Tonus Capital Book – Chapter 2

Tonus Capital prides itself on the work it does, as the bulk of our efforts centre around conducting proprietary research and analysing information. There are limitless resources for financial and business reportage these days, and many of them are free, too, so it is easy to simply use what is already out there. However, there is often a conflict between the source of the information and the reader's interests. For example, if an investment firm has invested in gold and owns a lot of the precious commodity for itself and its investors, it will not be happy to see the price of gold drop. If this same company also produces research about commodities and where to invest, it will have a hard time telling the public to sell gold if it holds a huge percentage of its assets in that same commodity. This is when we find conflicts of interest, in that the firm is torn between protecting its investments and also producing fair and accurate data. My favourite example is from a few years ago, when a Canadian bank released favourable research about the Toronto condo market, although the public already knew the entire market was clearly inflated and in bubble territory. But because that same Canadian bank underwrites more than half of all the mortgages in the Toronto market (in Canada, actually), of course it cannot tell the public there is a bubble because that would deter further investment, which would be detrimental to the bank's revenue. So, they produced a report that was inaccurate – if not fraudulent – to protect their interests at the expense of the Canadian public. Given the propensity of investment firms to behave this way, we do not care for their insights and comments. We know that we can only rely on ourselves to formulate our own opinion based on facts we find through our own hard work. This is what helps us ascertain the best approach – using our own proprietary research - for our investments.

There is another very troublesome conflict of interest with the stock reports that banks produce about specific companies. Let's say that Bank A does investment banking work for public companies, like helping them raise funds and go public with their shares. Bank A is also in the brokerage business, which means making the market between buyers and sellers of these stocks, and they are paid commission for the transactions they handle. In order to have a good relationship with the company that wants to raise money (and be able to complete the financing and sell the shares to investors), the brokering side must issue a bullish – or positive - analyst report. Otherwise, the company, i.e. the client, will be angry and then investors will not buy their shares. The problem is that the bank (equity services) and the broker (reports and sales) are the same company. What kind of report will Bank A release if it needs that report to encourage sales of the shares? Do you think the bank producing the report can be trusted to tell the truth? If they tell the public the company is no good, they will not sell any shares and they will not make any commission. So, what style of reports do investment banks like Bank A tend to print when they are also selling shares in those companies? What percentage of these documents are negative reports? And what percentage are positive reports? (Hint: they are almost always good.) This, again, is why we never blindly trust what large institutions say about investments.

We talked in the previous chapter about "skin in the game", and how you should only invest your money in the same investments your advisor trusts for their own portfolio. Doing otherwise is accepting an inferior relationship between you and your money and your investment advisor. After skin in the game, our next guiding principle is that we conduct our own research on our own investments. Of course, we do pay attention to what others are thinking and saying, but as we just explained, it is very hard to trust what others say without knowing their motivations clearly. Ergo, this is where one of our other philosophies comes into play, which is the notion of being "contrarian". Let's contrast what Alexander Pope wrote with the common idiom:

> Pope, "For fools rush in where angels fear to tread."
>
> versus
>
> Idiom, "Go where others fear to tread."

Funny how we have two contrasting opinions on the same situation. However, we highlight this dichotomy to elucidate the problem of markets and humans: emotionality. On the one hand, we can appreciate why it is good to follow the herd and stay safe with the majority. But no one ever made history – or outsized returns - playing along with everyone else. Conversely, it is precisely when everyone is fleeing for the doors that opportunities arise. So, what does that mean in practice for Tonus Capital?

We will give you a more complete picture of our ongoing activities, but one of our first, daily exercises is checking the stock market results every morning for the worst performers from the previous trading session. Suppose we see that yesterday ten stocks lost over 10% of their share value. Typically, the markets and all its participants are correct to sell their shares when things began turning for the worse because the problems are known to all and the investment thesis has turned too bearish, or negative. However, out of those ten stocks that all plummeted, there might be one company that perhaps has not been understood well by analysts. Or it might be that the market has reacted too extremely relative to the current business conditions. This is where we start our work!

Now, just because something has dropped in price does not mean it is now a good value. It might be that the company is truly heading towards bankruptcy or irrelevance, and no one should buy their shares. However, there are also times when market sentiment and human irrationality supercede the best laid plans causing humans to err in their judgment and sell unwisely because they fear the unknown future.

Investment success is predicated upon discipline and eliminating the foibles of our emotions. Hence why we have developed various steps for deciding how to allocate capital. So, we start by being contrarian and focus upon today's unloved stocks. We do not follow the overall movement – or momentum – of the whole stock market because, again, we do not believe we can add value by following macro, or large-scale, trends. Our mission is to find bargains, which means we work with specific companies and their individual results. There are investors who believe you can profit from going with the overall trends in markets, and so you buy when the markets are going up and then sell when they are going down. Unfortunately, no one knows when the market is truly turning up or heading down. This idea is known as "timing the market" and lots of people think it is possible to do. Facts and evidence prove otherwise and it is clear no one – working honestly and fairly within the law – knows these things. This reminds us of a famous quote from the economic legend, John Maynard Keynes, who quipped,

> "The market can remain irrational longer than you can remain solvent."

In our opinion, this adage is warning against the commonly believed fallacy that a person can tell the best time to get in and out of markets. Innumerable are the investors who were wiped out entirely thinking that the market would turn in their favour, i.e. they had picked the right time. This foolishness is a terrific formula for capital destruction.

So, given that investing is challenging and involves a lot of uncertainty, how do professionals make a living at it? Probably the most nefarious aspects of finance are the way certain representatives play up the idea that managing money and making investments are complicated and hard tasks. They are not. They are very simple ideas and it doesn't take much intelligence to get involved in the business of stock

markets and such. What is difficult is figuring out how to make sense of all the information and maintaining the strict discipline that is necessary to generate positive returns. At the time of writing in 2018, the stock markets were continuing their inexorable climb upwards to new all-time highs. We are not fighting that current, despite how it works against our desire to find bargains on the cheap. What is even more problematic is how this decade-old trend upwards has encouraged many folks to trade for themselves, a practice often labelled “day trading”. Pretty much anyone who has invested in the stock markets over the past ten years has made some money, and these lone players tend to believe that any fool can do this, hence they believe that there is no need to pay for expert management. This is a compelling argument and hard to counter during the good times. The harsh reality is that the stock markets do not care about expertise or talent. Stock markets do what they will, when and however they will, and no one can change that. Nonetheless, it is on the downturn that things get interesting – if not terrifying – for the armchair stock picker. In the now immortal words of Warren Buffett,

> “You only find out who is swimming naked when the tide goes out.”

What he is really saying is that when stock markets are rising, it is akin to all the boats (stocks) on the water (in markets) rising with the incoming tide. But eventually the tide must go back out, just like rising stock markets must eventually turn downwards again. Those who have determined a reasonable exit price, which is a hallmark of value investing, will typically sell and profit before the downturn. Those who are winging it and riding thoughts and prayers tend to do much worse.

We mentioned last chapter that one of our financial idols is Mr. Warren Buffett, and these days it would seem that almost everyone knows who he is, i.e. probably the most legendary investor alive. However, Mr. Buffett is a disciple of the man who many consider the father of value investing, Benjamin Graham. He wrote two seminal books that probably had more effect on investing in the 20th Century than anyone else’s works. If you are really keen to learn from where we come, we strongly recommend reading, “Security Analysis”, written by Benjamin Graham and David Dodd in 1934 when they were professors at Columbia Business School. This book laid the intellectual foundation for what we now call value investing. Then about fifteen years later, Mr. Graham published “The Intelligent Investor” in 1949, widely considered the practical handbook for value investing, which we also recommend very highly. Amazing that these books, written over 65+ years ago, still hold up in light of all the supposed “advancements” in investing since they were printed. Astonishing, really.

One of the most significant episodes in our firm’s history is a visit Philippe made to Omaha, Nebraska back in 2016. As a professor of equity investing at Concordia University, Philippe accompanied a university-sponsored field trip for several students to meet Mr. Warren Buffett at Berkshire Hathaway. While the students were excited about the opportunity, Philippe was the most excited! It turns out Mr. Buffett is truly as approachable and down-to-earth as his folksy writing and style suggest. And he is unquestionably brilliant. The best takeaway from a few hours spent with Mr. Buffett was his answer to a question about what he would do today if he had to start investing all over from scratch. The caveat? He would only have $1million cash to invest instead of the $100billion+ he has now. As he sipped his Cherry Coke, he answered that he would only invest in four or five stocks – in total - and go from there. Four or five stocks only!!! His idea is that you do not need to own all the stocks out there nor 100 or even dozens. If you focus upon a small number of companies, you are more likely to succeed because it takes so much to understand a company and its drivers of performance. At Tonus Capital, we are comfortable with fifteen to twenty stocks in our fund. Now compare the smartest living investor’s thinking with the

investments you hold and see if there are any investment managers doing anything like that for you right now, i.e. are you invested in indexes or funds with dozens and dozens of stock names? It is highly unlikely that your traditional banking advisor will allow such concentration like ours, notwithstanding how it makes compelling sense, which again speaks to the nefarious behaviour of so many players in finance.

To be continued…