacy feature, Frances Haugen's Facebook Papers, and Zuckerberg betting the company on

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the Metaverse, we knew that a storm was brewing but we felt that we could weather that part of it. What really put us on high alert was TikTok's rapid growth.

There's this great quote by Alex Rampell, which I will paraphrase a bit, but he said that the battle between the incumbent and the new entrant comes down to whether the new entrant gets distribution before the incumbent gets innovation.

Initially, it seemed TikTok had gotten distribution before Meta got innovation. So, the first thing we did was buy an Oculus and spend 30 hours exploring the Metaverse to understand how Zuckerberg was investing our money. And to be honest, we felt a little underwhelmed. And so we went back to focusing on the merits of the core business, which is the family of apps. This includes WhatsApp, Instagram, Facebook, and Messenger. We asked ourselves, "If we were building a company today that served the same product-market fit as Meta, would we rebuild it the same or would we build something different?" And ultimately, we determined we would do it the same. And that was due to one simple reason: we concluded that TikTok effectively had created an audience for a new market segment, short-form video, which could coexist and not necessarily cannibalize Meta's value proposition.

"We think Meta is now a bigger threat to TikTok than TikTok is to Meta."

Just as importantly, we think that Meta's superior ad infrastructure is going to be inimitable for many more years. And in time, Meta could use that advantage to chip away at TikTok's share in short-form video. It has already started to do so with Reels. Said differently, we think Meta is now a bigger threat to TikTok than TikTok is to Meta.

The verdict is still out on how this whole thing will play out in the long term, but we still own Meta, and we consider it to be a good business. And hopefully, that gives you a good understanding of how we think about investing.

G&D:

That's very helpful. When you are evaluating a business for potential inclusion in the portfolio, what are some of the qualitative and quantitative characteristics or signposts that you are looking for?

DB:

All these parameters and frameworks are rooted in our mission, which is to deliver above-market returns for our partners. Mathematically, the only way that we can get there is by buying a business with a normalized return that's higher than the market return. In practice, the most likely way is by finding companies with predictable long-term profitability and buying them when their yields are attractive relative to the market. And so, the question turns to, what makes a company's long-term returns predictable? Above all else, it's barriers to entry. And just to go one step further, Michael Porter taught us that, as measured by potency and durability, economies of scale combined with some degree of customer captivity create the most insurmountable barriers to entry. That's exactly what we're looking for in a business.

By definition, a Monopoly, which means no competition, is the end state of the best business; and an Infinitopoly, meaning perfect competition, is the end state of the worst business. The framework we designed enables us to grade where along this competitive spectrum our companies land.

G&D:

To follow that, in business school we always have to do pitches, and I don't think we've ever seen a long pitch that says a company is not competitively advantaged. With that said, are there any commonly cited buckets of competitive advantages that you

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don't think are that strong in the real world?

AF:

One that comes to mind is brand. Brand strength oftentimes changes quickly, and it can even happen to incumbent brands that have been around for a long time. I'm thinking of something like Gillette. You have Dollar Shave Club come along and flip that whole thing on its head. Brand would be one that can in some circumstances be powerful, but it's a hard one to know with a high degree of certainty.

DB:

I agree with Alex. Brands are overrated as a source of competitive advantage.

G&D:

Great. Moving on, could you describe a typical day for you at Unison?

AF:

I think having fun with a partner is a very big competitive advantage. And in our case, having a close childhood friend as a partner just makes work a lot more enjoyable. A typical day for us involves a lot of quiet reading and thinking time. We regularly pop into each other's offices, but it's an environment that resembles a library much more than it does a trading floor. We make it a point to have lunch at least twice a week. And we use those interactions to really flush out our current thinking on companies, news events, or whatever else might be consuming our minds at the moment.

G&D:

What is your process for idea generation?

DB:

On idea generation, at top of funnel, we are big believers in serendipitous discovery. And so, our process centers on increasing serendipity through exposure to random sources of uncorrelated information. Over and over, what we're trying to do is uncover new rabbit holes to explore. Along those lines, a balanced and robust diet of primary and secondary reading material is absolutely mandatory, but we'll also extract a lot by participating. We'll participate in community forums that are hosted by Reddit, Discord, Facebook, Twitter, LinkedIn, etc. We'll engage with industry experts. We'll attend trade conferences. And we'll make it a point to study change as compared to studying things. We've also ended up doing a lot of unconventional things in this process, and many times they serve for discovery as well as for diligence.

For example, I've personally been an Uber driver so that we could understand supply side service infrastructure for the gig economy. Alex and I visited, actually not long ago, a Mercedes dealership. And we test drove their EV models on display because we wanted to see how the tech and the design stacked up against Tesla. We also took a crash course on Python coding, just because we were reading about AI, and we wanted to develop a better appreciation for the architecture behind coding language.

Einstein has a good quote on this. He said, "Imagination is more important than knowledge, because imagination encompasses all that will ever be." And so, all the things that we do as it relates to idea generation is really to

> ***"Our [idea generation] process centers on increasing serendipity through exposure to random sources of uncorrelated information."***

prod our imagination, which we know leads to discovery.

Now, that said, we intentionally cast a wide net, and the downside of casting a wide net is that we will inevitably catch a lot of junk in the process. During a normal week, both Alex and I will sift through dozens of ideas. But we have a hard rule. And that rule is that we can only bring one idea to discuss at

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our weekly Monday pipeline meeting. And whether that idea passes on to our next filter is a decision that we make by unanimous consent.

AF:

No amount of reading can really substitute for going through life with eyes wide open. Many times, the best ideas come from unexpected places. Just observing the habits of your kids, your parents, and your friends. A lot of the time the ideas come in manners that are just coincidental with life, and not necessarily from reading.

G&D:

We've really enjoyed going through the weekly reads (https://www.unisonam.com/investors) that you post. Talk about how you got the idea to do that, and what you have gained as a firm from articulating so many of your ideas in writing so regularly.

DB:

Thank you and I'm glad you saw that. So, it's a short, simple answer. Doing the weekly reads is our attempt to engage our peers, our partners, and our prospective investors. It's a good way to crystallize our thoughts out in the ether and hopefully generate some goodwill in the process.

G&D:

We've covered business quality. You've also spent a lot of time writing about how Unison calculates normalized net operating profit after taxes (NOPAT). How do you go about calculating that number? And what are some of the challenges that you typically run into?

AF:

The first thing I'd say is that it's very challenging to calculate NOPAT for most businesses. The good thing about our approach is that we only need to do it for a handful of businesses, and then we can delegate the rest to the "too hard" pile. The challenges range from understanding where a company is in its business cycle, what competition might do to margins and returns in the future, to what growth rates to expect. Generally speaking, we're big believers in base rates and being approximately right instead of precisely wrong when calculating NOPAT. And so, we always emphasize approaching this imperfect exercise with an ample margin of safety.

As it relates to GAAP accounting, for instance, there are definitely flaws where GAAP accounting does not reflect the economic reality of a business. And it's our job as analysts to make the proper adjustments. We take each situation on a case-by-case basis and adjust, as necessary. For example, we're not fans of most non-GAAP measures, especially late into an economic cycle when companies tend to be pretty abusive. Just to give you specific examples, items such as amortization of intangibles arising from acquisitions is something we tend to add back, but companies that are constantly adding back restructuring charges and stock-based compensation is something that we frown upon. But again, each situation is evaluated on a case-by-case basis. There's no just one magic formula, if you will.

G&D:

How does Unison think about evaluating management teams?

AF:

The way we like to do this is to start with a proxy statement to really understand how management is being evaluated and compensated. All human beings react to incentives, and we want to make sure that the management teams we invest with are aligned to create long-term value. What we find curious is that despite using armies of consultants to produce these executive compensation plans, so few of them actually judge management teams on metrics that we believe are important, such as return on capital versus cost of capital.

We're also big believers that actions speak much louder than words. We

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pay close attention to how management teams have allocated capital in the past. Are they buying back shares just to offset dilution, or because the price of the shares was actually undervalued? We'd much prefer companies that grow organically versus those that do so via acquisitions. If you look at corporate America's M&A track record, it leaves much to be desired. M&A also tends to be pro-cyclical. Those are some of the things that we like to keep an eye on when evaluating management teams.

"Generally speaking, our largest positions are the ones where we can lose the least, not necessarily the ones where we can make the most."

G&D:

Your portfolio has 25 to 30 businesses at any given time. How do you go about sizing those positions?

DB:

That's a great question and it gets to the way that we manage our portfolio, which really contributes to returns just as much as our actual investment decisions. Generally speaking, when you spot a small position in our 13F, something less than 3%, it's because that position is either on its way to becoming a 3% or more holding or it's headed to the exit. We've got three levels of conviction. Our base case conviction is 3%. That's when a position makes it into the portfolio. The next tier up is a 5% position, and then the highest tier is 7%.

I wish I could say there was a precise mathematical formula behind this basis. Empirically, we have found sizing positions at these levels moves the needle when right but is not devastating when the inevitable mistake occurs. In large part, its intent is also to force us to rank our conviction. Position sizing is always fluid. It is a real-time reflection of how our data has informed our intuition.

AF:

I would say that generally speaking, our largest positions are the ones where we can lose the least, not necessarily the ones where we can make the most. It just speaks to the way we try to approach investing and the whole concept of margin of safety.

G&D:

Turning to individual names and starting with CDW Corporation [CDW]. What are your thoughts on the business and what is the investment thesis here?

AF:

Absolutely. CDW is the largest value-added reseller of IT products to small and medium-sized businesses in the U.S. They're the largest by a factor of three. They basically function as an outsourced sales and service organization for large IT companies, allowing these companies to reach a fairly fragmented customer base in a more cost-efficient manner. CDW's sweet spot is businesses with less than 5,000 employees. It's a company that consistently earns returns on capital in excess of 25%, due to its low capital intensity. Capex is less than 1% of sales for CDW. And the thing about the business is that its scale allows it to get better pricing from suppliers. This translates into them having a margin that's close to twice that of their largest competitors.

What's also nice is that CDW has a pretty small market share of around 5% of its addressable market. CDW and its next three largest competitors are less than 10% of the overall market. So you have a very fragmented market with many small players, providing ample opportunity for organic growth. Since 2006, CDW has outgrown the market by over 200 basis points per year. This trend has accelerated more in recent years and we expect will continue.

G&D:

Unison has owned CDW since 2014. What are

(Continued on page 15)

Unison Asset Management

some of the changes with the company or the competitive environment that you've seen since you owned this company?

AF:

You're right. We've held CDW in our portfolio since before Unison was founded. We hope to hold it for many more. The biggest change over the holding period has been the evolution of the business from being transactional to one that is more service oriented. Instead of just selling customers hardware solutions such as laptop servers, et cetera, they now help design, implement, and manage their entire ecosystem. For example, service revenue has nearly tripled and is now 8% of sales, but it's an even bigger percentage of profits. And while this evolution to being more service oriented takes time, the direction is unmistakable. The company now has 2,600 technical staff on its team to assist customers. As IT solutions become more complex, the need for these capabilities increases, and so does the moat around CDW. Smaller competitors don't really have the same resources to bring to customers. That has been the biggest change.

G&D:

Moving on to Elevance Health [ELV]. What is Unison's investment thesis here?

AF:

Elevance is the second-largest health insurer in the U.S. It has 48 million members. The company licenses the Blue Cross Blue Shield name across 14 states, where it enjoys 31% market share. This market share allows it to negotiate favorable rates with hospital networks. And when you combine the scale and well-known brand name, what you end up with is consistent returns on equity in the mid-teens, which we think is attractive for a business that's not terribly cyclical. In 2017, a new CEO came on board from its best-in-class peer, UnitedHealthcare [UNH]. And since then, Elevance has pushed to diversify and become a broader health provider instead of just an insurance company. It stood up a new segment called Carelon, which is made of four distinct pillars: insight, behavioral health, care delivery, and prescriptions.

Elevance has stated that it wants to bring this segment up to 30% of total profits within the next five years. We think this is important because when you look at the margins and returns that this segment could earn, they're higher than in the traditional insurance business. Just for a point of reference, UnitedHealth's Optum division already accounts for half of that company's profits. And United is trading at 21 times forward earnings, versus 15 times for Elevance. We think that as management continues to implement its plan and improves its margins, the gap between these two multiples should narrow. Importantly, our thesis isn't necessarily predicated on this happening. We think this is icing on the cake. We're already earning mid-teens ROEs, but this multiple expansion could certainly enhance our returns.

> ***"We've held CDW in our portfolio since before Unison was founded [in 2017]. We hope to hold it for many more."***

G&D:

As you looked out at the entire healthcare value chain, why did you pick the payer end of the spectrum? What stood out about that specific part of the value chain?

AF:

Well, I'll preface this by saying the healthcare problems that we have in this country are pretty complicated and not easy to solve. We could spend hours talking about our views, but I'll try to keep this answer concise. Historically, the healthcare system was set up as fee-for-service, where the incentive was to drive volumes without as much consideration for outcomes. In more recent years, to try to

(Continued on page 16)

Unison Asset Management

reign in the spending, there's been a push towards what's called value-based care where participants are rewarded more for outcomes, which makes sense. The most extreme form of this value-based care is something called capitation. This is where an insurance company receives a fixed amount for coordinating and managing the care of a patient. Under such a system, the margin is driven by how successful the company is at controlling costs. UnitedHealth has been at the forefront of this trend, but others have followed suit.

"Cultivate your intuition. Investing is more a game of accumulated experience than anything else."

And in the case of UnitedHealth, they actually are better at controlling costs. It's vertically integrated and now owns primary care clinics, doctor networks, and home healthcare assets. This strategy is yielding pretty interesting results. In a recent call, they cited a good statistic that in-home services reduce hospital visits by 15% versus traditional fee-for-service, while delivering comparable health outcomes and achieving a high NPS of 80.

In the case of Elevance, value-based care now counts for 63% of spending versus 56% in 2018. And all of this, just to be clear, isn't fully capitated, but it's definitely a move in the right direction to lower spend and improve outcomes. And that's why we've invested in the managed care space of healthcare because these are the gatekeepers of the spend. Ultimately, we think that these are the people that can help the system become more efficient.

G&D:

One last question on Elevance. What makes a health insurer more interesting to you compared to a traditional property and casualty (P&C) insurer?

AF:

There are a couple of different points. Healthcare insurance, as opposed to most of the P&C industry, have policies that are short-lived and repriced yearly. So, you don't end up with the long tail open-ended liabilities like asbestos claims. Also, the market shares for healthcare insurers are a lot more consolidated. There's just less competition. The result of all this is that the ROE's are in the mid-teens for the large healthcare insurers. UnitedHealthcare is ahead of that. But you look at the P&C sector broadly, the public ones at least, and you're talking mid-single-digit ROEs. So, it's just kind of apples and oranges in terms of profitability and attractiveness to us.

G&D:

Do you have any advice for undergraduate or MBA students looking to get into the investment management business? And along those lines, when you're looking to hire an analyst at Unison, what are the things that you are looking for?

DB:

Don't obsess over optionality. In other words, don't hedge your career bets too much. I think there's this kind of madness with seeking optionality, but it's really a means to an end, not the end itself. Instead, jump headfirst into substance. And this will really come through when you speak to people in the industry. The longer you spend acquiring options, the harder it is to develop substance. So, focus on finding substance.

Another one is to cultivate your intuition. Investing is more a game of accumulated experience than anything else. Of course, knowledge is important, but investing is one of the few domains where input does not correlate with output. And so, no matter how well-read you are or how developed your thesis may be, ultimately your decisions come down to judgment.

AF:

One key trait that we

(Continued on page 17)

Unison Asset Management

look for in analysts is unbounded curiosity and questioning. Robert Caro, Lyndon Johnson's excellent biographer and writer, received great advice from an early mentor: "Just remember one thing: Turn every page. Never assume anything. Turn every goddamn page." This aptly sums this up.

G&D:

This is very unique advice, and we just want to double-click on the substance part. By substance, do you mean sector or industry expertise?

DB:

It could go both ways. And you could get as micro or macro as you want. When you discover your unique skill, interest, or talent, focus on that. Generalists form alpha by connecting the dots across silos. Specialists, by knowing more than anyone else on one subject. Find the format that best aligns with your personality. Just make sure that there's a clear, concise path to what you're doing.

G&D:

On a more personal level, what do you each like to do for fun outside of investing?

DB:

I play piano. I used to have a band in college called Violet Hum. And one of the former members of that band is a professional DJ living in India. But Adam, who's our vocalist, lives in South Florida. And we've recently rekindled, which is fun. I'm also half a ski bum. During the pandemic, I moved my wife and kids out to Colorado, became a part -time ski pro, and got to live out one of my childhood fantasies.

AF:

I'm a little more conventional, I guess. I like to joke that when I'm not in the office, I'm perpetually preparing for a triathlon, which I have yet to do. But I do like to spend a lot of time enjoying outdoor sports in the nice Miami weather. More recently, we got a puppy and that's been a very big time commitment for the entire family.

G&D:

This was great, thank you Alex and Dan for taking the time to speak with us today.

Simpson Manufacturing (NYSE: SSD) - Long
2023 Artisan International Stock Pick Challenge (Winner)

Note: all writing, data and projections are as of Feb 6th, 2023 (date of competition)

Bryden Nugent, CFA, '23

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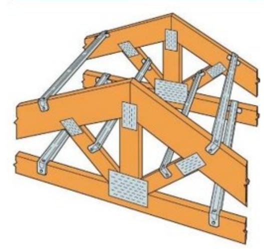
Bryden is a 2nd year MBA student at Columbia Business School and a member of the Value Investing Program. While at CBS, Bryden has completed internships at Royce Partners, Sands Capital and ARGA Investment Management. Prior to CBS, Bryden worked in investment consulting at Cambridge Associates.

Recommendation
Long position in SSD with a 2025 year-end price target of $190, based on an exit multiple of 17.0x NTM EPS (3x turn de-rating), for a 20% 3yr IRR (including dividends).

Trading Stats	
$4.8	Mkt Cap (bn)
$124 / 75	52 Week H/L
99.6%	Float
1.4%	Short Interest

	Base Case (housing downturn)	Bear Case (severe housing downturn)	Current LTM / NTM
Revenue Growth (Cumulative, '22E-26E)	**+18.7%** cumulative revenue growth • Assume annual housing completions fall ~13% cumulatively by '26 (-25% in '23, +12%* in '24, +1.5% in '25 and '26) • 2% YoY in non-residential markets (~1/3rd of rev.), with 0.8%/yr. market share gains • 3%/per yr. pricing (-> 50bps/yr. GM expansion)	**-11%** cumulative revenue growth • Assume housing completions fall ~36% cumulatively by '26 (-25%, -12% in '24, -12% in '25, +10% in '26) • 0% YoY growth in non-residential markets (~1/3rd rev.), with 0.4%/yr. share gains • 1%/yr. pricing growth (-> 50bps/yr. GM erosion)	--
EBIT Margin ('26E)	23.5%	16.8%	23.8 / 16.2%
Net Inc. Margin ('26E)	17.2%	12.1%	16.8 / 12.3%
EPS ('26E)	$11.2	$5.7	$8.0 / $5.4
Exit Fwd. P/E ('25E)	17.0x	15.0x (bottom 2nd percentile of last 15 yrs)	17.3x
Price ('25E)	$190	$88	$94
3yr IRR (inc. div.)	19.9%	-7.6%	--
Up./Downside	~2.6x		--

Product Example



<u>Business Summary:</u> Simpson designs and manufactures structural connectors, fasteners, anchors, and other construction products for the residential and commercial construction industry. The primary end markets are 1-5 story wood buildings, with 80% of revenues derived from North America and the remainder from Europe.

<u>Business Quality & Barriers to Entry</u>:

☑ **Barriers to entry** – Simpson holds 75% market share in US wood connectors, which make up ~2/3rds of the company's revenues. Despite Simpson's major patents expiring 10-20 years ago, Simpson has defended and even grown its market share over the last decade. Its moat is built on to two key factors:

1. **Building code complexity and mission-critical nature of product** – While a market for simple metal connectors would appear to have low barriers to entry, it's insulated by the complexity and heterogeneity of building codes. Building codes vary by state, with additional requirements if the area is prone to high wind, earthquakes, or other natural disasters. As a result, Simpson sells over 14,000 different products and spends 4% of sales on R&D, 2-3x the average industrial company. Furthermore, given that the joints are the weakest part of a structure, building designers (i.e., engineers and architects) are relatively price-insensitive and prefer to choose the market-leading brand. As a result, Simpson's products are "spec'd" into ~95% of home blueprints in the US. This means that if a builder wants to use a different product, they must get explicit approval from the architect, who assumes legal and reputational liability if the building collapses or experiences other structural issues. This added liability and hassle helps protect Simpson's dominant market share. This moat is enforced by local regulators, who inspect building sites to ensure conformity with blueprints.
2. **Relationships with "friendly middlemen:" engineers and construction companies** – Simpson maintains a network of 750 customer-support engineers who are available to answer questions from engineering/architecture customers. For instance, an architect can call Simpson, provide a zip code, and be given the exact Simpson product that will meet the local building codes. For construction customers, Simpson has invested substantially to ensure ~98% of their products can be delivered in under 48 hours, so that missing SKU's do not hold up a construction site. These relationships contribute to a beneficial "friendly-middlemen" effect: architects and construction companies, which pass through their costs to homeowners, prefer to use Simpson products if they know it will reduce time and hassle.

> "If you go to another manufacturer, you may not have that ability to call them up and say, 'This is what I'm doing. What do you think?' […] A little bit of it is that **<u>constant R&D, they always know what the right [building] code is.</u>** You can give them a ZIP code and they know what's appropriate."
>
> *- Former exec at both Home Depot and Lowe's (source: Tegus)*

☑ **Tested moat** – An excellent example of Simpson's moat is Lowe's failed attempt to compete with Simpson in the market for structural connectors. In the mid-2010s, Lowe's dropped Simpson's products in favor of their own white-label brand. However, after several years of weak sales to "professional" customers (a segment which prefers branded products), Lowe's scrapped their brand and returned to carrying Simpson products in 2020.

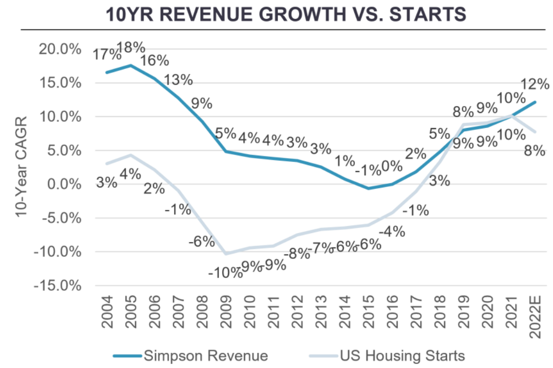
☑ **Low-cost product drives pricing power** – Based on comments from Simpson and independent conversations with homebuilders, I estimate that Simpson products typically make up under ~0.3% of the total cost of a new house. The low cost of their product relative to the total cost of the home helps to shield Simpson from scrutiny on price increases.

> "We're bringing in Simpson Strong-Tie, which is one of the premier Pro brands [...] when a Pro comes in with a construction spec, **<u>it's spec'd specifically for a SKU from Simpson Strong-Tie</u>** […] the ability to have that brand now in our assortment is **<u>incredibly important to giving us credibility with the Pro customer</u>**."
>
> *- Marvin Ellison, Lowe's CEO, Oct 9, 2020*

<u>Investment Thesis #1</u>: Simpson can grow cumulatively +5.4% through FY24 vs. -5.7% consensus

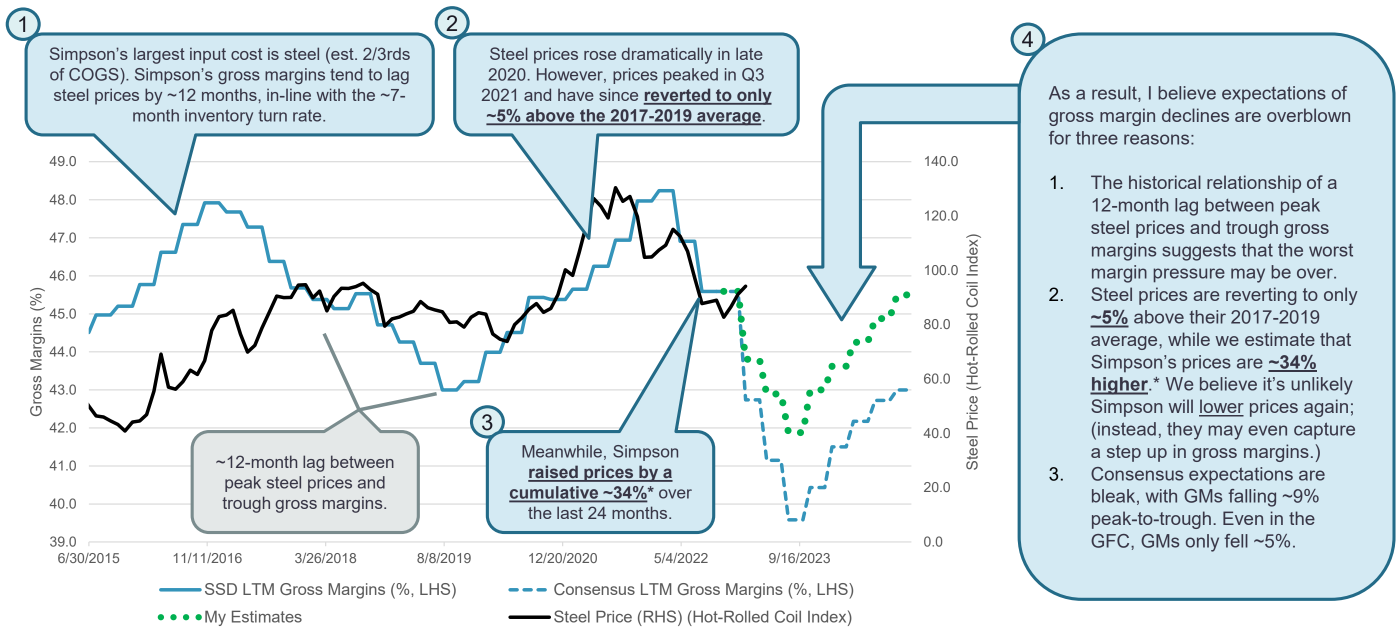
♦ Simpson's stated 5yr strategic priority is to grow revenues above the rate of US housing starts, while maintaining top-quartile ROIC and operating margins vs. peers. Simpson has comfortably achieved each of these targets over the last full "peak-to-peak" cycle (defined as the 15-years to 2021), with topline growth of 12.7% CAGR vs. -0.8% for US housing starts.

- Going forward, my base case assumes -8.3% growth in '23, a +13% rebound in '24 and +6.1% thereafter. This forecast assumes i) a 25% decline in 2023 housing starts (based on most-recent estimates by Fannie Mae) and therefore a 25% decline in volumes for the ~2/3rds of Simpson's revenues which are tied to US housing (of which, ~50% is new starts and the remaining ~15% is less-cyclical remodel/repair work), ii) 1.5%/yr growth in the ~1/3rd of revenue tied to commercial building, iii) 3% per-year of price increases (given the substantial moats discussed previously) and iv) 1.4% ($30m)/year of market share gains (assuming that share gains continue at half the rate that they have grown historically).
- Simpson has demonstrated an ability to consistently gain share in its core and ancillary markets (despite its products selling for 10-15% price premiums) leading to above-market growth. To this end, the company is making expansions into four new markets (OEM, Mass Timber, Structural Steel and DIY/R&R), with TAMs for each market ranging from $90-700m.



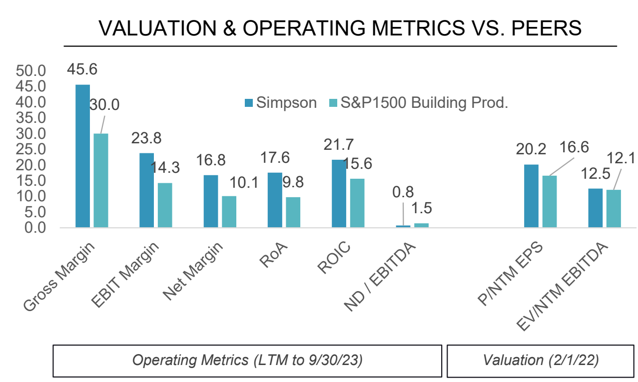
<u>Investment Thesis #2</u>: Consensus expectations of gross margin compression are overblown.

- We project 2024 gross margins of 45.5% vs. 43.2% consensus. Consensus gross margin forecasts appear to ignore several factors, including Simpson's recent >30% price increases and declining input costs (see exhibit below).



*Source: my estimates based on aggregating commentary from the last 10 earning calls, 1Q21 through 3Q22.

<u>Valuation</u>: Simpson's valuation is attractive given its superior operating performance. Simpson trades at the same EV/EBITDA multiple as other building product companies (as defined by the S&P1500 Building Products Index), despite consistently achieving superior operating metrics – e.g., ROIC >20%, ~15% higher gross and 10% higher EBIT margins. On a NTM P/E basis, Simpson's ~3 turn premium is consistent with Simpson's trading history (averaging a 4.1x premium over the last 10yrs) and Simpson's lower leverage (0.8x ND/EBITDA vs. 1.5x). My base case assumes a 2025 year-end exit multiple of 17x NTM EPS.



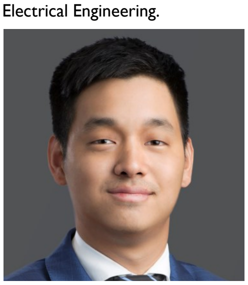
<u>Risks</u>: 1) US Housing market ~50% of revenues are directly tied to US new-starts. In the GFC, revenues fell ~40% peak-to-trough, while EBITDA margins declined from 21.6% to 11.7%. *Mitigants:* i) SSD is more diversified than it was during the GFC, when ~75% of revenues were tied to US starts (vs. ~50% today), ii) the current housing cycle peaked at ~1.6m starts, fewer than any prior cycles, iii) SSD now has a healthier margin structure (e.g., lower SG&A %, 0-based budgeting, higher R&D %) than pre-GFC (thanks to an activist in the mid-2010s). **2) Poorly timed Etanco acquisition** – In Jan '22 Simpson acquired French competitor Etanco for $800m at 12x LTM EBITDA (8.7x with synergies). The timing was unfortunate (peak of housing cycle/multiples + increasing Europe exposure pre-Ukraine invasion). *Mitigants:* i) while Simpson paid a full multiple, ETANCO is high-quality business (40% gross margins, 20% EBIT margins) and a strategic fit (highly engineered products, dedicated technical assistance team, best-in-class delivery timelines), ii) Etanco has performed well in the 1yr since the acquisition, exceeding revenue/margin expectations despite Ukraine-related challenges, and iii) Etanco is primarily commercial (vs. residential) and benefits from increasing French environmental regulations on building thermal efficiency.

Jose Alvarez ´24

Iose is a first-year MBA student at CBS. Prior to CBS, he worked at MAEVA Group, a distressed focused merchant bank. He began his career at Natixis in their investment banking team covering Latin America. Jose graduated from the University of South Florida with a BS in Finance.

Tanay Dixit ´24

Tanay is a first-year MBA student at CBS. Prior to CBS, he worked at Kedaara Capital, India's largest homegrown Private Equity platform with ~$4.5Bn of AuM, investing across Healthcare and Financial Services in emerging markets. He started his career in Investment Banking with Kotak, one of India's largest private sector banks. Tanay graduated from-BITS Pilani with a degree in Electrical Engineering.



Benjamin Hui ´24

Ben is a first-year MBA student at CBS. Prior to CBS, he worked at Swiss-based Asset Manager Quaero Capital in their Asian and Chinese Equities teams. He started his career as a Real Estate Lawyer at Mayer Brown, the number one ranked Real Estate legal team in Hong Kong. Ben graduated from The London School of Economics and Political Science with a degree in Law.

Trex Company, Inc. (NYSE: TREX) - Long
2022 Neuberger Berman ESG Investing Challenge (1st Place)

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Recommendation:
Long TREX with a 3-year price target of $84, representing 190% upside and an IRR of ~24%.

Trading Metrics	
Price ($)	44
Mkt Cap ($ Mn)	4,877
Net Debt ($ Mn)	106
EV ($ Mn)	4,982
52 Week High	141
Avg Daily Trading Volume (Mn)	1,355,904
Shares Out. (Mn)	110
Float Shares (Mn)	109
Insider Ownership	1.1%
Institutional Holdings	98.9%

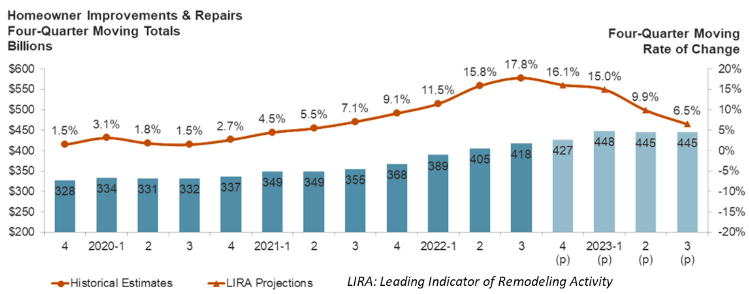
Financial Metrics	LTM
Revenue	1,218
EBITDA	357
EBITDA %	29.3%
FCFF	169
FCFF Yield	13.9%
Net Debt / EBITDA	0.3x
P/E (Fwd)	22.0x
P/FCF (Fwd)	17.6x
EV / EBITDA (FY22E)	18.1x
RoE	31.3%

Business Summary: Trex manufactures and distributes decking, railing, and outdoor living products and accessories for residential and commercial markets, primarily in the US; the company has a comprehensive suite of products across multiple price points and utilizes composites made of recycled plastic/wood fiber in its products. **Trex continues to be a high-quality compounder that has consistently delivered 15%+ Rev. growth, 25%+ EBITDA margins, 70%+ pre-tax RoCE and 60%+ earnings growth over the past 10 years.**

Investment Thesis:

I. Favorable macro drivers remain intact with exposure to a resilient segment within homebuilding:

- Decking as a category is more exposed to the Repair & Remodel (R&R) market which continues to have robust drivers in place
- Wealth effect from rising home equity as homeowners have seen significant price appreciation across the pandemic

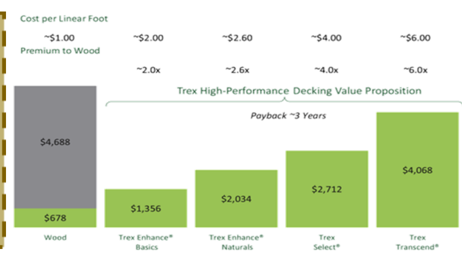


- Higher moving cost due to increased mortgage rates and high home prices will force homeowners to invest on their current homes
- Theme of transition from indoor to outdoor accelerated by the pandemic has more homeowners invest more on outdoor fixtures.
- Average deck purchaser is relatively insulated from higher mortgage rates vs the average homeowner and tend to be more affluent

II. Trex has achieved the unique feat of building an unmatched consumer discretionary brand within a commoditized space :

- Trex has an unrivaled presence in the US, with 6,700 locations and 50 distributors, and the most recognized name among composite decking players.
- **It has a dominant presence in the 2 largest home improvement retailers with its products being the top 2 names in both Home Depot and Lowe's (which represent ~60% of sales).**
- The value proposition of a deck remains attractive for consumers, where the life of the deck is ~10 years more and there is a 3-year payback to a composite

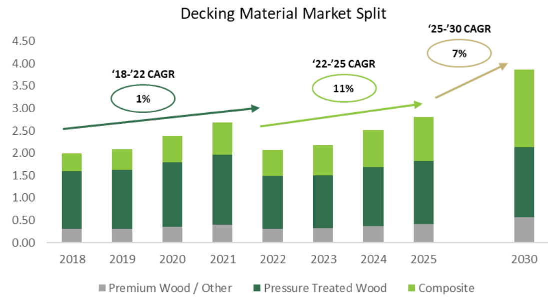
"…We get approximately, in the busy season, 150 calls a week. 140 of those are asking for Trex. Now what's unique about that is they don't even know what they're asking for. It's as if Trex has done what Kleenex did to Kleenex, if that makes sense. So when people go I want a composite deck, they don't go "I want a composite deck." They go, "I want a Trex deck." ***President at Platinum Decking, an Illinois based deck contractor that serves IL and WI with over 1,000 deck installations over the past 3 years***

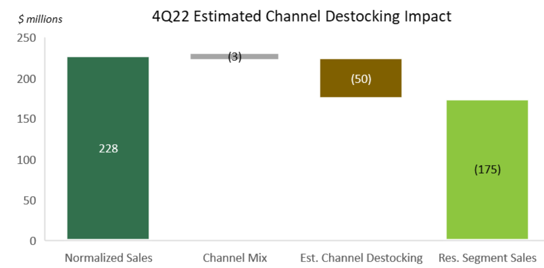


Trex Company, Inc. (NYSE: TREX) - Long

III. The industry's potential for overcapacity is negated by long growth runway

- Composite has been taking market share from pressure treated wood, **today it represents 29% of the market and is expected to increase its share to 45% by 2030**
- Within the space, **we expect Trex to remain the market leader with 48% of market share by 2030, just a 2% increase from today**. We believe that there is enough market for all players to grow without battling out for market share.
- Despite an acceleration of decking demand during the pandemic, we consider that the industry is right-sized in terms of capacity as composite will continue to take share from pressure treated wood, as **we expect the segment to grow at an average of 10% vs. 4% of pressure treated wood between 2021 and 2031.**
- The short-term challenges on the demand side due to high interest rates impacting current demand coupled with demand pull forward during the pandemic resulting in a higher base, has resulted in channel overstocking. The market has misread this as a structural decline in decking demand due to expectations of persistent inflation **We believe that the 2022 inventory buildup is a short term issue and should normalize during 2023.**

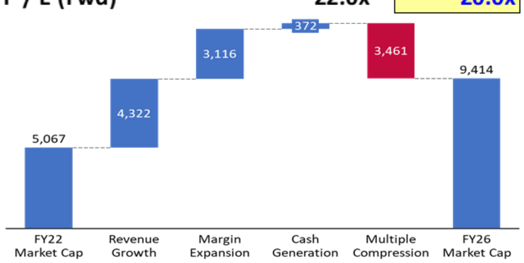




Valuation:

- **Exit multiple of 20.0x P/E, below historical average of 36.0x.**
- Assumes 20% revenue growth from '22-'27 vs. consensus estimates of 8%. Driven by 6% industry growth, pricing increases of 3% and composite taking further market share in the decking space (~39% vs. 29% today).
- Gross margins of ~38%-39% , in line with historical average
- With most of the cost structure below gross margin fixed in nature, there is significant scope for operating leverage, post the expansionary capex cycle the company has undergone recently, Incremental margins should increase significantly with EBITDA margin expanding to ~29% in FY27 from ~24% in FY22. Coupled with high RoIC (~80% peak historically), the company should generate ~$1.5Bn of cash
- **Our base case assumes an overall IRR of ~24% on the opportunity with a total upside of ~+190% in the next 3 years, with a Target Price of $84 in 2025**. Our variant view v/s consensus is based primarily on the growth forecast over the next 3-5 years, driven by increasing conversion from wood to composite coupled with macro tailwinds for the overall decking space driven by the switch from indoor to outdoor R&R.

US$ Mn	*31-Dec-22*	*31-Dec-25*
Share Price ($)	**44**	**84**
# of shares out. (Mn)	*115*	*112*
Market Cap	**5,067**	**9,414**
Net Debt	(277)	(648)
Enterprise Value	**4,790**	**8,766**
EV / EBITDA (LTM)	18.1x	14.9x
P / E (LTM)	30.9x	23.3x
EV / EBITDA (Fwd)	13.8x	12.6x
P / E (Fwd)	**22.0x**	**20.0x**



Risks and mitigants:

- Housing market slowdown: While a sharp rise in inflation and corresponding hike in interest rates has negatively impacted building product companies across the board due to rapidly rising mortgage rates and reduced affordability of new home purchases, decking is more exposed to repair & remodel (R&R) and the R&R segment could see continued activity due to the aging of the housing stock in the US, wealth effect from rising home equity and higher moving costs, specially for homeowners with mortgages at sub 3%.
- Overcapacity buildup in the industry: As composite continued to take share from wood, the major players started to add capacity to satisfy demand. As mentioned above, we consider that the industry is right-sized in terms of capacity as composite will continue to take share from pressure treated wood.

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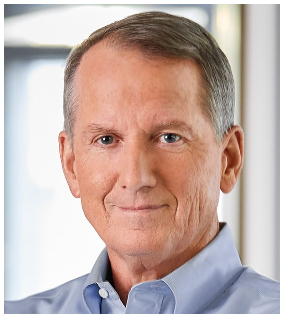

Chuck Bath

Austin Hawley

Varun Gupta

Chuck Bath, CFA
Chuck serves as a Portfolio Manager for Diamond Hill and joined the firm in 2002. Prior to joining Diamond Hill, Chuck was a Portfolio Manager and an Analyst with Nationwide Insurance and affiliates from 1982 to 2002, where he managed the Nationwide Fund. From 1979 to 1980, Chuck was an Internal Auditor at USAA. He also was an Auditor at Ernst & Whinney from 1977 to 1979. Chuck has a Bachelor of Science in Accounting from Miami University and a Master of Business Administration from The Ohio State University.

Austin Hawley, CFA
Austin serves as a Portfolio Manager for Diamond Hill and joined the firm in 2008. Prior to joining Diamond Hill, Austin was an Equity Analyst at Putnam Investments from 2004 to 2008. From 1999 to 2002, he was an Investment Associate at Putnam Investments. Austin has a Bachelor of Arts in History (cum laude) and a Master of Business Administration (with distinction) from Dartmouth College.

Varun Gupta, CFA
Varun serves as a Research Analyst for Diamond Hill and joined the firm in 2014. Prior to joining Diamond Hill, Varun was a Director, Business Development for Advanced Renewable Energy from 2009 to 2013. From 2004 to 2009, he was a Product Manager for Tigerlogic Corporation. From 2000 to 2004, Varun was a member of the Technical Staff at Sun Microsystems. Varun has a Bachelor of Science in Computer Science and Engineering from the Indian Institute of Technology in Varanasi, India, a Master of Computer Science from State University of New York and a Master of Business Administration from Columbia Business School.

Editor's Note: This interview took place on April 14th, 2023.

Graham & Doddsville (G&D):

Thanks Chuck, Austin, and Varun for speaking with us today. To start, could you walk us through your backgrounds and how each of you first became interested in investing?

Chuck Bath (CB):

I'm co-portfolio manager with Austin Hawley on the Diamond Hill Large Cap and Large Cap Concentrated Strategies. My interest in investing goes back to when I was a kid. My grandmother gave me 15 shares of AT&T. It was a little bit different back then, because you did not have a brokerage account. You'd actually receive a dividend check in the mail, and when you're a kid and you receive a dividend check, go to the bank, endorse it, and cash it, it made you think about the investment process. My family was not necessarily wealthy, but they did invest some of their savings in equities.

My father, grandfather, and both of my grandmothers were all very interested in investing. My grandfather invested in Exxon Mobil, which then passed to my mother, which then passed to me, and which I hope to pass to my children. We've had an investment in Exxon for 70 years in our family. A 70-year timeline is a bit longer than most have, but I'm hoping that, and I've done the calculation, my kids hold it to a hundred years. The point of the story is that we had conversations about this for basically my entire childhood. It was mostly at the retail level. No one in my family was a professional investor. Instead, it was something that they did with their personal savings.

I worked at Ernst & Young getting out of college. And while it was a great learning experience, I realized it wasn't for me, so I went back to graduate school like so many of you are doing. One thing I learned in graduate school is that it's an

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accepted way to change career paths. I went to Ohio State and when I graduated, I got an opportunity at Nationwide Insurance Company. The gentleman who ran Nationwide's insurance account, Harry Schermer, who retired and lives in Arizona, probably made the biggest impact on me in terms of being an investor. He was an outstanding investor that nobody ever heard of because he managed Nationwide's internal account and managed no fiduciary money. Harry had a very long-term time horizon and an outstanding long-term track record. And if you know how capital gains are taxed at the corporate level, especially back then, you'd understand the importance of maintaining long-term perspective. Many of the names we held were for decades. I remember one point Harry made once, this was back in the late '80s when Merck was our largest position, and it was our first position to get to $100 million in size. Merck had just come out with many important cardiovascular drugs, and the company was doing very well. They asked Harry about his Merck position, and he made the point that he was just going to own this. In other words, he wasn't looking at his ownership in Merck and thinking, "At what price I'm going to sell?" Nationwide's ownership was approaching 1% of Merck and remained there for the duration of Harry's career. His approach was not thinking of something as if you're going to flip in and out of it based upon a quarterly earnings surprise. But rather, having a minority ownership interest of a public company. That's how we thought of it. We were owners of Merck.

"There was no way a value investor could do anything but have a horrible record in 1999. Long story short, we saw a market opportunity."

G&D:

How did you end up at Diamond Hill?

CB:

Many of you are too young to know this story, but the 1999 to 2000 period was incredibly stressful for value investors such as myself. What ended up happening was that every value investor who maintained their discipline performed horribly. There was considerable pressure brought on me as the manager of the mutual funds to change my discipline. I refused to do so. This was not at Nationwide, we had been spun off to a subsidiary, Villanova Capital, which doesn't exist anymore.

Since I was refusing to abandon my value discipline, they put a co-manager on the portfolio who had a growth discipline. And that was a strange decision. We had $2 billion of assets. I'd been managing that portfolio for 15 years and shareholders knew my approach and style. If their money was there, it was there for a reason. Shareholders wanted the money invested in that style. But we had non-investment professionals who worked in financial service industry leading the company. They thought we needed more growth holdings in this value portfolio. Unfortunately, it did not work out and it led to me examining other career options.

At that time my friend Ric Dillon had started up Diamond Hill, and at the time we perceived there were a lot of value firms who lost their way. They all started chasing momentum, and as a result, there were a lot of unhappy clients out there. We saw there was an opportunity for a value shop, and a value discipline without the record of having abandoned their shareholders. Because quite frankly, if you did not have a horrible record in 1999, you had abandoned your discipline. There was no way a value investor could do anything but have a horrible record in 1999. Long story short, we saw a market opportunity. I came to Diamond Hill in 2002. I was a little anxious to get there sooner. I was afraid that the market was going to appreciate before I arrived at Diamond Hill.

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Fortunately, it did not. Our original success was in small cap and then long/short, and then finally the Large Cap Strategy.

I also want to highlight one thing, which is a subtle industry difference that I didn't notice until later. Growth has outperformed value for a meaningful period and yet our clients aren't particularly unhappy with us. On the other hand, they were very disappointed in 1999. What's the difference? Our clients are now measuring us against value indices such as the Russell 1000 Value Index. When I was managing money in 1999, firms were not using that approach. They were measuring investors against the S&P 500 Index. They were measuring their growth manager against the S&P 500 Index. They were measuring their value manager against the S&P 500 Index. So, when I was flat in a 19% year in 1999, my clients were very disappointed. In the last several years, we've had good relative years to the value index but have meaningfully trailed the broad index. But our clients are actually quite happy because they're measuring us differently. It's a subtle change in the industry that has changed the way we are evaluated. Austin and I are measured against the Russell 1000 Index internally, but we all know many of our clients measure us against Russell 1000 Value Index. Let me stop there and pass it on to Austin.

Austin Hawley (AH):

Thanks for having us here. I am co-manager with Chuck on our Large Cap and Large Cap Concentrated Strategies. I've been at Diamond Hill since 2008, right before Lehman went down in the financial crisis. It was a great time to change jobs in this industry. Similar to Chuck, it was a very fortuitous time to change, and I'll get to a little bit more of that. I have some similarities in my background to Chuck and some differences.

I was also fortunate enough to grow up in a family where not just my parents, but my grandparents were all active investors and talked a lot about stocks and bonds. None of them were active in the industry as investment managers or brokers. Both my dad and grandfather were doctors but were also active investors who loved talking about it. I had a better knowledge of just financial markets and stocks in general than most people. But it wasn't something I knew when I was 10 years old that I wanted to go out and be Warren Buffett or anything like that. Frankly, I got lucky that my first job right out of Dartmouth was working in a program at Putnam Investments in Boston. I actually started on the bond side of the business working as a credit analyst for two years, which was a great experience. I learned a ton, especially as someone out of a liberal arts background who needed to learn accounting and everything that goes with studying credit metrics for companies.

> ***"In the last several years, we've had good relative years to the value index but have meaningfully trailed the broad index. But our clients are actually quite happy because they're measuring us differently."***

I wandered around a little bit. I actually spent a year as a quant analyst in fixed income, believe it or not. That was also an interesting experience, but I knew it was not something I wanted to do longer term. I was lucky enough that Putnam was willing to pay for my business school education. And so, I went back to Dartmouth to Tuck for my MBA. I had an agreement that I could come back and work wherever I wanted. I got the value bug while in business school and started to read a little bit about Warren Buffett and Berkshire Hathaway. I decided that I wanted to go into equity research, and I had a commitment to be there for at least three years. I would tell you that Putnam was, in hindsight not the ideal place for me in that I don't think

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there was a real clear philosophy in terms of how they invested.

However, it was a fantastic experience. I worked with lots of really, really smart people. I got access to all kinds of management teams and companies and just learned a ton about being a good industry-focused analyst. And that was the model there. It was industry-focused, and I was lucky enough to start as a property and casualty insurance analyst. That really allowed me to dig deep into Berkshire Hathaway and all the teachings of Buffett over time. Like a lot of people say, once you read about value investing it either takes or it doesn't. And if it takes, you start pulling the strings and you find all kinds of interesting areas to read and learn about. And that's what I did over those first few years as an analyst at Putnam.

> ***"The key question was about what the right decisions were for our clients for the next five to ten years. And that environment is really, really unique."***

Eventually I knew I wanted to get to a smaller firm and a firm that had a clear value-oriented philosophy. And so, I started looking around and I was lucky enough that somewhere in that process someone said to me, "Austin, you're from Columbus, Ohio. There's this firm in Columbus, Ohio that you should take a look at, Diamond Hill." I had never heard of it. When I left Columbus, Diamond Hill didn't exist. I started digging around and Diamond Hill looked like exactly what I wanted. It was just getting to that inflection point of being a sustainable organization in terms of size, but it had a very clear single philosophy at that time. I convinced my wife to allow me to apply for an analyst role at Diamond Hill.

I'd say it's been everything I hoped it would be in that regard. We have stayed very, very true to that single equity philosophy – we also now manage fixed income with a valuation-disciplined approach. It continues to be a small to mid-size asset manager, which is a great size in terms of being able to know all the people at the firm while still feeling like you can make a real difference at the organization. I've been lucky enough to get more opportunities than I ever would've guessed when I came here in terms of both career path and leadership roles.

I'll make one final point just about that transition to Diamond Hill that I think's important, especially for people just thinking about those kind of career transitions. When I left, it was right before the heart of the financial crisis. You really learn what an organization is truly like during those periods of stress. It is amazing the contrast of being at a place like Diamond Hill during the heart of the financial crisis. I remember those early months sitting at my desk looking at insurance companies and feeling like you don't know what's going on in the market most of those days.

I felt complete freedom to go look at what I thought were the best opportunities and felt like the portfolio managers like Chuck and others were open to having those conversations and not worried about whether a stock was down 10% in a given day. That wasn't the key question. The key question was about what the right decisions were for our clients for the next five to ten years. And that environment is really, really unique. I learned very early on in my time at Diamond Hill how important it was to be at a smaller place and a place that had a true philosophy in that long-term orientation. It couldn't have been more different from the experience I'd had in the prior few years at my earlier employer.

Varun Gupta (VG):

I am a Columbia Business School alum and graduated in 2014. At CBS, I was a teaching assistant for Professor Tano Santos' Value Investing class. I also did an independent study on the

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semiconductor industry under his guidance. As I was learning from him and doing my independent study research, it struck me that my investment style and philosophy match with firms that invest in a concentrated manner and have long-term orientations to their investment philosophy, clients, and employees.

For me, culture was extremely important. I was fortunate to find Diamond Hill, which has an excellent culture. And I joined Diamond Hill immediately after graduation. I've been at Diamond Hill for about nine years. Today, I'm a large cap generalist, working very closely with Chuck and Austin to provide value to our clients.

G&D:

Could you provide a brief overview of Diamond Hill and the strategies that you manage?

AH:

We are a valuation disciplined investment manager. We're based in Columbus, Ohio, which is where Chuck and I are sitting today. Most employees work in the office here in Columbus. Roughly 90% of our $24.9 billion of assets (as of 31 March 2023) are in equity strategies and largely in seven strategies that vary based on market cap range, level of concentration, geography, and the ability to short. As Chuck referenced, we've had a long/short portfolio for over 20 years now at Diamond Hill, which was one of the first-ever long/short mutual funds. The other 10% are in two fixed income strategies that we started in 2016. These are also very much valuation-disciplined strategies but are a little different than our equity strategies, which follow a true intrinsic, value-based philosophy.

Our equity philosophy is intrinsic value-based, in that we try to think like owners. Whenever we're buying a share of stock, we think of it as a proportional interest in a business that has a value that's independent from where that stock might trade day to day. Our goal as investors is to try to narrow down the universe to those companies where we think we can reliably estimate what that intrinsic value is and then patiently wait for opportunities to buy those companies when they're trading at a discount to what our estimate of intrinsic value is. And we have a team of research analysts that help us in implementing that all within a structure that is an industry expert model.

And so, Varun, when he started here, worked at covering semiconductors. I covered insurance companies when I started here, and now we have a team of 25 global analysts that will help us do that. Then the final piece of our philosophy is just that long-term orientation.

We try to think of periods of at least five years when we're modeling companies. If you look at the turnover, it has typically been around 20% for the Large Cap strategy. And even when we think about the policies that enable people to be good long-term value investors, we try to be thoughtful and think of periods of at least five years. So, incentive comp for Chuck and me is based heavily on five-year rolling performance. Nothing for shorter time periods. And I think it's a really, really important thing. Lots of people claim to be long-term, but when you look at the policies they have at the firm, they don't really support long-term decision making.

"Our equity philosophy is intrinsic value-based, in that we try to think like owners."

And it's crucial because I don't worry about that career risk if I have a bad year that I'm going to get fired or it's going to dramatically impact my compensation. I'm always focused on what's most important over the next five years. And the final point I'll make about our philosophy is that we consider ourselves very much value investors, but we always use that term intrinsic value. To me, there's this subtle difference where value

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investing isn't about just buying cheap stuff. I think a lot of times with that generic term of value investing, people think about buying cheap price to book or cheap price to earnings and it's a much more complicated calculus for us. We will very explicitly incorporate things like the returns on capital and growth of a business over an extended period.

That leads us to have a broader universe that we look at in terms of what's investible for us. And so, you've seen us own Google and Microsoft in recent years. Amazon today is a holding in our Large Cap and Large Cap Concentrated Strategies. It's all about incorporating things like the competitive advantage, the ability to deploy capital at high rates of return, and the ability to grow the business. Growth can be a huge component of value. It's not always, but if you have attractive returns on capital, it can be a big component of value.

That is our philosophy in a nutshell. As I said, we have a single equity philosophy. The large cap strategies that Chuck and I manage uses that same philosophy as all of our other strategies that we manage on the equity side. It's helpful for our research analysts here because we're all speaking the same language. It's one philosophy. We all think about it and believe in it passionately and we can all talk about the same sorts of things in terms of the variables that really matter for that philosophy.

G&D:

Great, thanks Austin. Something you mentioned in that discussion was competitive advantages. What is your approach for identifying sustainable competitive advantages in the businesses that you want to own?

VG:

At Diamond Hill, we invest with at least a five -year time horizon. So, identifying sustainable competitive advantages is critical to the success of our idea, and it also helps us invest with a margin of safety. Over the years, I have found books written by Professor Bruce Greenwald and other Columbia professors like Paul Johnson and Paul Sonkin, along with a book called '7 Powers' by Hamilton Helmer as helpful resources.

Sustainable competitive advantages often fall into three categories for most of the firms we look at: efficiency advantages, customer captivity advantages, and production advantages. I'll break down what each of these means.

Efficiency advantages allow the company to use its capital more efficiently than the competition. Typically, you can think of economies of scale, network effects, or a company being ahead in the experience curve relative to their competition. This allows the company to produce its products much more efficiently.

Customer captivity advantages are typically found in firms with pricing power because the customers have high switching costs, which makes them very reluctant to switch to a lower-cost competitor offering.

> *"It's all about incorporating things like the competitive advantage, the ability to deploy capital at high rates of return, and the ability to grow the business. Growth can be a huge component of value."*

Finally, production advantages allow a firm to incur lower costs than competitors when serving customers. Typically, we have found that these companies have structurally lower input costs than competitors. They also have proprietary technology or a unique distribution capability that is difficult or unattractive for their competitors to replicate. Texas Instruments is one of our portfolio holdings and benefits from efficiency, customer captivity, and production advantages.

Occasionally we also find

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companies that enjoy a counter-positioning competitive advantage, which Helmer talks about in the 7 Powers book. Counter positioning involves a company developing a new superior business model. Counter positioning is driven by some technological change that the incumbent companies cannot mimic because it damages their existing business model.

AH:

I'll just add one thing. There's lots of good models out there to think about competitive advantage. We're talking about moats and barriers to keep competitors out. And I would just say that we don't always invest in businesses that are growing fast over the next five years or have huge competitive advantages. But if you're going to invest in a company and part of your thesis is around that business growing over time, documenting why you think there's an advantage or barrier that keeps the competitors out is really crucial because otherwise the natural course of competitive markets is that those excess returns are going to get competed away. And so, it's really important that if you're going to invest in higher quality businesses where part of your thesis is value creation from growth over time, that you have a well-founded view about why there are those barriers.

"Our competitors' incentive structure is often too short-term focused. A lot of people don't feel as though they have that job security, or they can't afford the hit to their bonus if they take a short-term risk. So, they're invariably chasing short-term momentum."

G&D:

To continue with this discussion of competitive advantages, what do you think is Diamond Hill's competitive advantage as an investment management firm?

CB:

Austin hinted at this, but our approach differentiates us from a lot of value investors because we incorporate growth into our calculation of value. We are incorporating a five-year outlook or longer and you can't take a five-year outlook or longer in calculating value without incorporating growth. It just doesn't make sense not to. If you were going to buy the whole company, you would certainly incorporate growth. I also think that our portfolio turnover ratio, our holding period and just our investment philosophy differentiates us in an environment where every firm theoretically also has the ability to take this approach. However, our competitors' incentive structure is often too short-term focused. A lot of people don't feel as though they have that job security, or they can't afford the hit to their bonus if they take a short-term risk. So, they're invariably chasing short-term momentum when in fact we often find short-term momentum as an opportunity to establish or eliminate positions.

G&D:

When you look back to your early years investing, could you point to any successes or mistakes that really stand out?

CB:

Let me go back way to when I first began as a portfolio manager in 1985 prior to Diamond Hill. I took over a portfolio of large cap value stocks. The three large retail holdings were Sears, Kmart and JCPenney. Statistically, they looked incredibly cheap. But what was wrong with that picture? All three were consistently losing meaningful market share over long periods of time. And that's when I started questioning these statistical measures of value. Things like secular trends in market share don't show up on the

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income statement or the balance sheet but are very important in terms of determining long-term value.

The opposite of that situation was in the '80s when I realized the pharmaceutical industry was very attractive. There were R&D efforts that were becoming very successful. The monopolies that these companies were establishing were very lucrative. But by 2001, I had concluded that the secular fundamentals of the pharmaceutical industry were changing permanently for the worse. The change in the generic laws were becoming so dramatic that companies were not able to extend their patent lives. Generic competition was becoming much more problematic, and I meaningfully reduced the portfolio's exposure to the industry by the end of 2001. Sometimes it is important and try to learn from your success. Everyone will ask you, what did you learn from your failures? Try to learn from your successes. I think there's often as much or more to be learned from successes than from mistakes.

G&D:

Diamond Hill's Large Cap Strategy has been closed to most investors in the past and recently was re-opened. How does Diamond Hill think about capacity and deciding whether to close or open a strategy to investors?

AH:

We go to great lengths to align ourselves with the client and put ourselves in the client's shoes. And that's where that capacity discipline comes into play. If you take on more and more assets, you eventually reach a place where it constrains your ability to deliver the same types of returns for clients. If we had $50 billion in assets today instead of $16 billion in the Large Cap Strategy, we wouldn't be able to invest in several of the names that we've been buying over the last couple quarters because we just couldn't get a position size large enough to make a difference for our clients. And we want to be able to deliver a similar type of experience with similar expectations about returns for both our new clients that come in the door tomorrow as well as our clients that came in 10 years ago. When we think about capacity, we go through an exercise every year across the whole firm where we think about how much we can manage across each strategy considering the overlaps in the strategies without impinging on our ability to fully utilize the market cap range available to us and still run a concentrated portfolio. Where we are today is that we think in large cap we could manage somewhere around $20 billion to $25 billion and still be able to fully utilize that low-end of the market cap range, which for us is somewhere between $5 billion to $10 billion depending on the market environment.

We've closed several of our strategies historically, and we'll continue to do that in the future. We're at a point today at $16 billion where earlier this year we felt very confident in re-opening the strategy.

G&D:

From our perspective as students, typically you're never going to pitch something as long that you don't think has some sort of competitive advantage. With that said, are any types of commonly articulated competitive advantages that you don't think are actually that strong? Any examples where you might disagree with the conventional wisdom out there?

AH:

Well, the one that comes up often is technology. A lot of times you'll hear some companies say, well, we developed XYZ new technology and we're investing billions of dollars in this technology. That said, a lot of times that stuff gets replicated pretty fast by your competitors. I don't consider technology changes, especially on the margin, to be competitive advantages, even though I'll hear that a lot. I'll hear people pitch those as advantages, but I don't consider them structural advantages unless there's some sort

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of network effect or scale advantage to the company that's implementing that new technology.

G&D:

Something we wanted to touch on was the recent activity regarding Silicon Valley Bank. How did you think about the decision to exit your position in the company? And more broadly, with the turmoil and the banking space, what are your thoughts on the opportunities right now in the banking industry?

AH:

This one is definitely fresh in our minds. We purchased SVB in the second quarter of 2022 in our Large Cap Strategy. As you know, the tech world was experiencing significant stock price declines as valuations returned to more realistic levels. SVB's business was very closely tied to the innovation economy and had seen its stock sell off pretty dramatically as well. We had followed the fortunes of this bank pretty closely and thought they had a very interesting niche with some real competitive advantages, including network effects, which are really unusual to see in a financial organization. We thought they existed with SVB given how tightly that innovation economy, startups and venture capital firms were tied into the bank. As the stock sold off, we bought a small position.

"It's fascinating because some of those network effects worked in reverse for SVB. You had this really close-knit group of depositors, and it was actually more close-knit than you thought."

As we watched the fundamentals over the next couple quarters, we saw some things that troubled us and weren't consistent with our expectations. The most important of those was some of the data we saw around the stability of the deposit base. We saw early indications over the next couple quarters that significant cash burn at SVB's clients was leading to some volatility in the deposits, which causes a host of other kinds of problems for a bank. As you start to lose deposits, you have to fill that hole somehow and it leads to a lot of decisions that have to be made at the institution that were not necessarily the optimal decisions.

We started to think and ask ourselves a pretty simple question, which was, all right, let's think about this customer base and the clients they have and the situation they're in today and the outlook for those clients over the next three years. And if we had to buy as investors just a blind pool of the stock in those clients, would we more likely be long or short that group of companies? We stepped back and said, this might be a good franchise with real advantages over the very long term, but it seems like a pretty rocky road over the next couple of years and it opens up a lot of uncertainties for a levered institution in terms of potential outcomes.

And so, we ended up just completely selling out of that bank in our Large Cap Strategy about six months after we bought it. Fast-forward to this year and what we saw in early March, and I would just tell you that I would've never guessed, despite selling out of SVB when we did last year, that we would be seeing SVB fail in very short order. The speed was shocking to us. And in hindsight, it's fascinating because some of those network effects worked in reverse for SVB. You had this really close-knit group of depositors, and it was actually more close-knit than you thought because there were these gatekeepers that actually controlled the activities of a lot of those individual depositors.

Turning to opportunities within financial stocks today. If you think about the area where investors experienced the greatest pain – regional banks -- my guess is a handful of names that sold off significantly during the mini bank panic in March will end up being great investments from those reduced prices.

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However, I would also say that the uncertainty level is pretty high. I think there's a lot of reasons to think the fundamentals are going to be more challenged than we thought prior to March 9th. We're going to have higher funding costs because competition for deposits is certainly going to heat up. We're going to have higher capital costs because for the regulators, even if you don't think this was a capital issue, which I'm not sure it was, the easiest way for the regulators to show that they're doing something is to have higher capital requirements. That is a clear quantitative metric that regulators can put in place. And so, I think the ability for regional banks to earn returns on equity that are similar to what they have been historically is going to be very challenging.

When I think about the opportunities here, some of the companies that were down similar amounts but in different industries might be a better option. AIG has been one of our biggest positions for the past few years. AIG was down as much as many of these regional banks. If you look at the liability structure of a property in casualty insurer, they don't have callable liabilities. Those liabilities are typically a few years in duration and costless in most cases. You have a large securities portfolio, but you have a better ability to hold to maturity for those fixed income investments at a property and casualty insurer than you do in a bank where you might have runs and be forced to sell those assets. And so, when we look at a company like AIG, which we think is in middle stages of a successful turnaround with a talented management team, that's a place where I think is a better opportunity at least on a risk adjusted basis.

We've had very strong pricing across the commercial insurance industry, so AIG is benefitting from strong industry fundamentals and a talented management team turning around an institution that was very poorly managed. Turnarounds are hard. They always take five times longer than you think. It takes a long time to improve the profitability of the existing book of business. That said, we are well on our way at AIG, and while it takes a long time, the other side of that is once you get it going in a good direction it can be a really long runway of improvement.

G&D:

How do you think about the broad and growing adoption of passive investing? In the long term, do you see it as a tailwind, headwind, or more neutral for active managers?

CB:

I've seen it become somewhat of a cyclical phenomenon. Passive investing is incredibly popular when large mega cap stocks are outperforming because they're more heavily weighted in indexes than active managers are in their portfolios. The most inefficient market in my lifetime was the period around 2000. The popular strategy at the time was low tracking error investing. It grew to the point where that lack of active management created inefficiency in the marketplace. And we also got there a little bit in 2021. Much of the performance of the S&P 500 Index was driven by Apple, Alphabet, Microsoft, and Amazon. Overall, I would say that passive investing is a cyclical phenomenon. And I would say right now this is not the optimal time to be moving that way because the smaller capitalization companies are so much more attractive in terms of valuation.

> ***"AIG is benefitting from strong industry fundamentals and a talented management team turning around an institution that was very poorly managed."***

AH:

I totally agree with Chuck's point that I think if you think about where we are cyclically, it might not be the right time to take that 0% option. But I think over

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the long term it's a very beneficial thing for the retail investor or institutional investor broadly. We've driven down the cost of investing in the market to a really low level.

It makes it all the more shocking, like Chuck pointed out earlier, that we haven't had more pressure on fees broadly across our industry. You guys know all the studies of looking at the industry historically. Active management hasn't broadly added a ton of value. And it's not like that changed dramatically over the last 25 years when cost of passive has come down close to zero.

G&D:

Could you talk about a couple positions that are particularly exciting to Diamond Hill right now?

CB:

Martin Marietta Materials (MLM) is an interesting company that we added to the Large Cap Strategy last year. It's a company that we've monitored for years. I purchased a competitor Vulcan Materials (VMC) in 1985 and owned it for a couple of decades. When I came to Diamond Hill, I didn't immediately establish a position in MLM. After the selloff in 2022, MLM became attractive and gave us a rare opportunity to establish a position. The biggest portion of the earnings come from limestone aggregates, which are used in construction. It's a local monopoly everywhere it serves.

When I was in college, I worked in the state highway department,

> ***"It's incredibly difficult to establish a new limestone quarry because no one wants one next to their house. Each quarry has its own local monopoly."***

and we would get a truckload of crushed limestone to do various projects. There'd be three people in the truck driving 15 miles to get four tons of limestone at $4 a ton. That's $16 total. We were not going to drive another 20 miles with three people because the next limestone quarry was providing a 10% discount. The point of the story is that it's incredibly difficult to establish a new limestone quarry because no one wants one next to their house. Each quarry has its own local monopoly. And one of the things that's interesting is that there are a lot of family legacy businesses in this industry that have survived and thrived over the years basically because of the monopoly nature of the business. If you see a lot if family run businesses in an industry that do well for long periods of time, it may be because it's a very good industry.

Martin Marietta Materials has grown through acquisition, generates a ton of free cash flow, and has been very good to its shareholders. It's a unique monopoly, although the company doesn't call itself one for obvious reasons. It is the kind of business where you want to be an owner. It will compound and generate excess returns over long periods of time. It's certainly not a trading position.

AH:

I'll talk a little bit about SS&C Technologies (SSNC), which is a newer position for us in the Large Cap Strategy. We established a position at the end of 2021. SSNC does back-office software and administrative work for asset managers and other financial institutions. But the largest and most valuable portion of the business is fund administration for alternative asset managers. SSNC here is by far the market leader with north of 20% market share. And this is a business that has a lot of characteristics that we love and it's under the radar. It's not a sexy business. SSNC does a lot of unglamorous work that goes on behind the scenes for these asset managers. Think about things like taxes, accounting, and regulatory. All those are part of the purview of SSNC when you think about fund administration for alternative asset managers.

There are very high

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switching costs for this business because it's not a significant portion of the total cost structure for an asset manager. However, the service is mission critical. If something goes wrong, it is a major problem for your clients if you screw up any of the pieces of this back-office work. As a result, if you get in there and get market share, the asset managers tend not to switch you because the risk of having something go wrong is high. And so, if you look at the retention rate for this business, it tends to run in the mid-nineties. You have that recurring revenue stream, you have a product that's not a huge portion of total expenses for the client but is mission-critical, which gives them some pricing power over time. And as a result, you get a business that has very high margins and converts those earnings to cash flows at a very high rate.

And then the final piece is you have a lot of verticals where you can apply this knowledge within the back-office software administration. And you have a CEO in Bill Stone who's the founder of this company and still owns over a billion dollars of stock today who has been very skillful at finding adjacent niches that they can acquire and integrate very effectively into the overall business. And it has allowed SSNC to compound over time. People sometime call these platform businesses. I just think of it as a company that's a really good business that has recycled its cash flow into really attractive investment opportunities in similar adjacent businesses.

We think the opportunity exists today as a result of SSNC's acquisition of DST in 2018, which has been the largest acquisition the company has ever made. DST is a mutual fund administrator in an industry that saw its growth slow pretty significantly over the past few years. As a result, total organic revenue growth for SSNC has been pretty weak over the last few years as they have gone through the integration process with DST. When we look at the returns from that acquisition, they more than doubled the EBITDA margins in that business as well as the level of free cash flow. But the optics in terms of the organic revenue growth profile, which has been a significant focus of technology investors, has really weighed on the stock recently. And so, we're happy to take on that controversy buy at what we think is a pretty healthy discount to our estimated intrinsic value.

G&D:

Those sound like two pretty incredible businesses. We'll now get into some closing questions. What are some of the things that you three do on a regular basis to improve as investors?

CB:

I'm 68 years old, so some of the best investors I know are retired from our industry. But I keep in touch with them regularly and I like to exchange ideas with those individuals as they aren't involved in the day-to-day markets sort of thing and thus don't get caught in the day-to-day turmoil. It is so interesting that they have a big picture perspective. I enjoy just tossing ideas back and forth with them. It is a unique perspective to get exposure to because sometimes we get so focused on what's happening right now in the markets.

AH:

I'm a big podcast fan, so I listen to a lot of podcasts. I try to be pretty broad in terms of what I take in and it's a little bit the same point Chuck's making. I think so much of this industry you can get very, very focused on the minutiae of the market and where things are trading and lose track of what really matters big picture over the next five to ten years. I'd say that listening to non-value investors like growth investors is a healthy way to learn about markets. I think if you get too focused on value investing and just the minutiae of the day-to-day stuff, it can be misleading and it can constrain your ability to be creative and will constrain where good new ideas might come

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from.

G&D:

Varun, you have a different undergraduate background than most people in the investment industry. How have you leveraged your training as an engineer to get an edge?

VG:

I'll share a personal experience because all of you are Columbia students, and I'm a Columbia alum. When I was at Columbia, I went to Professor Bruce Greenwald for career advice at the end of my first year. He suggested that I specialize deeply and build my circle of competence based on the educational and professional experience that I already had. He said, "Why don't you just focus on the technology sector? You have domain expertise there." So, in my second year, I followed his advice. I took only technology-specific investment courses. I did an independent study under Professor Tano Santos. I did a school-year internship program at a technology-focused hedge fund in New York. All of that helped build my knowledge base and helped me find a role at Diamond Hill once I graduated.

When I joined Diamond Hill, I initially covered semiconductors and online advertising. I could find profitable investment ideas across the globe because I had the domain knowledge in those sectors, something generalist investors would not necessarily have. I have used my technology background to find my edge, and it has helped me carve out a very attractive role at Diamond Hill. We hear about cloud computing, machine learning, artificial intelligence, and 5G. Because of my technology background, I can clarify what is hype versus what is reality. If any of you have domain expertise, use that because that gives you an edge against your competition.

> ***"When I was at Columbia, I went to Professor Bruce Greenwald for career advice at the end of my first year. He suggested that I specialize deeply."***

G&D:

When hiring an analyst, what does Diamond Hill typically look for? Are you looking for sector specialists?

AH:

It depends a little bit on the stage of your career. If we're looking to hire someone for a more junior role, straight out of an undergraduate institution, it's not for a specific role where we would expect any sort of domain expertise. However, if we are hiring a more senior person, it is most definitely with a specific role in mind and a specific industry or sector. And to the extent we find someone like Varun who has significant domain expertise, that's a home run for us.

But that is not always the most important thing. The most important thing for us is that investment philosophy match. You can make some errors on the level of domain expertise, and you could still have someone who adds value to the organization. If you get someone in the organization who's not a good fit in terms of philosophy or culture, it's a disaster for the organization and we do not want to make those types of mistakes. And so, we are very, very careful in our screening process to ask a lot of questions, trying to ensure a cultural fit. When I interview people, to me the most important thing is just a demonstration that you are passionate about investing and about this type of investing in particular and really want to make a career out of being an intrinsic value focused investor. And then ultimately, if that person has that, we move on to that next step of thinking about whether they have cleared that bar in terms of IQ and skillset. And if they do have that domain expertise, it makes it even easier for us.

CB:

I'll add one other thing – temperament. I have

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always felt that temperament was incredibly important for taking a long term focus. I've met too many people in our industry who are very sharp people but didn't have the temperament to be managing other people's money. I hate to use this phrase, but their philosophy was too similar to "get rich quick." And that's a phrase I certainly wouldn't apply to anybody at Diamond Hill, but I see it regularly at other organizations.

G&D:

Do you have any advice you would give to younger investors who want to learn more about value investing?

AH:

Just start with the classics of reading Buffett. If you really enjoy it, you'll start to on your own pull that string and get to Greenwald and Greenblatt and Mauboussin and all these people who all have different flavors of knowledge that they bring to the broad term of value investing.

There's a reality in this business that we make lots of mistakes. We're trying to predict the future and we're never really right. And some of the times we're disastrously wrong. I mean, Silicon Valley was certainly one of those for us. And I would encourage people just as a piece of advice to really think a lot about your process and how you're going to react to those types of situations and whether that process fits well with the organization where you're working.

VG:

Your own personal investment philosophy should match the firm you are working at. Otherwise, just day-to-day dealing with the market gyrations and volatility is going to be difficult. All of you MBA students at Columbia get access to all sorts of flavors of investing courses, from ones that focus on primary research, to the ones that have short-term horizons, to the ones which have a long-term horizon, shorting, etcetera. See what feels right to your emotional makeup, and then go for that.

G&D:

One last question. What do you three like to do for fun outside of investing?

AH:

Well, I have three kids who are all close to teenage years, so a lot of sporting events with my kids. Outside of that, I was a competitive tennis player growing up. I played tennis in college. I still spend a couple of days a week playing competitive tennis. I'm a big runner and cyclist too. So, outside of my kids, those are my biggest hobbies.

CB:

I'm just this stereotype golf kind of guy. It's embarrassing to say because everybody says it. But it's the truth. And in the Midwest here, it's the great outdoor activity you can do regularly with friends. And my youngest daughter is graduating high school right now, so whether that'll change our lifestyle, I'm not really sure. But for right now, it's mostly just work and relaxation with family.

VG:

For me, it's very simple. I'm a first-time dad. I had a baby girl two weeks ago, so my time outside of investment research is entirely dedicated to being with my daughter and seeing her grow. Right now, she's so young, and no two days are alike.

The views expressed are those of the speakers as of April 2023 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Investing involves risk, including the possible loss of principal. Past performance is not a guarantee of future results.

Laughing Water Capital

Matthew Sweeney

Matt Sweeney is the founder and managing member of Laughing Water Capital, a concentrated, unlevered, long biased investment partnership focused primarily on small cap investments. The fund follows a fundamental, research driven process while taking a multi-year view on how the dual forces of increased earnings power and improving perception can fuel investment returns. Matt is a CFA Charterholder, former co-chair of the New York Society of Security Analysts Value Investing Committee, and graduated with a BA in History from The College of the Holy Cross. He began his career in an equity sales role at Cantor Fitzgerald, where he also led the Equity Syndicate Desk, and pioneered the firm's Equity Idea Generation efforts.

Editor's Note: This interview took place on April 21, 2023.

Graham & Doddsville (G&D):

Thanks, Matt, for speaking with the G&D team today. We're really excited to speak with you today. It'd be great if you could walk us through your background and go over how you first got interested in investing.

Matt Sweeney (MS):

I have what I think is a very non-traditional background in the sense that I did not go to target schools, and I managed to make it through college without ever taking an accounting class or a finance class or a business class or anything like that. I was at a liberal arts school, where I was a history major, and it was a very research-intensive curriculum that had nothing to do with finance or even numbers in general. But through a twist of fate, I wound up in a middle office role at Cantor Fitzgerald a week after 9/11. I never expected to be in a finance role, but I wound up in one because there were 26 people from my hometown who were killed, including two of my friends from high school who both worked at Cantor Fitzgerald.

And I knew somebody else from my town who worked at Cantor Fitzgerald that survived. At the time, I was basically bartending and not really sure what I was going to do next because I was taking a gap year before planning on law school. This guy knew that I was in the wind sort of, and he knew that Cantor Fitzgerald needed help, so he tracked me down and said, "I know you're a smart guy, I know you're not really sure what you're doing next, why don't you come into Cantor? We really need the help." So, I went into Cantor Fitzgerald and started in a middle office role with literally no knowledge at all.

Within a couple of months, I was on the sales trading desk and covering institutional equity accounts. It was trial by fire. I mean, I didn't speak the language at all, so I was educating myself as quickly as I could, literally hearing a term or a phrase I didn't understand and Googling it or going to Investopedia.com and trying to figure out what it was so people didn't know I was basically in "fake it till you make it" mode.

In some ways, that non-traditional background has been an advantage for me because it leaves me with a very healthy level of self-doubt, bordering on imposter syndrome, and it makes it very easy for me to assume that I'm the dumbest person in the room which I think is very useful when you're dealing with the stock market. I don't know if you've heard the term, "The Great Humiliator," but that's what people have referred to the stock market as. When you are aware that you started in the wrong place and that you're not the smartest guy in the room, it's a good way to keep your defenses up and make it easier to set the bar for inclusion in the portfolio super high.

For me, an idea really has to boil down to two or three bullet points at most that explain how earnings power for a business is going to be changing for the better and how perception is going to change over the

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next few years. And I'm a big believer that as long as you don't overpay going in, if you can find a business that will have significantly higher earnings power in a few years and it's currently unloved, you have a very strong foundation from which to generate acceptable investment returns.

G&D:

Who were some of the investors or mentors that you looked up to during the early part of your career that you think really shaped your investment approach?

MS:

I think of myself as being both fortunate and unfortunate in that I never had a true mentor. The unfortunate part is obvious. If you have an opportunity to work closely with a master of the craft, I think you probably can't help but learn through osmosis. The reality though is that very few people are fortunate enough to find that perfect mentor. And despite my best efforts, I never did. Where I was fortunate though is that in my job as an equity sales trader in the early stages of my career, I had the opportunity to speak with more than a dozen portfolio managers on a regular basis. And each of these portfolio managers had their own style. Some of them were value oriented. And some of them were deep value, growth, special situations, etc. I would do everything that I could to try and understand their processes and how they thought about their investments. And that included everything from trying to re-engineer their investments and then asking them if I was seeing it the same way they were, to developing my own ideas, and then pitching them, and asking them for brutal feedback. Over time, having access to these varying perspectives in an expectations free manner, in a way, made it easier for me to form my own style and solidify my own perspective, unique to my own skills and my own personality and abilities because there was no one person shaping my process. It truly is my process.

Beyond that, I spent a lot of time just reading, really anything and everything I could from the great investors that came before me from Ben Graham to more modern masters like Joel Greenblatt. Joel Greenblatt is the one that I identify with most closely probably.

G&D:

Could you talk about your time between Cantor Fitzgerald and when you went out to start Laughing Water Capital? What drove you to go out on your own and start the firm in 2016?

MS:

Somewhere along the line at Cantor Fitzgerald, I just became really disillusioned. The job was very much a commission-generating role, and to generate commissions you're really trying to generate a lot of noise. And as a salesperson, I didn't even know the businesses that I was talking about. I was just creating noise. So, again, I started from zero, but as I began to educate myself, I realized how ridiculous it all was and started to take notice that the people who generated the most commissions and traded every day – a lot of these were the bigger mutual funds – were not really getting much return on that compared to just owning the S&P 500.

> ***"I spent a lot of time just reading, really anything and everything I could from the great investors that came before me from Ben Graham to more modern masters like Joel Greenblatt."***

And then there were others that were not great clients, but you could look at their holdings and it was maybe 10 or 15 stocks. And oftentimes, they were just super disciplined on price. They would wait months for a limit to come in sometimes, and then wait years to exit the

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position. In any case, I wound up at a dinner with some guys that worked at the Royce Funds, which is a small-cap value mutual fund. I basically said to one of the guys at Royce Funds how I was just having trouble finding my place in this world because, to me, making all this noise was a complete waste of time. But then there were funds like the Royce Funds where they had a much more disciplined approach and they were buying small cap off-the-beaten-track kind of things, and sometimes, it would take them weeks or months to build a position.

And I'll never forget what the guy at Royce Funds said. His exact words were, "Oh my God, I think you might have a brain in your head." I guess before that point, he wasn't convinced. But he said, listen, go read Ben Graham, read Warren Buffett, read Joel Greenblatt, read Ken Fisher, read Phil Fisher. Read, read, read, read. And I took his advice. I went home and I started reading and it was like my doors were blown off immediately. I always think of it as if I found something I had been looking for my whole life, but I didn't even know it existed.

That's where the seeds of Laughing Water Capital were planted. I probably spent 34 of those next 36 hours just reading and trying to figure things out and basically getting myself pointed in the right direction after a couple of years of being pointed in the wrong direction. I of course also spent time learning accounting, and the other fundamental building blocks for successful investing, including becoming a CFA Charterholder. Laughing Water Capital is a long-biased investment partnership. I typically own 15 stocks with a focus on fundamental value that can be expressed in different ways. When I think of value, I tend to think of it as existing on a spectrum, from traditional Ben Graham-type value on one side to more underappreciated growth on the other end of the spectrum. I want to diversify across that spectrum. Most of my investments have lined up somewhere in the middle where it's a pretty good businesses that has some sort of quirky event or special situation or change. Something that makes me think that the stock market is missing something. And I'm biased towards small cap and domestic, although the strategy is unconstrained.

G&D:

Why did you call it Laughing Water Capital?

MS:

Laughing Water is a small community on the North Fork of Long Island where my family has a small place. And when I was a kid out there, it was more like just corn fields and potato fields. It's gotten a little more built up these days, but it's still a great place to go and forget about the world and read a book and think. The joke in the hedge fund world is you name your fund after the street you grew up on. But I grew up on Homestead Avenue and there are already 12 different homestead funds, so I had to dig a little deeper and that's where I got to.

> ***"When I think of value, I tend to think of it as existing on a spectrum, from traditional Ben Graham-type value on one side to more underappreciated growth on the other end of the spectrum."***

G&D:

When you look back at 2016 when you started Laughing Water Capital, what did you get right? What did you get wrong?

MS:

I think one of the things I got right was that I spent several years picking the brains of these portfolio managers I had access to through my sales and trading roles, asking them, "What should I do? What mistakes did you make?" And that expressed itself in two major ways. One of them is just deciding what you want your

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strategy to be. It is a commitment to say, "I'm going to stay as a small fund. I'm going to invest primarily in small-cap stocks." Right now the average market cap in the fund is somewhere around $1 Billion, but there are often stocks that are only a few hundred million in market cap. That strategy is not going to scale forever. Some people start up with a goal of getting to a billion in AUM. If I got to a billion, I'd have a problem because I don't think I could put a billion to work and maintain past outperformance. I'm very comfortable with probably, I don't know, call it $300 million. But a lot of people, they'll tell you that's not even big enough to have a viable business model, which I of course disagree with.

I was very much aware that I was choosing a path that would lend itself towards performance but not scale. And then the other part of it, there was a very heavy emphasis on the quality of the investors you take on as your limited partners. And a lot of these conversations were happening right around 2008, 2009, and 2010, when a lot of people who thought they had great partners realized that they actually did not. During those times when the market is going down every day and fear and panic are peaking, a portfolio manager needs to be thinking very clearly, which is impossible if you have partners that are panicking. So, I very heavily screen my limited partners and expect a multi-year commitment from everybody that comes in. And I don't think of that as a lockup being there to keep people in. I think of it as a commitment to a strategy that requires time to work, and to keeping the wrong people out. I do have some large family office partners, but the partnership base over indexes toward individuals, but they are very high-quality individuals. Think like individual investors who have been going to Omaha for the Berkshire meeting for 20 years. They're almost all fluent in investing. Like for example I've never had to explain to one of my LPs the definition of a special situation, or who Joel Greenblatt is.

"A lot of times, if you're looking for a change in three to five years, the first couple quarters of that can be really painful. It might involve increased investment that can depress margins."

G&D:

That's a good segue to get into talking about the concept of "edge". In your letters, you've articulated a few different buckets where you think your firm has a competitive advantage. Could you share some thoughts on that with our readers?

MS:

There's some overlap in what we just talked about. I think having sticky capital is a huge competitive advantage, especially with my style where I don't really focus so much on what happens quarter to quarter. I'm more thinking big picture. How is the earnings power of this business going to change on a three to five -year timeline? And a lot of times, if you're looking for a change in three to five years, the first couple quarters of that can be really painful. It might involve increased investment that can depress margins. And then the sell side is disappointed by that quarter and it's painful. But given my capital base, I'm able to look at those opportunities. Of course, I wish I could bottom tick things. But I've never met a value investor who said they buy things and then they go up right away.

G&D:

You've mentioned that you have a willingness to say "no" to pretty much everything. Are there any situations that most value investors might say "yes" to where you would actually stay away?

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MS:

My job is to say no. Everybody that owns a stock owns it for a reason, presumably. There's some pitch that somebody else believes. Why is that not good enough for me? The answer is that I want to outperform. I have to be super selective. And it's not really a direct answer to your question but I guess it's the way I think of it. I'm always surprised by how many pitches, even on high-quality forums like Value Investors Club, boil down to "it's trading at 14 times earnings and it should trade at 18 times."

That does nothing for me. In my mind, the multiple expansion part always must be the cherry on top, because that is speculative. That is trying to predict the madness of the crowds, in a way. And you could, of course, look at comps and everything else and M&A transactions. But you just never know what multiple you're going to get. So, the analysis should really be on how the earnings power is going to change. And there are an awful lot of investment pitches out there that never even touch on that. That's fine. That's how most people operate. I just think if you're running a concentrated portfolio with, call it, 15 stocks, you can do better than relying on mean reversion. You can find much more interesting stories that are not about mean reversion. Instead, it's about some sort of change that's taking place that will explain why earnings power will be meaningfully higher in a couple years.

G&D:

Matt, walk us through a typical day. How are you allocating your time? It would be interesting to hear if that allocation has changed or evolved since you started your fund.

MS:

My mornings typically start with my search process, which is very much keyword driven. I have a number of alerts set up to flag different sets of keywords that might appear in public filings or elsewhere. It's some combination of words that, over time, I've narrowed down to give me a reason to look at something. And it could be as simple as a tender offer, for example. If a company is making a tender offer, that suggests that they think their stock is undervalued. Now, that's a very simple example. A tender offer, by itself, is not super interesting. They happen a lot. But you can find ways to combine that data point with other things.

"In my mind, the multiple expansion part always must be the cherry on top, because that is speculative. That is trying to predict the madness of the crowds."

For example, one thing I always try to pay attention to is when management compensation changes off-cycle. Typically, management compensation is released in the proxy or maybe the 10-K and it typically happens at the same time every year. But if it happens in an 8-K in the middle of the year, for some unknown reason, and then they're doing a tender offer or making some other decision, it's a reason to say, "Wait a second, what's going on here?" A lot of times, that's five minutes because you look at it and don't understand it, or the incentives aren't aligned, or it's not a good business, or whatever it might be. But I always start my day by spending just an hour or so looking through what might be happening in the world to put things on my watch list.

From there, it's split between portfolio maintenance and working on new ideas. The best case is that I find a new idea I'm super excited about and drop everything. In other cases, it's sometimes just making some phone calls to people in the industry of a current holding such as former employees, competitors, and management teams. Other times, it's talking to other investors who maybe were involved with the name or are

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involved with a competitor or something. I'm just trying to understand what people are doing, how people are thinking, and how the landscape is evolving.

Lastly, there's always some time to just sit quietly and read something interesting. I think of it as part of my idea generation process. But it's very low hit rate and I think of it as what I call the "rabbit hole." You start reading one 10-K and maybe you see that they have a supplier that is really a key part of their business. Then you can read about that supplier and then maybe you notice that supplier has one large customer and maybe that supplier has a competitor, whatever it might be, and then you read about that one. It's a good way to just expand your universe and you never know what you're going to come up with. It helps round out the process.

G&D:

You've written about the way you spend your first hour on a new name is a lot different than most investors. Could you talk about that?

MS:

I start with a four-point process. It's understanding, one, is it a good business? And it's totally possible to make money buying a really bad business and hoping it gets a little bit less bad. There are people who have been very successful doing that. That's just not what I want to do because I sleep better at night knowing I own better businesses. What is a good business? It's everything from the quantitative metrics, returns on capital, et cetera, but also more qualitative. Just close your eyes and imagine, is this business going to look reasonably the same in five or ten years? Is this business tied to some sort of disruptive success that I don't really know how to underwrite? That's probably not for me.

The next one is, who are the people that are running the business and who are we partnering with? That could be the management team, that could be the board, that could be an activist, but I basically want to understand that there's somebody there with skin in the game who's making sure that decisions are going to be made effectively. Especially with small caps, that's really important. There are just tons of small caps where the chart has been flat for 30 years. It often comes down to bad incentives, and I don't want to get involved with that. The next piece is understanding how it does through the cycle, or what happens when something goes wrong. You can quickly look at 10 or 15 years of history and see how the business performed historically through a recession.

Something that's more cyclical isn't an automatic no. But you want to understand what you're doing and how it's going to function through the cycle. And it might be a cyclical business but if it could come out of a downturn stronger than the competition, that might be a good thing. All businesses run into speed bumps. What are they going to do at that moment? Do they have a history of intelligent capital allocation during difficult periods? Or do they have a history of panicking and doing something stupid? Do they have some sort of defensive revenues? Do they have a rock-solid balance sheet with a history of returning capital during downturns? Or M&A when competitors are struggling? Really anything to suggest that they can take advantage of a cyclical downturn in some way.

"I basically want to understand that there's somebody there with skin in the game who's making sure that decisions are going to be made effectively. Especially with small caps, that's really important."

And then the last piece is understanding why something might be cheap. Why does this opportunity exist? I place a high emphasis on understanding why I

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might be so fortunate to find this mispriced security, which ties back to what I said earlier about assuming I am the dumbest person in the room. If I can identify some reason that the market might be making a mistake, then that goes a long way toward identifying a margin of safety. I typically think of it as identifying some kind of optical, operational, or structural problem either with the business, or market mechanisms that explain why I am able to look at the situation differently than whoever the seller might be.

Assuming I get through all of those, and most often I don't, then I can start to think about price and what something might actually be worth. And then it is about really digging into each one of those four points to understand what the opportunity might come down and what needs to happen for earnings power to move higher, and for sentiment to improve.

> ***"Even just trying to reach out to management teams at a time where it's not the day after or the day of quarterly earnings, I think you get a whole different set of answers from them."***

G&D:

On the management point, how are you assessing management teams and their capital allocation prowess? Do you typically engage with management? And, if so, to what extent?

MS:

Yes, it's hard. A quick shortcut is just looking at their ownership and looking at the decision-making they've done over the past however many years. I almost always talk to management teams, and at least introduce myself. Typically, I'll introduce myself in an email before I even speak to them. I'll tell them that I'm with Laughing Water Capital, and everything we do is a three to five-year-plus view. We are not interested in your quarterly earnings; we're interested in the big picture and how the business is going to change.

I think that kind of sets the tone. If you talk to any CEO, they will tell you how frustrating it is to deal with however many people that want to ask about what's going to happen next quarter. Or if they guided in a range, whether we are leaning towards the high end of the range or not. And it's a waste of the management team's time to do that sort of stuff, and frankly, it's a waste of my time too. But for the vast majority of people in the investing world, that's where they spend their time.

Even just trying to reach out to management teams at a time where it's not the day after or the day of quarterly earnings, I think you get a whole different set of answers from them, and the conversation goes in a totally different way when you're the only one that they've talked to in two or three weeks.

G&D:

Could you go over how you think about answering the question, "why does this opportunity exist?" Why is that such an important concept to think about? In your letters, you've laid out a bunch of different situation-specific buckets that you like to fish in, so maybe you could talk about that as well.

MS:

With value investing, it all really comes back to a margin of safety. Historically, that was often quantitative. And I think in today's world, that just doesn't work the way it used to. If you look at everything from what Ben Graham was doing to Warren Buffett's early days to the Fama-French data, they all suggest that paying lower multiples works over time because, over longer periods of time, the market is a weighing machine, not a voting machine. But I think you have to be aware of the world we're in today where information is ubiquitous.

Back in Buffett's early

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days, you could look at something and say it's trading at one times earnings or two times

> ***"I think a more interesting way to come about it is to deliberately look at something that the quants will not find attractive, so something that is maybe optically expensive."***

earnings, and you could honestly say it's trading there because nobody knows this even exists. But in today's world, everybody with a laptop or a smartphone can instantly have a look at every stock that's trading at a low multiple. If it's trading at a low multiple, and everyone can see that it is trading at a low multiple, you have to ask, is it cheap for a reason? Has everybody with a simple screener already taken a look at it and passed? And if everyone has already passed, what does that say about the incremental buyer? Because while the market is definitely a weighing machine over reasonable periods of time, opportunity cost is real, and the data also show that over shorter periods of time, momentum trumps all. That is essentially value trap risk. Additionally, if you believe the research that J.P. Morgan has put out, they say that 80% of the world these days are making their investment decisions based on some sort of quantitative input. And that 80% is looking at those cheap stocks and apparently passing, because if they weren't passing, they wouldn't still be cheap.

I think a more interesting way to come about it is to deliberately look at something that the quants will not find attractive, so something that is maybe optically expensive. It's very easy if you're a quant doing no actual fundamental research to look at this and say, oh, it's trading at 50 or 100 times earnings, we're going to pass on that because Fama-French says that's not going to work. That's fine and I have no doubt that the quants are way more sophisticated than I'll ever realize, but at a very high level, the quants are making their decisions based on two sets of inputs.

One is trailing financials and the other is forward estimates typically from the sell-side. So generally speaking, if you're only making decisions based on trailing financials and the trailing financials are not meaningful because there's been some change in the business, well, then the market is blind to that opportunity or 80% of the market is blind to that opportunity. If the other piece is forward estimates and it's a stock that's small-cap and has very little coverage, the market is also blind on that aspect. I don't want to compete with everybody else. I'd rather be doing my own thing, and eliminating 80% of the market from the competitive pool is a great place to start. But then you also have to understand why it might be cheap and explain how those numbers are going to change over time, so that eventually, the incremental buyer that is not digging past the GAAP financials will have to take notice.

G&D:

In terms of what quant funds do and do not focus on based on their screens, would you lump in passive and index investing in that bucket? And then more broadly, do you think the rise of passive investing is a longer-term headwind or tailwind for active managers?

MS:

I do think about the ETF-ization of the world, if you will, and I think there are some very obvious problems with it. The first being that the S&P 500 index is market cap-weighted and float-adjusted, which essentially means that all else equal, the index will want to own more of a stock that's more expensive and the index will want to own less of a stock that has high insider ownership. That is nonsensical. You want to own more of something that's cheap and you want to own more of something where the management team owns a lot of stock.

ETF-ization is another

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one of those things in today's world where again, you have something that's expensive and the market just keeps buying more of it without anyone doing any work. It's just flows. It explains how things can get out of whack. I don't know how to think about whether that is a headwind or a tailwind. There's an argument that over the last 10 or 15 or 20 years, it has been a headwind as the money has flowed out of active and into passive. And we're at the point now where I don't want to say it's saturated, but I think it's more than half the market as ETFs at this point. So, you have to argue that it's not going to be as bad going forward as it was in the past, just by definition.

G&D:

Can you give an example of an investment that is optically expensive to quants and other screeners, but that you think is actually cheap?

MS:

Sure. Avid Bioservices (CDMO) is a great example. If you were to look at Avid right now, it looks like it's trading at 100 times EBITDA or something like that. Nobody would call that cheap. But it's not a typical disruptive growth story that's trading at 100 times EBITDA. That's not what it is at all. At its core, it's a manufacturing business. CDMO is a contract drug manufacturing organization and they're tied to markets with little or no cyclicality.

"There are maybe three or four sell-side analysts that are covering CDMO. The trailing numbers are meaningless. And even the ones that do cover it, they straight line their growth assumptions."

And if you're paying 100 times EBITDA for a growth company that's trying to change the world, you have to underwrite it in a different way. There are a lot of very difficult intangibles you have to value and questions you have to answer. What's the product? Who's the customer? What is the adoption curve going to look like? What is the competition doing? Those things are hard. And a lot of times, you need winner take all economics to make it work. But then you look at Avid Bioservices, and all they're doing is expanding their manufacturing footprint. So, for fiscal '23 (April 30th year end), they are guiding to $150 million in revenue. Within two to three years, they could have $400 million in revenue because they're expanding their footprint and will have $400 million in revenue capacity available by this summer. And at that point, the analysis comes down to a supply-demand conversation, which is a lot easier to investigate rather than adoption curves for some sort of new and untested technology.

You can look at the way the world is shifting towards biologic drugs or large molecule drugs, and there's just a severe lack of capacity. These guys are adding capacity. They're not the only ones adding capacity, but they have a real competitive advantage because they have a 20-plus-year track record with no regulatory problems with the FDA. And if you're a biotech and you're working on a new drug, you have a budget, and you have a burn rate, and you have a drop-dead date where you're just out of money. You cannot take a chance with an unproven manufacturer that either has no FDA track record or some blemishes on their existing track record. If you run into a problem with your manufacturer, you're going to run out of money and you're going to be bankrupt. So, CDMO has a huge competitive advantage in winning new business.

There are maybe three or four sell-side analysts that are covering CDMO. The trailing numbers are meaningless. And even the ones that do cover it, they straight line their growth assumptions where management has said, look at our track record, in the past, when we added capacity, we've filled it almost immediately. So, the sell side is thinking that it's

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going to take them five or six years to fill this capacity. The delta is 250 million in additional capacity. And then you look at the bigger players like Catalent or Lonza or some of these other big biologic CDMOs, and they add 500 million of capacity in a single year. Why can't CDMO do 250 million in two or three years? I can't think of a reason. But if they're successful, it's going to look like it's trading at 10 times free cash flow in two or three years. That is a really low multiple for a business that is arguably recession-proof, and certainly recession resistant, and benefitting from massive secular tailwinds that are fueling growth.

So, the current headline valuation looks like a venture story, except they're just building a factory. They're not trying to change the world. They're not trying to push some unproven technology, they're just adding another building, bricks, and mortar. Can things go wrong with the construction process? Of course. But they have a bulletproof balance sheet, a regulatory track record that you can't fake, and it has taken 25 years to develop that regulatory track record. It's a huge competitive advantage. And as CDMO shifts from something that people look at and immediately dismiss because at 100x EBITDA it's so expensive to "it's only 10 times free cash flow for a business that is super high quality." I think we're going to get really well rewarded.

G&D:

How did CDMO first come across your desk?

MS:

I've owned Avid now for, I don't know, six or seven years probably. And it started as this contract drug manufacturing organization that also had a pharmaceutical development arm and a management team that basically tripled the share count over a number of years in pursuit of some novel drug that they never really figured out. And at some point, an activist came along and told them that they were lighting an enormous amount of money on fire in pursuit of a drug that doesn't seem to work. At the same time, you have this business in the manufacturing arm that is a cash cow, and the trend is really going towards biologics and outsourcing. So, if you look before the Great Financial Crisis, most pharmaceutical companies did their manufacturing in-house and then they realized, we're tying up a lot of capital in this. And if you're in-house and you already have your inventory on-hand, then those assets are idle. But if you're a third party and you have one customer that doesn't need more inventory, then you bring your next customer on so you could run your assets all the time and get much higher utilization rates and much higher returns on capital. So, there's just been a huge trend towards outsourcing from the pharmaceutical companies. But this old management team was quite content to pay themselves a lot of money and just triple the share count. So, the activists wound up throwing them out, and then it became a pure play CDMO. They had some balance sheet problems in the early days, but they did a couple capital raises to repair the balance sheet and then they started investing in the future and it's been off and running since then.

G&D:

Another company that you own, Thryv (THRY), is a really interesting example of your "GoodCo, BadCo" framework. Can you give our readers an overview of Thryv, your investment thesis, and this framework?

MS:

I'll start with an overview of GoodCo, BadCo. We covered quants and how market participants that are relying on mechanical screens might look at something. If you're just looking at the headline, consolidated GAAP numbers and there's a business that has two different business lines and one of them earns a dollar a share and one of them loses 50 cents a share, on a net basis, you're making 50 cents

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a share. And then the market puts some multiple on those 50 cents. There are always some people that are smarter, and they'll do a sum of the parts, and I'm sure there are quants that are sophisticated enough to look past the headline numbers. But broadly speaking, the market will put a multiple on the consolidated earnings. And then the analysis at that point comes down to, well, what happens if they shut down that segment or business that loses 50 cents? And essentially, what happens is that if you shut down that money-losing business, overnight your earnings power doubles. Instead of looking like you're making 50 cents, now you're making a dollar. And that analysis comes down to human behavior and incentives and figuring out if the management team wants to pull the right levers to double earnings power overnight. I think it's often easier to underwrite how a management team will behave and whether or not they will pull those levers rather than to try and figure out future growth, for example. If the good business is reasonably stable, the analysis is almost entirely about how the management team will behave.

Thryv is an example of a GoodCo, BadCo, though it's a little bit different than the scenario I just described, and this is an example that is on the growthier side of the value spectrum for us. It has a very, very high, what I call, "ick" factor where people would look at this and wonder how I could ever own it. The legacy business is essentially the Yellow Pages, and here we are in 2023 and everybody knows the Yellow Pages is going the way of the dodo. And I don't disagree with that sentiment. Neither does management. Management is very aware that it is a business in decline, but it's also a business that kicks off a lot of cash flow. Perhaps more importantly, it gives them a huge competitive advantage with their other business line. And the other business is essentially a software product designed to help all elements of a small and medium business run its operations. Think of your local plumber. The old system was your local plumber maybe had a pile of sticky notes or post-it notes and an Excel spreadsheet and tried to keep his business together.

With Thryv, you can do everything from email marketing, to scheduling different teams to go to different locations, to texting the customer, to telling them when you're going to be there, to reminding them about service, to sending them their bill via text message. Everything is integrated through software. And what's interesting about this is that combining it with the Yellow Pages business is a huge competitive advantage for two main reasons.

First, Yellow Pages, or what they call marketing services, is kicking off a lot of cash flow. There are other software competitors out there, and over the last several years capital was free as everybody had access to that capital. But now, all of a sudden, the world has changed. And Thryv is able to internally finance themselves through the Yellow Pages business, which is a big advantage to not having to worry about capital markets. If you are a small pre-profit software company, as most of the competitors are, you have a problem in the current funding environment.

"If you are a small pre-profit software company, as most of the competitors are, you have a problem in the current funding environment."

Second, all of the businesses that are still using the Yellow Pages are potential customers for Thryv's software. There are still a lot of customers out there that use the Yellow Pages because it's actually the highest return on marketing spend you can get. It does not cost a lot of money to put an ad in the Yellow Pages, but you have people that find you. What Thryv is doing, essentially, is taking businesses that advertise in the Yellow Pages and calling them to pitch them on this software product. This is

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the natural customer base. Management calls it "hunting in the zoo."

You are essentially subsidizing your software sales force with a distribution advantage. 400,000 businesses are still using the Yellow Pages. So, you have access to these 400,000 businesses, all of whom are great potential customers for the software offering. And since you're calling them anyway to renew Yellow Page advertising, you're not even really paying your sales force anything extra. Now, at some point, those economies are going to degrade somewhat, but for right now, it's a big competitive advantage to have a direct line to your potential customers in place and have a sales force that is already calling on them, especially in end markets that are so diverse. With SMBs its not like one customer can make your whole year. It's a numbers game.

"I've actually talked to people who are software specialists about this name, and they've never heard of it because it doesn't show up on their screens. But this year, when they finally cross over, all of a sudden, it'll show up on software screens."

The next piece is that Thryv has the best software product at the lowest price point. There are other competitors, like HubSpot, who are bigger and say that they focus on small and medium businesses. But Thryv starts at five employees and HubSpot defines small businesses as around 50 employees. HubSpot has a freemium offering, which is tough to compete with, but it is very limited in scope compared to Thryv's offering which is about half the price of HubSpot's introductory paid offering. Thryv's software business is currently profitable in the U.S. The international side is a slight drag on profitability. For the first time this year, the SaaS revenue is actually going to cross over. It'll be a greater piece of the pie than the print revenue.

I think that's important because this business is still relatively unknown. One part is because of the "ick" factor. People hear Yellow Pages, and they don't even look at it. They don't take the time to investigate the SaaS opportunity. The next piece is that they came public through a direct listing. So, there was no roadshow educating people about it. And then the last piece is that it still screens as a marketing business because, historically, the Yellow Pages business has accounted for most of the company's total revenue. And the GICS system that categorizes businesses by industry and sector is based on revenue. I've actually talked to people who are software specialists about this name, and they've never heard of it because it doesn't show up on their screens. But this year, when they finally cross over, all of a sudden, it'll show up on software screens. At the very least, that will raise awareness.

From there, you can look at how their earnings power is going to improve. This is a growth story. They look at it and say that they can increase their customer count from around 60,000 today to 150,000 in 2027, while also growing ARPU by adding additional modules. At that point, they'll be doing $200 million in EBITDA. And if you look at what SMB software comps trade at, that suggests that the THRY stock could be up about 5x. We, of course, have to be suspicious of that, but we are not paying much for the potential today, and there is a massive secular tailwind in that SMBs have not yet embraced software the way that larger businesses have. And this is not winner take all SAAS. They are targeting less than 2% market share of SMBs, which does not strike me as super ambitious. But again, they have these competitive advantages that will help them get there.

And as soon as some people in the local business community start adopting this product, almost

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everybody has to. I think the adoption curve is going to get very steep at some point. Let's say there's three plumbers in a town and one of them can update you on their timing by text message, and send you your invoice by text message and make everything super simple. And the other plumbers, you can't even get in touch with them because they lost the sticky note that had your piece of business on it, and you're sitting around all day waiting for them to arrive. As soon as one person adopts this type of software, then everybody has to go in that direction or they're just going to lose all their business. And we can see already that this business grows by word of mouth because 30% of new customers are coming by referral these days.

I think the growth story is going to work, but if it doesn't, the other piece is that the Yellow Pages business produces a ton of cash flow. And right now, you have a fair amount of leverage on the business that was tied to the historic Yellow Pages business. But they expect to be paying it down really quickly. They're starting the year right now with $470 million in debt and expect to pay down $100 million this year. The de-leveraging story, by itself, is very good for the equity.

So, we have a couple years until we know for sure whether or not the growth story is going to work. But even before that point, just cleaning up the balance sheet should help improve the stock. There are obviously things that could go wrong, but there's some very easy-to-track metrics that could tell us if they're on track in terms of this transition from the legacy business to the future business.

G&D:

Tell us about Hilton Grand Vacations (HGV). What is your investment thesis?

MS:

HGV is basically a case where I think the market views it as a cyclical business with some ESG concerns. And I think that view is mostly misplaced. In actuality, it's much less cyclical than you'd expect. HGV is a cash flow machine on top of that. If you think of Hilton, you think of hotels. But that's not what this is. It's basically property management. And then, of course, there's a sales angle to it as well. But for the core business, 50% of revenue is recurring and another 20% is highly predictable because they have 25 years of cohort data showing how people upgrade their spending over time. And then 30% of revenue is tied to new sales. But that actually has a huge variable cost to it because the big part of the sales COGS is sales commissions.

People tend to be surprised that historically HGV has not been that cyclical. They grew through every recession prior to the financial crisis, and revenue was down only 3% during the financial crisis. And part of that is because it's not a true hotel where you're tied to business travel in a lot of ways. It's all leisure travel. It's stickier than business travel during downturns.

The other thing that's interesting on the culture side is that they do things a lot differently than the competitors. They use a fair amount of asset-light development. Rather than keeping all their buildings on balance sheet, they'll have an outside developer build a building and then they'll sell through the inventory. And that's interesting because it's a lower margin model, but it's also a much higher return on capital. I think that prioritizing ROIC over margin is the right way to think about it.

"It's much less cyclical than you'd expect. HGV is a cash flow machine on top of that."

Despite that being a better model, I don't think the competition can switch at this point because they're public companies. If they switch, then they have to explain how they are going to sacrifice margins and earnings. That is just very difficult to do in public markets. Stocks like Marriott Vacations would be

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punished if they did that. So, I think Hilton has an advantage in that they have the flexibility to do asset-light development.

The other piece is that they focus on new owner growth whereas most of the competitors spend most of their time upselling the existing owners. It's a lot easier to upsell an existing owner than it is to win a new customer. And that's important because, during a downturn, HGV can actually lean more heavily on existing customers, whereas competitors are already leaning on existing customers. That allows HGV to do better in a difficult period. And a big part of the reason they're able to do that is because they're tied into the Hilton loyalty network which is 140 million members strong.

It is a huge advantage in this business to have access to a brand and a loyalty network. And I'll explain more about that in a minute.

You're just paying a low price today, roughly nine times normalized cash earnings. But more important than that, there's a clear path to see how earnings are going to improve over time. I mentioned it previously, but HGV has 25 years of cohort data showing how customers spend more as they age. So, just the new owners that they've added over the last couple of years, 25 years of data say that those people alone are going to drive earnings power higher. So, you have a low starting multiple with built-in growth.

But where it really got interesting for me is that they recently acquired a non-branded competitor, Diamond Resorts. Having a brand in this business is a huge advantage. The simplest way for me to illustrate that is, in this business, when you have unused inventory, you basically make it available to the general public. And if you're unbranded, what that means is spending a fortune on Google search or the OTAs. Diamond was running their rental business at a loss. If you're Hilton and you have unused inventory, you just make it available to the millions of people on the Hilton Honors network. It costs you almost nothing to do that. And they have a relationship with Hilton Hotels that sees Hilton Hotels get a cut. But basically, they're able to run that business at a 35% margin.

You can just take Diamond's historic rental revenue and put HGV's rental margin on it and underwrite revenue synergies of about $100M in EBITDA from this transaction. But the management team has never spoken about those revenue synergies. They talked about the cost synergies, but they've never talked about the revenue synergies. And if you look at the go-forward estimates that they put out in the merger proxy, you could say that they're not baking in any of these revenue synergies. If you look at the very limited analyst universe that covers it, they're basically straight lining their estimates right along with the merger proxy. But in reality, there should be a huge uplift from combining the Hilton brand with the non-branded properties. And it's not just on the rental business. There is also a huge advantage in customer acquisition costs when you have a brand. A huge portion of HGV's customer acquisition is from people who are already booked into a Hilton Hotel room and then call the Hilton hotline to ask a question about their room. And then the operator can ask if they would like to learn about the timeshare options. So they have an inbound funnel, versus competitors that are out there with kiosks in the mall or something.

I think all the things that have worked for the HGV business, historically, are going to also work on the Diamond properties. It's just a matter of time. They have to rebrand and update things and integrate the computer system. So, it's probably a two to three-year process. But ultimately, I think it's a business you can look at and say on a normalized basis it generates a ton of cash, trades at a low multiple, and there's strong reason to believe it's going to become a share cannibal. The ESG and cyclical concerns keep the multiple low. The management team is

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aware of the true economics of the business, and they take advantage of that low multiple by buying back stock. Over time, you probably should see multiple expansion as people come to realize, wait a second, the float is shrinking by 3% to 6% every year as cash flow and earnings power is also growing. Those businesses don't stay at single-digit multiples forever.

G&D:

One thing that always comes to mind when we’re looking at cyclical stocks is trying to understand what it's going to take for the market to respect them. What do you think is going to drive that change in the sentiment?

“If you have good ideas, you're going to be fine. So, work on your ideas and then share them with people because if you have a good idea, there's automatically a target audience of people to speak with.”

MS:

A couple things. First, this business hasn't been public that long. So, if you want to see how this business actually did through the financial crisis, it's work. You have to go look at Hilton Hotels which was private at the time, but you can track down some of their stuff through their bonds that were outstanding to get to what actually happened at Hilton Grand Vacations. I think once this goes through a normal recession in public markets, people will see how it can actually perform during a difficult period. And you can look at the experience with COVID and that was very much not a normal recession because people literally couldn't travel. But in a garden-variety recession, I think people say, wait a second, this is nowhere near as cyclical as I thought it was.

Or the market will just look at it and say, this business, maybe it has some cyclical elements but it's chugging along and they're returning capital, they're shrinking the float. And there's plenty of examples of businesses like that, that people thought were cyclical in the beginning and then realized over time, they weren't as cyclical. The example that comes to mind is when Eddie Lampert got involved with AutoZone. People thought, oh, it's auto parts. Auto parts are cyclical. Well, turns out they're not when there's a big DIY market for auto parts. During a recession, people do more DIY work, and the business did fine. Every year, they grew earnings a little and they used a little more leverage to buy back stock. And over time, the multiple goes from 10x to 20x because people wake up and realize that this is working.

G&D:

Great. Moving on to closing questions. Do you have any advice for undergrad or MBA students who want to get into this industry?

MS:

The thing I would say first is that ideas are the currency of the investing world. And I'm a prime example. I didn't have the advantages that come from the right pedigree. I'm entirely self-taught. And if you have good ideas, you're going to be fine. So, work on your ideas and then share them with people because if you have a good idea, there's automatically a target audience of people to speak with. Anyone that shows up on the 13F list should want to talk to you, and you never know where that conversation can lead. One of the things that always baffles me is that I get a fair number of emails from people trying to break into the industry, specifically in undergrad, but grad school as well, where they say, hey my name is so-and-so. And they include their resume, and they say that they would love to talk. I always respond. But your resume tells me who you are. I don't care who you are. I care how you think. Send me something that shows me how you think, which means an investment

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idea, and then we should talk. And most of them, I never hear from again. But those that I do hear from, there's a couple examples of younger analysts that I still have ongoing relationships with.

G&D:

Last question, what do you like to do for fun outside of investing?

MS:

I have three little kids now so I try to spend as much time with them as I can, but historically, a lot of my hobbies were very good for investing. So, it's basically just activities you can do where you can let your mind wander. So, going for a hike, going fishing, skiing. These are all things where you have to be comfortable inside your own head and let your thoughts wander. I think that there's a lot of value that comes from that. You never know where it's going to take you. Maybe at some point later, you connect some dots that you came up with while you were hiking or fishing or whatever it might be. I'm just a big fan, in general, of those kinds of activities.

G&D:

Great. Matt, thanks for joining us today.

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