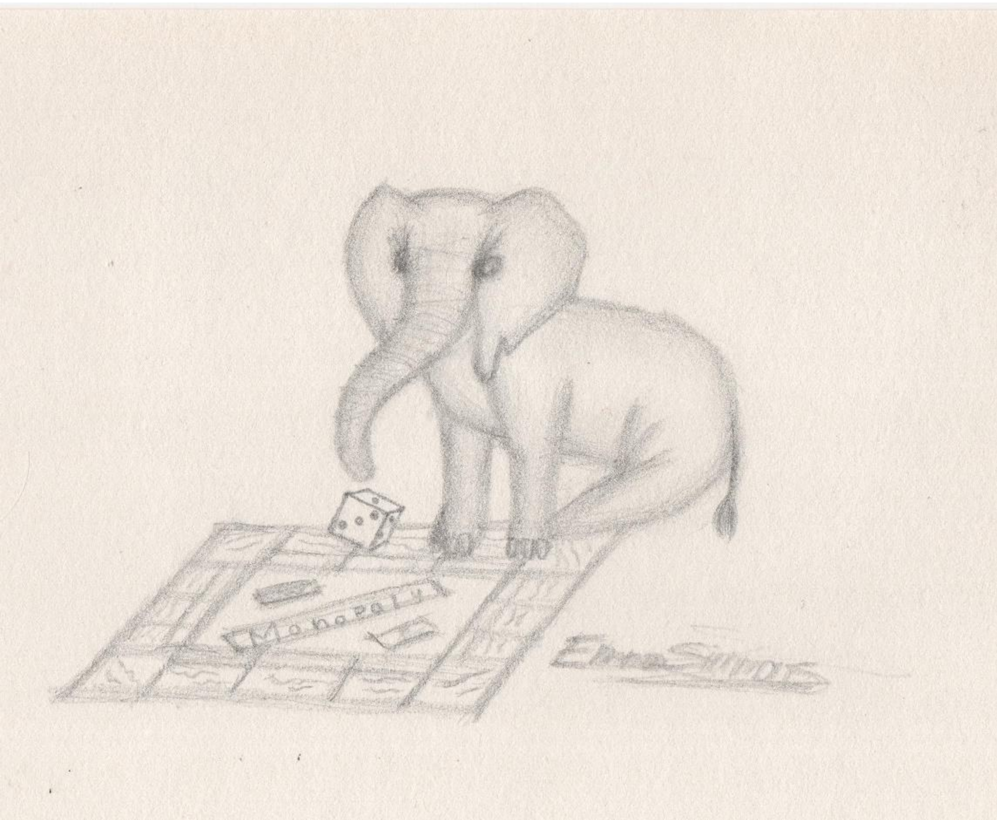
Dear fellow shareholder,

What is Value?



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As we tiptoe gingerly towards the institutional market, I am surprised by the distance between our perception of value investing and the received one. In virtually every meeting we need to explain that we are not value investors by the standards adopted by trackers, ETFs and most investment consultants. However, we are nevertheless confident that what we practice is value investing as many practitioners now recognise it. So, in this letter, I shall set out the taxonomies of investing and where value - in its many guises - fits.

Investing is the purchase of securities. We are concerned with stocks in this analysis.

Fundamental Investing is the purchase of securities with regard to the underlying characteristics of the business which issued the securities, most typically qualitative (what the industry is, how competitive it is, how good the management is) and quantitative factors (how much profit is generated, return on capital, leverage). This probably sounds unexceptional but, in fact, most investing today is not fundamental. Most index funds are not fundamentally constructed and they account for about half of stock ownership. Many other investors are either closet indexers, buying a basket of stocks hardly different from the index, or not concerned with fundamentals (traders, speculators, momentum investors).

Value Investing could be seen as almost synonymous with fundamental investing. All fundamental investors buy stocks they believe are undervalued but value investors as a class can usually articulate why. I suggest the following subtypes of value investing:

Relative Value Investing is buying securities that are cheaper on some metric compared to similar securities e.g. Pepsi is selling on a lower price earnings ratio ("p/e") than Coke. Or more broadly, a security is cheaper than the average security on a similar measure. For example, Pepsi is cheap because its p/e is 12 but the stock market as a whole is trading on a p/e of 15. Common alternatives to earnings as a relative metric are book value and dividends.

Heuristic Value Investing[1] is like Relative Value but the security is cheap compared to a well-known industry standard. In my banking days, pubs were often valued relative to the local population ("the chimney-stack" method) and nursing homes were compared to how many bed spaces they had. Today, asset managers are often measured relative to assets under management and fast-growing technology companies are sometimes measured relative to sales. Heuristic Value Investors are quite often also **Catalyst Investors**, that is they expect to realise the value through the company being acquired.[2]

Modern Value Investing is buying securities that are cheap compared to anticipated future cashflows (aka intrinsic value). This is the sub-sector made popular by Warren Buffett, following the example of his mentor Benjamin Graham. Cashflow can come from any source – earnings, free cashflow in excess of earnings or asset sales. Pepsi would be cheap in this category if its share price was $100 but anticipated future profits, discounted for inflation, were $200 per share.

Derby Street is a practitioner within the last category, Modern Value Investing. Presumably because this is the most subjective type of value investing (since it is reliant on projecting the future)[3], investment consultants and other advisers to the institutional investing market have found it difficult to define. One can objectively say whether Pepsi has a lower p/e than the average stock but it is a matter of opinion whether its price is less than its intrinsic value. There is therefore a tendency to conflate Relative Value (with its easier method of identifying value stocks) with all value investing.

[1] I have invented this term but the phenomenon is common
[2] But "cheap compared to a multiple of EBITDA" is plain wrong
[3] One could argue that all of the value investing styles I have laid out entail prediction but only in Modern Value Investing is that prediction explicit. Buying in the Relative Value style is sometimes rationalised as a belief in reversion to the mean – that Pepsi is so similar to Coke that they ought to trade at similar multiples; unfortunately it might just turn out that Coke is expensive rather than Pepsi is cheap

2

In the corporate finance module of my MBA, the teacher said the whole topic could be summarised in three rules:

Make good investment decisions

Make good financing decisions

Don't run out of cash

You could argue that the second rule is redundant. The best financing decision you can make in a business is to use little or no debt; then, in most cases, you won't run out of cash.

Monopoly, a childhood favourite board game I am now enjoying with my kids, strikes me as a good illustration of these principles: you simply have to buy property well (*Make good investment decisions*) and stay liquid (*Don't run out of cash*). Since Derby Street does not employ leverage we never run out of cash, so in this analysis of Monopoly I shall concentrate on the first rule. In fact, doing well in Monopoly means applying this simple restatement of Modern Value Investing: try to take out more than you put in.

Here are the prices and rents for the two most expensive streets on the board (all values in pounds)[4]:

	Park Lane	Mayfair
Price of land	350	400
Price of house/hotel	200	200
Rent, unimproved	70	100
Rent with 1 house	175	200
with 2 houses	500	600
with 3 houses	1,100	1,400
with 4 houses	1,300	1,700
with hotel	1,500	2,000

Let's say there are twenty rounds in a typical game and three other players. We'll also assume that another player lands on one of these two properties once in ten turns. That means you will earn (20 rounds x 3 other players x 0.1 chance of landing) = six lots of rent. To keep things simple, let's also assume that all of the costs and rents accrue from Mayfair. We can now calculate a Value schedule to show the costs and benefits of each level of investment.

[4] These are the prices from my childhood set. £350 would the cost of a good dinner in Park Lane now

	Cost	Value[5]
Land only	750	510
1 house	1,150	1,125
2 houses	1,550	3,300
3 houses	1,950	7,500
4 houses	2,350	9,000
Hotel	2,750	10,500

What do we learn? Land on its own loses you money, as does land with one house, and each new level of investment past two houses brings more absolute value. So – to win at Monopoly buy as many houses and hotels as you can (*Make good investment decisions*) without going bankrupt in the process (*Don't run out of cash*).[6]

But the lessons run deeper. Why make double your money (with two houses) when you could make four times (with a hotel)? In other words, sometimes the more costly the security, the higher the return.

3

Monopoly prints all the payoffs on each card; in investing we need to estimate them. In fact, since we know the prices of securities, almost the entire art of Modern Value Investing is in the estimation. Take a share we have been buying recently, Robert Walters plc. It is a recruitment company, long established in Asia, Europe and the UK. As you might expect its business has taken a hit during the pandemic, because companies are recruiting less. There are a number of precedents in the company's history, including the Lehman crisis, and the business has always recovered. Its earnings per share have compounded at just over 10% per annum in the twenty years since it listed, adjusted for dividends. Its pre-Covid earnings per share were around 50p. Moreover, it has accumulated substantial cash reserves, most recently stated at £1.82 per share.

If this were a Monopoly card, what would we be prepared to pay for it? Let's stipulate that the £1.82 per share of cash is the baseline value. If the business under our ownership enjoys at least twenty more "turns" (where each turn is one year of profits) we would additionally gain twenty years of cashflow. If the business doesn't recover, perhaps we will receive twenty times 25p in earnings (plus inflation). If it recovers and its earnings merely track inflation, we would receive twenty times 50p annual earnings. And if it reverts to its former good performance maybe we would receive something a lot higher, say 6% after inflation, which would be twenty times around 90p. Adding back the cash gives a value payoff of anything from £6.82 (downside), through £11.82 (base case) to £19.82 (upside). You can think of these as the Monopoly equivalents of unimproved land, land with two houses and land with a hotel.

[5] Each cost is the total cumulative price of two properties plus the cost of each house. Each Value is six times the average rent of the two properties. There is a further simplification, as in practice you would never experience the full twenty rounds with all of these ownership options; it takes a few rounds to assemble the estate and build property

[6] Playing with my kids is also a good revealer of character - the lies, the boredom, the tantrums. And the children get quite emotional, too

We paid an average price per share of £3.70. I hope this practical example illustrates how Modern Value Investing works. But it may also explain why what is institutionally called Value (but is in fact the Relative Value style) has underperformed in recent years. Relative Value as a blind tool has led investors to prefer lower quality businesses. Robert Walters is trading on a low cash-adjusted p/e, and its earnings are temporarily depressed, which would not screen well in Relative Value (as it tends not to look at the cash balance); but it is also one of thousands of companies with depressed share prices under lockdown. Most of them are poor quality. The typical restaurant chain, for example, is poorly financed (either with excessive debt or leasing) and faces highly competitive markets. Even in average times it will not have good economics. That deserves a low multiple. In sum, a portfolio of low multiple businesses, blindly chosen by ratio will largely be a collection of low-quality businesses.

The most opposed style to Value in the institutional matrix is called Growth, a screen selecting for companies with high growth (usually of earnings). Perhaps Derby Street is a Growth investor instead? Although growth is an important component of intrinsic value this does not work either, as it misses the important factor of valuation. A Growth company may well be better than a Relative Value one, but not at any price. You will recall that Mayfair with a hotel produced an expected return of £10,500 but if we paid £11,000 for it we would expect a loss. If we paid £10,000 we would expect a profit but perhaps not enough to win the game. Equally, Robert Walters would have been less appealing if the price were near to its base case value.

4

A possible objection to the Modern Value method is that there is no sense of how long it will take to make money or indeed how that money will arrive in the hands of shareholders. Companies will pay dividends and, on an unpredictable timetable, sometimes be acquired, but in most cases value investors of our type are waiting for other investors to see the errors of their ways and be willing to pay a higher price for the shares. This is a mysterious process and often a lonely one. Why can't they see what I can see now? Or have they noticed a problem I did not?

Investing is walking an elephant. The elephant is the business. It will go its own way regardless of you as an owner. If it is a strong, well behaved elephant its destination will be far and its journey rapid. If you have a short rope you will end up at the same place as the elephant at about the same time. And if you have a long rope you will end up in exactly the same place, only a little bit later.

The strength of the elephant is like the strength of the business. The distance covered is the appreciation in share price. The length of the rope is the multiple you paid. If you are buying stocks choose a strong elephant. And the longer the journey the less important the length of the rope becomes.

Thank you for supporting Derby Street. We look forward to speaking to you all soon,

Richard Simmons
Derby Street Managers Limited
Investment Adviser to the Fund

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