Positive Skewness

Introductions

- Pat Dorsey, CFA
  - Founder, Dorsey Asset Management
  - Former Director of Equity Research at Morningstar: Created investment philosophy, built team from 20 to 100 analysts, developed institutional research platform
  - Author of *The Five Rules for Successful Stock Investing*, and *The Little Book that Builds Wealth*

- Dorsey Asset Management
  - Single strategy, separately managed accounts
  - Long-only, all-cap, global mandate
  - Concentrated in 10-15 stocks

What We Look For

We focus on moats, management, and compounding potential because all three are sources of perpetual inefficiency.

Finding Inefficiency

"All of the information is in the past,
but all of the value is in the future."

(Bill Miller)

<u>Quantitative data</u> is efficiently priced

$$\overline{\int_a^b f(x)dx} = \lim_{n\to\infty} \bar{A}(f,n) = \lim_{n\to\infty} \frac{b-a}{n}\sum_{k=1}^{n}(\bar{f}_k) = \lim_{n\to\infty}\frac{1}{n}\sum_{k=1}^{n} x_{k+1}$$

$$= \lim_{n\to\infty} \frac{1}{n} \sum_{k=1}^{n} \left(1+\frac{k+1}{n}\right) = \lim_{n\to\infty} \frac{1}{n}\left[\sum_{k=1}^{n} 1 + \frac{1}{n} \sum_{k=1}^{n} (k+1)\right]$$

$$= \lim_{n\to\infty} \frac{1}{n}\left[\sum_{k=1}^{n} 1 + \frac{1}{n}\left(\sum_{k=1}^{n} k + \sum_{k=1}^{n} 1\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[n+\frac{1}{n}\left(\frac{1}{2} n(n+1)+n\right)\right]$$

$$= \lim_{n\to\infty} \frac{1}{n}\left[n+\left(\frac{1}{2}(n+1)+1\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[n+\left(\frac{n+1+2}{2}\right)\right]$$

$$= \lim_{n\to\infty} \frac{1}{n}\left[\frac{2n}{2}+\left(\frac{n+1+2}{2}\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[\frac{3}{2} n\right] = \frac{3}{2}$$

<u>Qualitative insight</u> is less efficiently priced

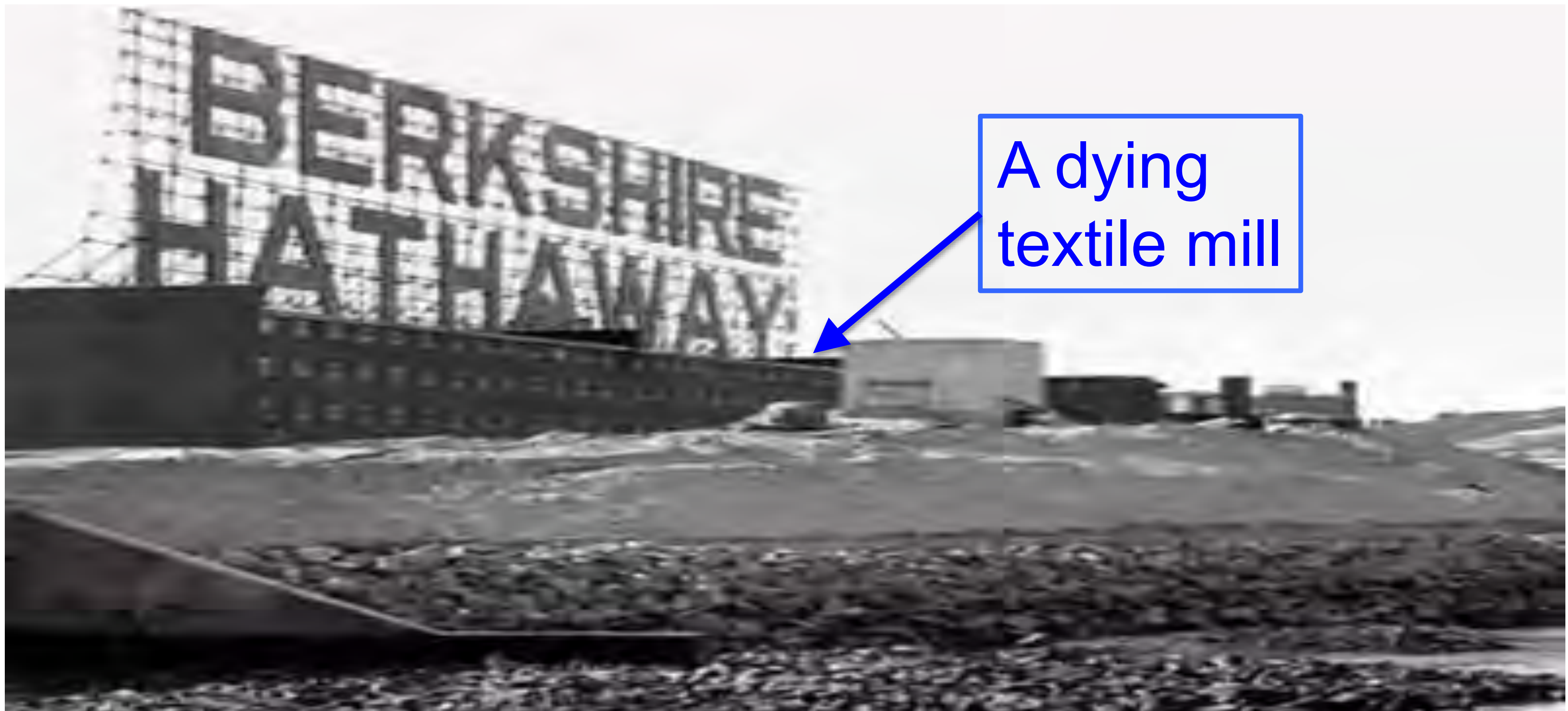
Agenda

- Horses and Jockeys
- Jockeys and Skeptics
- The Big Question
- Positively Skewed Managers
- Two Ideas

Jockeys & Horses

- “Good jockeys will do well on good horses, but not on broken-down nags.” (Buffett)
- Ciccio wins!

But Buffett Started with This…



Talk about a “broken-down nag”!

…And Created This

$300 billion

*This is not a recommendation to buy or sell a security.
Past performance is not an indicative of future results.

Wait – How Does That Work?

- A tiny minority of managers can create enormous value via astute capital allocation – even if they don't start with great horses.
  - John Malone, Bill Stiritz, Rales brothers, Brian Joffe, Li Ka-Shing, Brian Jellison, Brad Jacobs, Bruce Flatt, etc.

- Strangely, most investors doubt the decisions of such managers *even after they've had substantial records of success.*

The Skeptics Speak

- *"He/she will run out of targets."* (When?)
- *"We don't forecast acquisitions."* (Why not?)
- *"What if they blow a deal?"* (What if they don't?)
- *"You can't trust acquisitive firms."* (Like Berkshire?)
- *"They always use non-GAAP accounting."* (Since when is GAAP the gospel truth?)
- *"Anybody can do Lean."* (No, not properly.)
- *"Most acquisitions fail."* (True…but most ≠ all.)

“Most” & “All” Are Not the Same!

- Most corporate acquisitions destroy value
  - A true statement
  - So, investors generally avoid business models driven by acquisitions or capital allocation

- Most investors lose to the index over time
  - Also a true statement
  - Yet, we know a small minority can beat the market over time.

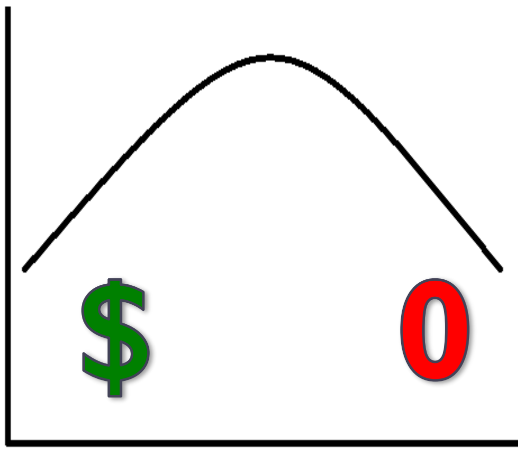
The Big Question

- *If a minority of investors can beat the market by investing intelligently, why can't a minority of managers create value by acquiring intelligently? (Or "allocating capital intelligently," if you prefer.)*

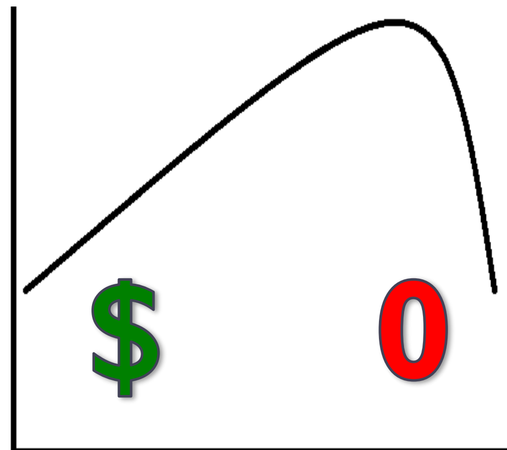
The Key: Positive Skewness

- For great managers, the distribution of decision outcomes is <u>not normally distributed</u> – it's skewed.

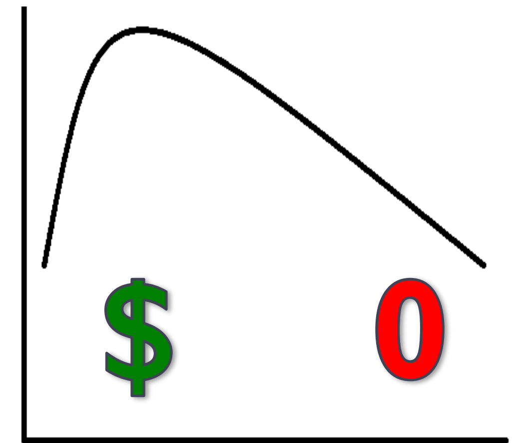
- Random Outcome



- Average Corporate Manager



- Buffett, Malone, Rales, Flatt



Positively Skewed Capital Allocation

- A rich source of market inefficiency.
  - Unpredictable -- Impossible for the sell-side to model.
  - Unconventional -- Creating value via acquisitions when most companies destroy value.
  - Lumpy – Value creation is financially messy, and comes in spurts rather than a smooth line.
  - Patient – Not focused on meeting short-term projections.

- *Structurally lowballed market expectations create enormous opportunity.*

What's the Catch?

- The managers are hard to find.
- You have to do lots of work to gain comfort.
- False positives abound.
- The stocks rarely look cheap.
- Investing always requires a leap of faith.

- But…getting it right can create large rewards

Idea #1: Roper (ROP_US)

- Technically, a "multi-industrial" company
  - (Like calling Google an advertising company)
- High recurring revenue & low capex:
  - Open-road tolling
  - Wireless water meters
  - Control software for gas compressors
- Some stats:
  - Gross margins = 55%+ / Op margins 25%+
  - FCF / Net income = 120%
  - EBIT growth =15% annually over past 10 years

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Roper: Acquisition Process

- Buy good businesses & make them even better with a long-term ownership mentality
  - Deals sourced at top – more disciplined
  - Cash return on investment focus
  - "Everything driven by the Vs" (variance)

- At 5% FCF/EV, is it "cheap?" No.
- But assuming 4b deployed @ reasonable deal multiples, worth ~$200/sh vs $145 with a high degree of upside optionality.

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Idea #2: PSG Group (PSG_ZA)

- South African holding company, listed in 1997 @ ZAR 0.35, now quoted @ ZAR 95.
  - I am not making this up. (Do the math.)
- Bulk of current value in three assets
  - Capitec: SA bank w/ consumer-driven model taking tons of share from incumbents.
  - Konsult: Largest SA network of independent wealth managers + sizeable asset management unit.
  - Curro: For-profit primary/secondary education provider filling massive unmet need.

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PSG Group: Main Assets

- Capitec undervalued @ 2.2x book, 12x earnings – for a bank w/ 23% ROE, 30% core Tier One, and a massive runway.
- Konsult undervalued given opportunity for margin improvement (20% EBIT is low) and expansion of asset management unit.
- Curro is not cheap – but has a reasonable chance of growing by 3x in next ~6 years.

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Thank You.

Questions?

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