Tonus Capital Book – Chapter 2 cont'd…

At this point, we would like to define our concept of Value Investing. We have covered a lot of the basics already, so now let us provide a cogent synopsis for you. This is our definition...

The Tonus Capital Definition of Value Investing

To quote renowned value investor Seth Klarman:

"When all feels calm and prices surge, the markets may feel safe; but, in fact, they are dangerous because few investors are focusing on risk. When one feels in the pit of one's stomach the fear that accompanies plunging market prices, risk-taking becomes considerably less risky, because risk is often priced into an asset's lower market valuation."

Investing in the stock market is an inherently risky proposition because there is no guarantee as to where a security's price will go. As Messrs. Buffett and Munger say, *"Uncertainty is the friend of the value investor."* However, value investors manage this risk by buying stocks at prices that limit their downside. For every company, no matter how good or bad its business model, there is a price at which it becomes a buy (all bad news is priced in and future potential is ignored) and a price at which it becomes a sell (all good news is priced in and future risks are ignored).

Value investing is about finding high quality bargains. When looking to buy a consumer item, such as a TV, you get more for your money if you wait for a discount or a sale instead of paying full price. This, in a nutshell, is our game plan: we wait for stocks to be on sale before we purchase them, that is, to trade below our assessment of their intrinsic value. As Mr. Klarman also said, *"A lot of stocks are cheap for a reason. A value investor will figure out the reason."*

In times of panic and volatility, market participants tend to focus more on risks and ignore opportunities. This drives down prices. Though it may seem counterintuitive, when prices plunge, there is actually less risk, given that negative factors are priced into the stock and the odds of further decline are diminished. As Howard Marks says, *"Investment risk comes primarily from too-high prices, and too-high prices often come from excessive optimism and inadequate skepticism and risk aversion."* That doesn't sound like the herd-like behavior around the tech stock bubble's inexorable rise, does it?

It is during downturns that we want to be active because that is when bargains can be found. Most of our value purchases carry a small potential loss, as most of the price decline has already taken place, i.e. most of the risk is already priced in by the market, and the promise of a decent long-term potential gain, once investor apprehension abates and the stock's discount to intrinsic value wanes. It then becomes a waiting game as there is no predicting when investors will once again embrace the stock. However, if our downside is quite limited, then risk becomes the opportunity cost of prices treading water for an extended period of time.

Again from Mr. Marks, *"The choice isn't really between value and growth, but between value today and value tomorrow…value investing is based primarily on analysis of a company's current wealth."*

And as a company's information and its circumstances change, we are always re-evaluating our investment thesis about the company's downside risks. We continuously update our targeted exit price following the publication of the results, because our preferred sales threshold can always increase. Or decrease! As we already wrote, it is insufficient thinking to know when to buy if you do not know when to sell.

And that, in a one-page nutshell, is how we see value investing!

TCI Methodology

This next section might come across as a bit dry, but we do not pretend that the bulk of our work is glamourous. It is methodical and straightforward, which is where the hard work comes in. It takes a certain mindset and discipline to spend one's career analysing data. It takes mental fortitude to maintain constant vigilance and perform the same necessary, yet exhaustive, exercises. At Tonus Capital, we do not pretend that our work is ever complete because our industry is constantly in flux with new information daily.

So, what does that mean in practice? How do we go about making our decisions to buy and sell certain particular shares instead of others? Herein now is a breakdown of our regular and ongoing responsibilities that create the circumstances for Tonus Capital to make the positive returns it does.

On a daily basis, we focus on watching the various markets wherein our stocks trade. We do not make too many purchases or sales on an annual basis. However, we are always seeking more information, so we ask our target companies for updates regularly. We do this by making phone calls, participating in conference calls, meeting with investor relations teams, and even booking meetings and quarterly calls with CEOs, CFOs, and other members of the C-suite. We eschew third-party research and go directly to the source for all data on our stocks. Above all, there is much more an investor can learn from physical meetings and live phone calls than through mere paperwork alone, i.e. we study human behaviour as well as financial reporting.

We only hold about 15-20 stocks in our fund, and we might move on about 4-6 shares a year. This means we are not high-volume traders because we are not transfixed trying to capitalise on all price moves by the minute. That is not sustainable for a 30+ year career in the business and is why so many professionals burn out and move on to other roles. While there are many strategies for investing in equities, we have always worked at devising a practicable model that we can manage and replicate for decades. It's also part of how we analyse stocks, i.e. continuity. We like to invest in companies that look more or less the same today as they did five or ten years ago. And we like having some comfort that their business model is going to endure from today in the same way, more or less. We practice this with how we run our company, by ensuring it adheres to the same principles and guidelines from one year to the next. If you come in to visit us in ten years from now, we will all be doing the same things!

So, we will watch markets all the time, of course, but not to make short-term or trendy moves. We typically operate along a long-term cycle with each of our investments, i.e. three-to-five years, which removes a lot of the very short-term pressure to do something. On a weekly basis, the team sits down together to discuss the state of the public markets, the state of our current holdings, and we vet together any potential opportunities, as per our ongoing tracking of about 100 different stocks that have come down in price at some point. Our strategy is relatively clear: what is the opportunity for this share based upon its intrinsic value (i.e. our price estimate) vs. the market's value (i.e. the actual price)? We break down the drivers of performance for each company and work to estimate how those will impact the share price in the future. Generally speaking, we are looking for a price appreciation of +50% to +100% over our three-to-five-year time horizon. In other words, we want to double our money. When we are comfortable that a share's price has plenty of potential upward growth to realise, then we begin the process of buying a small amount to begin our investment. Hence why we prefer working with companies that have lengthy and comprehensible track records over a number of years. This is also why we struggle at times to evaluate tech stocks that are nascent without any real-world history of performance to measure and understand. If we do not understand clearly where the company has come from, it is then even harder to ascertain where it is going.

TCI Operations

Our monthly activities revolve primarily around reconciling the numbers we have on our side with the numbers our administrators have on their side for the fund's performance. This is a measure of security and a safeguard for all parties because there are two firms calculating the actual value of our fund. Together, this ensures everything is reported accurately. Our fund is open to buy and sell on the first day of each month. And, we need to know what that price is for clients to buy units of our fund. It is called the Net Asset Value, or NAV, and this is what one unit in our fund costs. We launched the Tonus Partners Fund at a cost of $10.00 per individual unit, so the NAV price today reflects the total return we have made since we launched our fund. We also charge part of our annual management fee each month.

Every three months, or quarterly, we send out our newsletter which discusses our fund's performance during the previous period, along with providing the actual data on our work to date. In January 2016, we elected to use a fund structure in order to simplify the investment process for our clients. There is now an easy platform for everyone to understand our performance and how our investments have done in each portfolio. It also simplifies end-of-year tax reporting for our clients, which is paramount given the many moving parts involved in our portfolio over the course of a full fiscal year. This makes depositing and liquidating funds very straightforward, too. Previously, we used segregated accounts, which worked well when we were a smaller shop with fewer clients and reports. Given our size and scope now, this is the optimal solution for everyone to enjoy transparency and clarity on what we're doing and how our strategy is working.

As for our annual activities, we are subject to a yearly audit from E&Y as a third-party verification of our activities. This report must be submitted to the local regulator to ensure our compliance within the existing legal framework. We issue annual statements of performance for every account to each of our clients. And we work with our clients on making contributions to registered accounts, for either their RSP or TFSA holdings. We also send out a Christmas card!

One last activity, which might be our favourite of all, is we are always available to meet and speak with our clients and potential new joiners. We do not believe there can ever be too much communication from our end and we know one of our missions is to educate people about investments. (Do not forget Philippe teaches equity investing at university as another way to enlighten and teach others!) In our experience, we all benefit when we share knowledge, hence why we call it our "Partners Fund" because we are all in this together, with all our interests aligned, so our mutual prospects for success are bright!