Chapter 2 Part 4 – 4 Pillars cont'd

Last time, we talked about the four overarching pillars that form our philosophy, and which we clearly define for all to see on our website. They concern the concepts of independence, concentration, transparency, and performance. We covered independence and concentration in the last excerpt, so now we are defining transparency and performance for you.

Transparency: Investing alongside our Partners

Tonus Capital's Portfolio Manager has invested a significant portion of his personal net worth in our fund, which assures the perfect alignment of our interests with our investors' interests. Furthermore, the employees of the firm are all investors in the Tonus Partners' Fund because we know this approach is beneficial for you as well as for us.

And we mention this because it is possibly the most important criterion for you, the investor, because without our money invested beside yours, you can never be completely sure your financial manager has your best interests at heart. It is only by investing your money precisely with your investment manager's money that you are guaranteed their very best effort. No other arrangement can match the almost sure certainty with which "skin-in-the-game" protects your wealth. So, if your financial advisor does not have the exact same investments that you do, then you are not getting the best possible results. It is truly that simple.

We have a transparent cost structure and we are strict adherents to always providing all relevant information for all concerned parties, from our partners to our auditors and the financial regulators. We have absolutely nothing to hide and are open to all questions. This attitude complements value investing well because our methodology is built on straightforward parameters, i.e. find durable bargains and buy them cheaply, so we do not need to cloak our actions in secrecy. One of the more seedy and nefarious aspects of the financial industry is there are many players who prey upon the uninformed by pretending this investment work is akin to rocket science. As already stated, no, this business is not that complicated. It takes a lot of disciplined and constant work. But anyone can go out and buy a stock on their own, so let us not act as if we are the gatekeepers to some arcane knowledge or unfathomable alchemy.

You may have heard of "hedge funds", which are a type of fund of investments – similar to ours – however these investments are treated as the domain of the rich only. And the business was conceived by financial players in the 80s who cooked up a model predicated upon, "You're not smart enough to understand or do this work." Which is patently false. The hedge fund scheme involved raising money from wealthy investors, while not disclosing how the internal investment criteria of the fund work. This is called the "black box", similar to the black box in airplanes that records all flight data. The black box concept soon acquired the status of Holy Grail in the industry and was allowed to remain private and undisclosed, which meant the financial managers never had to divulge their secret recipe for "success". Obviously, the book you are reading now proves that we have the exact opposite mindset and we are always open about telling people what we do and how we do it.

In fact, the lesson learned from the demise of hedge funds through the financial crisis is simple: if you cannot explain it to a ten-year-old, run away! Back in 2007, there were over 15,000 hedge funds globally, a total number which plummeted to less than 5,000 ten years later. Anyone can make money when all equity markets are rising. It is how you fare during the crises and loss periods that determine your worth as a financial professional. With the common hedge fund mentality that no one outside the fund itself is allowed to know how they make their investments, it can be extra problematic when there are market crises because the outside investor has no clue as to the hedge fund's tactics for dealing with such periods. We have survived the downturns very well since we began during the crisis itself and we work hard to make sure you always know how we make our decisions. This means you know exactly what you are getting into when investing with Tonus Capital. Please always remember that if someone shows you an investment which you cannot clearly explain to a random stranger next, then the vendor is likely taking advantage of you and your trust. You should not work with such people.

At Tonus Capital, we promote transparency with our partners. Therefore, our management and performance fees are explained clearly and simply, and can always be found on our website for public viewing.

Performance: Adopting a different point of view

We want to develop a different, or "contrarian", point of view from the rest of the market in order to identify opportunities that provide superior returns. Our approach is focused on discovering bargains and unpopular stocks that have fallen out of favor in the market. Recall that in a previous excerpt, we quoted Seth Klarman's line that a value investor will figure out why a stock has become cheap, and decide to invest or not based upon a clear understanding of its performance drivers. Which is another way to say we know why it's cheap and whether it's a good investment now.

Another key practice is that we invest for the long term, which to us means buying and holding a stock for three-to-five years. In the digital age, you might also find that there is more "noise" than ever in our lives. We suffer from the same in finance whereby there is no end to the commentators and "experts" who profess to know the immediate future and what is coming next. Charlatans! No one knows what the short-term future will bring, so we do not pretend to know definitively. But, we do believe you can identify trends with realistic probabilities of occurring – or not. We use extensive financial models for each company's share price based upon the data in their annual report and using industry-specific information. This is how we identify the probability for making a positive return. And as the situation changes over time with new data and company developments, we update and review our models to make sure we are still accurate in our assessment of the risk to our capital. Again, this is not the most difficult work on Earth, but it requires enormous effort every day and week to stay on top of all the many, moving parts.

Another benefit of our infrequent trading style is we are able to minimise transaction fees, which in turn helps to reduce the tax impact of capital gains. We work with a sensible and manageable number of stocks in our portfolio, typically between fifteen and twenty. If we hold these for a few years at a time, it means we do not sell them quickly and so we only need to find around four to six new stocks a year to replace the handful we sell annually. This might seem a small amount to select, but it still takes several analysts working together to source the pool of stocks from which our final selection is made. Before we spend our money on anything, we try as hard as we can to ensure we are not going to lose a single penny when we do so, and that requires a lot of careful consideration on our part before we decide to act.

Our performance is based on our ability to research stocks and pick ones that will do well. This is known as "active management", in the sense that we are actively working to choose and buy stocks. There is another school of thought that believes you can avoid thinking by simply buying every stock on the stock market and holding that without making decisions about it. This is known as "passive investing", or "index investing", whereby a manager will put every stock in the stock index into a fund for you to own. A popular version of this strategy is the "exchange traded fund", or ETF, which has exploded in popularity over the past ten years. The correlation of the growth in ETFs with the one-way unidirectional rise of stock markets has lulled countless investors to sleep and they believe they will always make money with this strategy. We beg to differ. At a certain point, the market is going to come back down again. Does the ETF investor then have to make a decision to sell? Or do they leave everything in and keep their fingers crossed for better performance to recover their losses?

This is a brief and facile treatment of the active investing versus passive investing debate, but it should highlight one of passive investing's inherent contradictions, which is deciding what to buy and when to buy and then when to sell it. Those are "active" decisions that have to be made at some point. Even worse, it is during this unprecedented upward trajectory of stocks that the industry has made outsized promises about these ETF investments and how they work, so they have exploded globally, and there are now over 4,500 ETFs to choose from. (On a side note, there are also now over 9,000 mutual funds in the U.S. alone!) We mention these numbers to highlight that there are too many funds available today and when the stock market turns down again for a material period of time, we expect many, many passive investors are going to suffer greatly.

Our Tonus Capital investment is not for everyone, and we can be part of an investment portfolio that also includes passive investments. Indeed, passive investing might be more suitable for certain asset classes, like large-cap stocks, than it is for others. But fair warning to all now, we have yet to see how ETFs function during a serious, prolonged downturn when the majority of investors simultaneously try to redeem their holdings and take back their money. History tells us that when everyone tries to get out at the same time, the results end badly for most. We are most curious to see how this type of passive investment – which is just computers making investment buy-and-sell choices as per their programming – fares when the stock market really crashes again. Our belief is that you need someone managing your money for you to ensure you do not lose your capital forever. And our impressive performance numbers bear out the validity of this thinking.