Fish the Ocean, Not the Pond

June 2024

"The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell." – Sir John Templeton

The Moerus Investment Philosophy

At Moerus, our Investment Philosophy[i] is predicated on the belief that great long-term investment opportunities can arise out of the market placing too much weight on negative near-term factors, obscuring or even completely ignoring the long-term underlying value of a company. We seek to take advantage of these transitory deviations between price and value by buying companies that we believe have survivability in the near-term and the ability to thrive in the long-term.

We believe the future is notoriously and inherently difficult to predict. As such, we don't try to forecast, and instead base our valuations on the "here and now" – what a company's value is *today*, not in some expected future scenario. While we utilize a bottom-up process in evaluating securities, we also seek to be "macro myopic, but macro aware," meaning that we *don't* make investments predicated on future expectations of macroeconomic factors, but that we *do* seek to deeply understand the influence these factors have on the fundamentals of the business as it stands today and where these factors may be in relation to a "normalized" environment.

What this all means is that we utilize an asset-based approach that estimates the Net Asset Value of a company using what we think are conservative estimates that weigh the balance sheet and the here and now <u>much more heavily</u> than projections or expectations of future earnings or cash flows. Simplistically, we try to buy shares of a business at a deep discount to the price we think it could get if it sold all of its assets today – a "bedrock valuation" – based on conservative assumptions. We believe that buying at a large discount to this bedrock valuation provides a cushion that not only provides downside protection, but also offers meaningful upside potential in the event of favorable future outcomes, which tend not to be priced into the stock at such beaten down levels.

As almost all securities that trade cheaply do so because there are significant perceived issues – be it in the form of technological disruption, industry transformation, a prolonged cyclical downturn, or a company-specific issue – we at Moerus focus heavily on identifying the myriad risks facing a company – both internal and external to each company and both at the individual company level and the portfolio level. In order to make an investment, we need to be confident that the company has the staying power and wherewithal to survive adversity and thrive when the situation normalizes. This results in an overarching preference for strong balance sheets, which we believe is one of the key attributes of survivability, although survivability can come in many forms.

Finally, it's important to note that, to us, risk is more nuanced, and we don't use the term "risk" without an adjective. To most investors, risk is a generic term representing the chance that a stock price will decline. Risk is widely accepted to be – in one form or another – a simple statistical measure of volatility, generally derived from the historic price movement of a stock. At Moerus, we believe that risk is significantly more complex than just a statistical measure of historic price movements and, as such, always use a qualifier to specify the type of risk we are talking about. We tend to embrace *Market Risk* (historic stock price volatility) as a positive, as it creates opportunities for long-term investors such as Moerus, while we seek to avoid *Price Risk* (risk created when the market's optimistic expectations bid prices up to reflect expectations for the future) and *Business Risk* (risk of a permanent impairment of our capital). Simplistically, our investment approach seeks

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to buy stocks where there is a disconnect between how the market perceives a security (*Market Risk*) and what we believe the company's underlying Net Asset Value is in the long term, and we seek to avoid companies that have optimistic future expectations already priced in (*Price Risk*) and companies where survivability is uncertain (*Business Risk*).

Simple, But Not Easy

This asset-based investment approach stands in contrast to those of most other investors, who tend to focus much more heavily on earnings and cash flows and their predictions of the growth of these metrics into the future. This generally leads us to eschew many areas of the market that are currently in vogue, focusing instead on things that are out-of-favor and disliked by others, where companies are discounted because of the market's expectations for diminished or subpar future and/or near-term earnings. These situations result in what we believe are security mis-pricings, where our view of the underlying value is significantly different than the broader market's view.

To do this, we believe we need to focus not on areas where everyone else is, which, almost by definition, is likely not cheap, but rather to find securities overlooked by others – *securities that are bargains but that don't look attractive to others*. We like to look where we believe we have limited (or no) competition. That means that we typically look where others **can't, won't, or just don't want to**. Some reasons for this limited interest from others may be geography (countries perceived as "riskier," emerging & frontier markets, etc.), weak expected fundamentals (technological disruption, industry reorganizations, multi-year cyclical downturns in the business or economy, etc.), or business complexity (limited sell-side coverage, foreign laws and customs, countries with quirky accounting conventions and/or business practices, multi-tiered holding companies, etc.). In all cases, we seek to sift through the perceived detritus of these situations to find gems, using the deeply discounted prices and time arbitrage to deliver future prospective returns to our clients.

This most often results in us taking contrarian positions. Although many investors claim they are contrarian, their portfolios generally look the same as most others', excepting small active allocations versus the index. A *real* contrarian is not just someone who takes a different direction from others for the sake of it, but someone who thinks differently about the same situation others are viewing. In practice, most investment managers seem not to be able to stomach a contrarian approach. For investors with short time horizons, the near-term uncertainty and turmoil inherent in these types of investments may likely rule out long-term opportunities. For investors worried about keeping a boss or clients happy, deviations from the index may entail too much career risk – never mind the prospect of investing in countries completely outside of the index! And finally, for investors who want an easy, enjoyable job, looking at the complex situations noted above may be of little interest. However, at Moerus, we believe these biases create opportunities for long-term investors. By utilizing a long-term time horizon and applying a differentiated perspective, we believe we can find rewarding opportunities overlooked by others.

This is why we at Moerus have a broad opportunity set. We have the privilege of being able to look beyond the United States (US), so the wider world is available to us. This allows us to focus our portfolio wherever attractive opportunities are instead of trying to replicate the index. All of this results in a relatively concentrated portfolio (currently 37 securities) that tends to look very different than the index. Our Active Share[ii] is typically above 99%. We are not different because it is easier, but rather because we believe it leads to better opportunities.

Too Much of a Good Thing?

We have written in the past about the growing complacency around index concentration that is the result of a decade-plus of growth supremacy and the potential risks this creates for passive

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investors. Since last writing about it in July 2023 (That ETF Might Be Riskier Than You Think), the problem has only grown worse. As of the end of May 2024, the Top 10 Holdings of the S&P accounted for a record 34% allocation - well above the level reached during the tech bubble (25%), the average over the past 35 years (20%), and the previous peak (30%[iii] in 1963). This level of concentration certainly doesn't preclude further upside for these securities and the index – a small handful of the largest-cap, most dominant securities drove a substantial amount of the S&P 500's performance YTD – but we do believe the truism that "trees don't grow to the sky." On the downside, this concentration would be disproportionately painful, just as it has been disproportionately positive in the recent past. This may all result in a risk that investors – especially passive investors – should be aware may be growing within their portfolios.

The silver lining of these historic levels of concentration is that they also create an opportunity for investors that are willing to look where the market's light isn't shining. We have seen examples of businesses with good fundamentals that have seen depressed valuations solely because they are not named "Amazon" or "Nvidia" and are thus generally uninteresting to many investors. In many cases, these are businesses with attractive growth prospects and good market positions, but that are outside of the small subset of stocks the market is clamoring for. Oftentimes, outside the US, these businesses are analogues for US-domiciled businesses that the market loves, but which just happen to operate outside of the US. Our opportunistic, global opportunity set and lack of a need to match index allocations allows us to take advantage of these opportunities.

One additional important factor that sets Moerus apart is our exposure to non-market-dependent sources of returns. In our opinion, our investments often have return characteristics that are less tied to the direction of the overall markets, being more driven by individual corporate events and developments (M&A, asset sales, recapitalizations, share buybacks, industry consolidation, spin-offs, etc.) and thus reducing our reliance on the market coming around to our view on the companies to surface value. We call these actions "resource conversions."[iv] While the timing of these developments can't be predicted, we believe that buying at a deep discount to NAV substantially increases the likelihood of resource conversions – developments that tend to be uncorrelated to market-level movements. In markets like today's, when historic levels of concentration in the index are driving performance – and the holdings within the index may be more and more correlated with each other – we believe that having market-independent sources of return should be a core allocation for all investors. Resource conversions were one of the key drivers of performance for our strategy in 2023 and continue to contribute so far in 2024.

In all market environments, arguably even more so in today's, we believe that the way to find mispriced investment opportunities is not to give in to FOMO (Fear of Missing Out) and compete with everyone else, but rather to focus on areas that are out of favor – where others aren't looking. Today, to generalize, many of these opportunities are in traditional "value" businesses, foreign companies, emerging and frontier markets, and smaller market cap companies. We would argue that buying the handful of securities that the whole market loves (US-listed technology and AI investments seem to be the flavor of the day) will not lead to discounted investments. In our opinion, having an opportunistic mandate that allows for looking beyond the US is a massive benefit and should be something that all investors make sure their portfolio has exposure to.

In summary, passive investing – historically perceived by many to be a "safer" approach – may indeed be becoming the riskier one. In all markets, we believe that looking where others don't is a way to generate attractive returns. While the risk to indexing may be growing – akin to the apologue of frogs boiling in water – the flipside are plentiful opportunities for those willing to look beyond the small pond they are currently fishing in.

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About Moerus Capital Management

Moerus Capital Management was founded in 2015 and is a 100% employee-owned organization. We run one global, deep value investment strategy that utilizes an opportunistic approach that results in a concentrated portfolio of securities in developed, emerging, or frontier markets where we are seeing the most attractive long-term opportunities. The investment team led by Amit Wadhwaney, Portfolio Manager and Co-Founder, has worked together for more than 15 years and has experience investing in most countries around the world.

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[i] We have written in-depth about our investment philosophy in the following Investor Memos: An Introduction to Moerus, Asset-Based Investing in an Earnings-Focused World, and Perspectives on Risk: How You Can Lose Money.

[ii] Active share is a measure of a portfolio's differentiation from a benchmark index.

[iii] https://www.morganstanley.com/im/publication/insights/articles/article_stockmarketconcentration.pdf

[iv] A term brought into our vernacular by the irreplaceable Marty Whitman, founder of Third Avenue Management.