The Joys of Pessimism

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I'm a pessimist. I see the down side in everything – gloom and doom everywhere, pitfalls and traps, dangers around every corner. I have always been this way – as a kid, I was the one who was known to carry around his raincoat. And, after all these years, I haven't changed.

Thankfully, it turns out that there is a profession ideally suited for the pessimist: Value Fund Management. As a value investor, an extraordinarily high level of pessimism is a hugely useful tool – for me it's an essential part of the toolkit. If used properly, pessimism is very positive. It can even be uplifting. Welcome to the Joys of Pessimism.

At Kennox we are very concerned about capital preservation – the return of capital, not the return on capital. The key is to approach all our stocks in the same way – like true pessimists – "Why am I being offered this apparent quality stock at what looks like a great price? What's wrong here? What's the catch?" It's then about doing the hard work – using this pessimism to reach the full conviction that this stock is special, from a capital preservation point of view.

We're not easily convinced – last year we added just 3 stocks.

To understand how pessimism can be used to deliver good absolute returns, with capital preservation at its foundation, we can examine a specific company and outline how, as pessimists, we gain conviction prior to a buy. The company is Fujikon:

- a family-controlled, contract manufacturer of acoustic goods, based and listed in Hong Kong.
- They design and manufacture headsets for the mobile phone companies and headphones for the music industry, for companies like Beats, Bose, Skullcandy, and Pioneer.
- It was founded in 1983 and listed on the HK stock exchange in 2000.
- It has a market capitalisation of US$100m – one of the great advantages and joys of our mandate is that we are not constrained by company size – we can search anywhere for great value.
- Fujikon has over 8,000 employees.
- It started out as an OEM but has evolved into design and ODM work, moving closer to its clients and up the value chain.

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Presented with the opportunity to invest, a pessimist has to be convinced that it satisfies a critical interrogation. To that end, we have created a checklist which encapsulates our pessimism and to which every investment idea is subjected:

- Track Record
- Don't Pay Up
- Non peak earnings
- Dividend paying
- Conservatively Financed

First on the Checklist is 'Track Record'. A pessimist's approach is to not be taken in by a decent set of recent results. A pessimist's first thought when looking at a recent, positive track record is to think "it's all a flash in the pan. I bet the recent earnings were a fluke, and I'll bet they can't pull that off again".

The only possible way to satisfy the critical voice is not by ignoring it but by digging in to the historic track record. Not just the last couple of years – that by itself often tells you very little. Rather, a track record of two cycles or more (if possible).

- How long have they been successful?
- How good are the good times?
- How bad are the tough times?
- How many times have they faced up to real difficulty?

Only by looking at concrete examples of the past can you convince the pessimist's critical voice that this is in fact an excellent opportunity.

Focussing specifically on Fujikon and the pessimist should be satisfied: a track record of over 15 years as a listed company and over 30 altogether with an earnings record that goes through stronger and tougher periods. Fujikon's track record shows a company that knows how to manage its cycle, and has survived tough times before. It's battle-hardened, and always emerged stronger and more competitive.

Second on the checklist is 'Don't pay up'. In practice this translates into the pessimist's question of "what are you being asked to pay for this great opportunity?" A good pessimist is really stingy and never

wants to pay up for lofty promises and high expectations – a margin of safety comes from buying quality companies at very attractive valuations.

In this scenario, the only way to satisfy the pessimist's interrogation ("Am I paying too much? It looks cheap, but I bet it's still risky and overpriced") is to use a range of valuation metrics, alongside hundreds of ratios from the track record. The key here is to make sure that there isn't reliance on any one metric or ratio. It takes far more than one or two numbers to gain an appropriate perspective on something as complex as a company. Overall we use almost a thousand numbers. It's the only way to begin to gain comfort.

Continuing with Fujikon, how does it stand up to this scrutiny? Fujikon is on 9x historic earnings, and it has a FCF yield of about 10%. EV/EBITDA is 2.5x. As well, it is trading on only 1x tangible book, so we had a degree of comfort that it is trading at a break-up valuation. These are the types of valuations where an investor can make excellent absolute returns. For the pessimists this looks attractive and translates into another tick on the checklist.

Third on the list is non-peak earnings. But why? A pessimist knows (better than most) that very few companies grow without fail for years and that none do it forever. An excellent example of this is Coke in 1998: it's a great company; it has an identifiable moat; it is a long term compounder. For this quality of company, an investor can be willing to pay up.

In Coke's case though, earnings fell in 1998. If you bought in 1998, you didn't make money in total return terms until 2011. We are long term investors, prepared to wait - but even we feel that 13 years without making absolute returns is not a great outcome.

But what of Fujikon? Earnings are neither at trough nor at peak, but between the two. Whilst our ideal is to be on absolute trough earnings, we're happy enough with the current situation.

Another approach to earnings is to take cyclically-adjusted historic valuations, averaging earnings over 5 and 10 years to see what the earnings power is through the cycle. Fujikon is trading at 11x the average of the last five years' earnings, and 9x 10 year's average. What this says is that if Fujikon is able to do even roughly what it has in the past, it is a good investment. This is not a company that needs to scale new heights to justify its valuation. Although not perfect, it passes our earnings test and satisfies the pessimist's demands.

The fourth item on the pessimist's list is the question of dividend payments. Kennox are minority shareholders in all our investments, so are beholden to the controllers. The Pessimist's concern is "Even if the operations do well, minority shareholders won't share in that success". A consistent dividend policy is a very good signal of management's attitude toward minorities and is a good way of aligning interests.

Fujikon scores highly on this – they pay a consistent dividend as the controlling family is keen to have the income. This gives about a 4.25% dividend yield on current prices. In addition, they pay special dividends when they feel they can afford it. This pushes the historic dividend yield up to 10%. This is a company who is willing to share with minority shareholders. For a pessimist this assuages concerns relating to how management treats stakeholders, particularly minorities.

The last item on the pessimist's checklist is conservative financing. A pessimist is keenly aware (and expects) that all companies will fall on hard times at some point. The default view for a pessimist is "I bet this is a good-times company that doesn't have the wherewithal to live through the tougher times. They'll be forced to go to the bank or into sales of assets at exactly the wrong time". The aim of this critical approach is to find companies that are conservatively managed with little debt and low gearing or (even better) net cash. This will see it through tough times.

On this point Fujikon scores well and meets the pessimist's inquisition: no debt and a high level of cash (50% of the Mcap) generated from cashflows over the years. This is a very useful margin of safety for when times get tough.

Although Fujikon meets the pessimist's challenge on its own merit, there is still one final consideration before a buy is triggered: we had to make sure it would fit into our existing portfolio.

We are avowed stock pickers. However, we know that good portfolio management makes our individual stock picks even stronger and that a pessimist's approach can help to position a portfolio so it will hold up in tougher times.

A pessimist knows that bad things will happen but also realises the enormous difficulty in predicting "the what" and "the when". At Kennox, we happily confess to being terrible at forecasting – it's a guess, and our guess is as good as anyone's. That is, likely to be wrong. We prefer to deal in facts and the only indisputable fact is that bad things can and do happen, and no-one can predict them all.

So how can an investor possibly prepare for the unknown disaster? Two ways. First, don't try to predict the future. Your inner pessimist should be warning you against this. Second, make sure you're not relying on traditional metrics (sector, geography, MCap) as your key diversification tool.

Instead, focus on ensuring that the underlying profit drivers of the companies in your portfolio are properly diversified. Be wary if they all rely on any one source – whether it's the US consumer, emerging markets, or a steep interest curve, cheap credit, or anything else. Think of this as the one-bullet approach to portfolio management – don't line your soldiers up so that one bullet can take them all out.

Considering a handful of stocks in our portfolio allows the pessimist to consider whether Fujikon would be a good fit:

- Munich Re is reliant on the global reinsurance cycle.
- Games Workshop relies on highly intelligent, middle-class, networked 10- to 18-year old males, mostly in the UK and the US.
- Western Union relies on global remittances from workers overseas sending money back home to places like Pakistan or the Philippines, Morocco or Mexico.
- Asia Satellite relies on middle-class and high-end consumers in China and India.

Does Fujikon, from a pessimist's perspective, fit? As we've seen, Fujikon relies on music- and sound-loving Western consumers. This couldn't be more different from the above stocks and so the pessimist is satisfied that the underlying profit drivers are such that there is unlikely to be a convergence of factors that affects them all simultaneously. With that conclusion, coupled with the checklist, Kennox bought over 4% of the company.

Welcome to the Joys of Pessimism. There's a world of opportunity out there. Unleash your own inner pessimist on it.

Delivered to the London Value Conference
May 2014