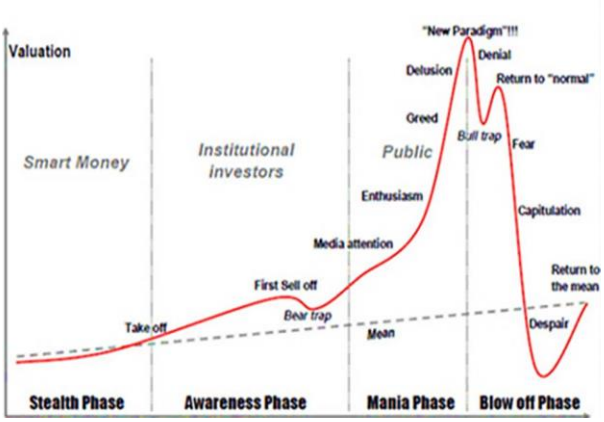
Intelligent Cloning

The Spring 2021 Edition

All of those risk models… They are great, until complete chaos happens. And then all the correlations break down and can suck you into a false security.

In this Edition on Intelligent Cloning we'll start with some thoughts on the quote above. Then we'll have a look at the idea of **Hyper Value Creators**, by looking at the Terry Smith Funds and the AAII Buffett Hagstrom Screener, and finally some comments on a study entitled "The Makings of a Multi-Bagger" by Alta Fox Capital Management. Enjoy!

The quote above is from Stanley Druckenmiller, Chairman and CEO of Duquesne Family Office. To put this quote into perspective, let's have a look at this graph from Dr. Jean-Paul Rodrigue, Professor of Global Studies and Geography, Hofstra University in Hempstead, New York.



Mathematical models work until they don't. During the stealth phase, the awareness phase and way into the mania phase you can build up a false sense of security by using these models. And then the bubble bursts anyhow. No warning signs.

For quite some time now, Howard Marks emphasizes cautiousness. "One of the smartest things I have learnt was back in the early 70s and wise investors said to me that there are three stages to the bull market, the first stage when only a very few foresighted people began to believe there could be improvement. The second stage when everybody knows things are getting better. And the third stage when people believe things can only get better forever. It is important to know which stage we are. We are certainly not in the first stage, we are probably not in the second stage. We have to worry about being in the third stage and that is why I think it is important to be cautious."

"The biggest risk of all is the possibility of rising interest rates. Rates have declined quite steadily for the last 40 years. This has been a huge tailwind for investors, since a declining-rate environment lowers the demanded returns on assets, making for higher asset prices. The linkage between falling interest rates and rising asset valuations is a good part of the reason why p/e ratios on stocks are above average and bond yields are the lowest we've ever seen. But the downtrend in rates is over. Thus, while interest rates can rise from here – implying higher demanded returns on everything and thus lower asset prices – they can't decline. This creates a negatively asymmetrical proposition. So today's high asset prices may be justified at today's interest rates, but that's clearly a source of vulnerability if rates were to rise."

Also Charlie Munger recently said that the U.S. Stock Market is overvalued, but he doesn't know when the bubble will burst. The inconvenient question to be answered is how much cash you want to keep aside to be able to invest when the bubble bursts, knowing that you don't know when it will burst.

Terry Smith

Terry Smith, founder and chief executive of Fundsmith, looks for companies with above average ROCE, gross margin, operating margin, cash conversion ratio and interest cover ratio. That is certainly a solid approach and the results speak for themselves: an annual compounded annual growth rate (CAGR) for the portfolio of 18.2% since November 2010. His way of working?

Buy good companies. Don't overpay. Do nothing.

Fundsmith Equity Fund

Here are the Terry Smith 10 Golden Rules:

1. If you don't fully understand it, don't invest
2. Don't try to time the market
3. Minimize fees
4. Deal as infrequently as possible
5. Don't over diversify
6. Never invest just to avoid tax
7. Never invest in poor quality companies
8. Buy shares in a business which can be run by an idiot
9. Don't engage in "greater fool theory"
10. If you don't like what's happening to your shares, switch off the screen

The 10 year CAGR of 18.2% is exceptional. He would do even better than that if he decided to just focus on Hyper Value Creators (HVCs).

So what is a HVC? Well, the Oracle of Omaha Warren Buffett once said that a good company is a company that earns a high rate of return on tangible assets. And the best ones are the ones that earn a high rate of return on tangible assets and grow.

What I am looking for is the very best of the best, the Hyper Value Creators (HVCs), and these are companies with an exceptional high Value Creation Engine (VCE), which is indeed a for growth adjusted Return on Invested Capital (ROIC) measure. In the Terry Smith portfolio there are quite some Hyper Value Creators:

Company	TSR (%)
Microsoft Corp.	787
IDEXX Laboratories	1318
Facebook Inc.	583
Intuit Inc.	683
Philip Morris Intl.	37
Visa Inc.	103
Starbucks Corp.	542
Qualys Inc.	603
Fortinet Inc.	746
Verisign Inc.	452
Paycom Software Inc.	2469
Mercadolibre Inc.	2647
Zoetis Inc.	413
PayPal	665
MSCI Inc.	1063

The TSR (%) is the 10 year Total Stock Return as per 23 February 2021. On average, that is a 10 year gross CAGR of 25.6%.

And if we look at the companies that did not make the grade of a Hyper Value Creator, the 10 year gross CAGR of this group of stocks was 17%, which is still great.

It makes a lot of sense to focus on the Hyper Value Creators. Invest in the best, forget about the rest.

American Association of Individual Investors

On March 10, the American Association of Individual Investors (AAII) covered the stock-picking strategy of Warren Buffett and gave us a list of 30 stocks that passed their screen based on Robert Hagstrom's extensive writings about Buffett's approach. You can find the article HERE.

Here is the list of Hyper Value Creators found in the 30 stock list of the Buffett Hagstrom screener:

Company	Market Cap	P/S
Fortinet Inc	30263	11,7
Medifast Inc	2918	3,1
Chemed Corporation	7100	3,4
The Ensign Group, Inc.	4907	2,0
Accenture Plc	166575	3,8
ABIOMED, Inc.	13576	16,1
Qualys Inc	3977	11,0
National Beverage Corp.	5204	5,2
Logitech International SA (USA)	16225	5,5
Humana Inc	53604	0,7
WNS (Holdings) Limited (ADR)	3899	4,2
Facebook Inc	765031	8,9
Arista Networks Inc	21623	9,3

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The 10 year average Total Shareholder Return, TSR (%), of the Hyper Value Creators is 760%.

Some might think that "the algorithm" is "just" another type of Buffett Munger screener. Yes and no. Of course I use the well proven Buffett metrics like return on invested capital (ROC/ROIC) , but there is much more to it. I believe that "the algorithm" better balances risk, growth and profitability than any other "screener" that I know of and also has a better approach towards ranking the stocks. But I am perfectly ready to be proven wrong.

Alta Fox Capital Management

Connor Haley founded Alta Fox Capital Management, LLC in April 2018. It's a long/short hedge fund based in Fort Worth, Texas. They scour the world for the highest quality businesses at the lowest possible prices regardless of size. This often leads to unusual corners of the market that the majority of institutional investors cannot or do not consider.

Their prototypical investment is a high-quality business that has not yet attracted significant institutional coverage, is not included in major stock indices, and has a multi-year profitable growth runway with high returns on capital. It is their belief that these undiscovered gems can produce attractive and often uncorrelated results relative to the broader market.

The Alta Fox 2020 Summer Intern Class Project, consisting of Owen Stimpson, Max Schieferdecker and Elizabeth DeSouza, analyzed the highest performing stocks over the last five years and identified their common characteristics, trends, and catalysts to identify strategies to find the next set of high performing stocks. These interns did a fantastic job. It's definitely worth reading. You can find it on the Alta Fox website.

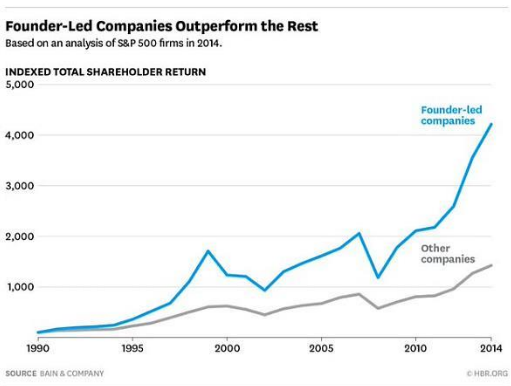
They researched the business of each company individually using a standardized 6-page slide deck format and compiled quantitative and qualitative data from all companies, analyzed it, and then drew conclusions based on it. Here are the 5 high-level takeaways and a framework to screen for future multi-baggers:

1. Look for businesses with advantageous positioning: 80% of businesses had moderate-to-high barriers to entry and 91% had moderate-to-high competitive advantages.
2. Spend time on financially healthy companies: 88% of outperformers came from a position of financial health in June 2015 and grew faster than the market might have anticipated. Looking for financially healthy companies, rather than turnarounds, is also less risky.
3. Acquisitions can create value: While many acquisitions fail to create value, the highest performing stocks often leverage acquisitions to bolster their returns. If you are looking for phenomenal returns, finding companies that make strong acquisitions will increase your odds of success.
4. Don't rely on multiples: While it is always better to buy a great business at a low multiple rather than a high one, many of the top performing stocks began with already healthy multiples – those multiples often expanded even further.
5. Be open to international companies.

The third one is an eye opener to me:

The highest performing stocks often leverage acquisitions to bolster their returns.

Thank you, Elisabeth, Max and Owen. Let me return the favor. What I would like to add to this list is: look for an operator-owner with skin in the game and/or a family-controlled business. Here is a chart that illustrates how founder led companies outperform:



I mentioned before that "the algorithm" has this ability to identify Hyper Value Creators early in their competitive life cycle. The algorithm was designed with something that's known as "reinforcement learning" in mind. Reinforcement learning, also known as "learning by trial and error" is one of the basic building blocks of the Artificial Intelligence programs used by DeepMind, to develop software that's able to play Atari Games very well.

I studied stocks that did very well over the last 10 years, like Amazon, Monster Beverage and Mercadolibre, looking for commonalities is terms of balance sheet strength, return on invested capital (ROIC) and growth. I put these insights into code and ran "the algorithm" on the financial data from 2005 to 2009 for all NYSE or

NASDAQ listed companies by then. The result was not very compelling.

Then I studied these mediocre results, identified improvements, put it into code and ran “the algorithm”. Again not very compelling. So I studied the results, etcetera, etcetera. And that’s what you repeat time after time, until you come up with something that actually works in terms of generating a list of 25 stocks with a high degree of multi-baggers in it, based upon the 2005 to 2009 financial data.

What you look for is something that worked very well in the past and what you hope for is that it will work very well from now on and way into the future. The Value Creation Engine (VCE), a for growth adjusted return on capital (ROIC) measure, is based upon the results of this reinforcement learning approach that I applied to the historical financial data of superior multi-baggers. Is this a winning formula? I just don’t know. But given its back test results, which you can find in the Winter 2021 Edition on Intelligent Cloning, it would be a fantastic act of omission not to give it a go.

I ran the algorithm on the 104 Alta Fox multi-baggers to find out if “the algorithm” was able to identify these companies as a Hyper Value Creator. Please find the results in the attachment.

For instance, Zynex, the first company on the list, was identified by the algorithm as a Hyper Value Creator in 2018, based upon the financial data from 2013 to 2017.

The algorithm was able to identify 25% of these multi-baggers in 2015. And since you only have to find a few ideas a year, I am more than happy with the result.

As you know, most of the todays great companies once started as a small one. And there comes a time when such a company, early in its competitive life cycle, catches up steam and steps on the path of “robust profitable growth”, or “profitable compounding” if you will. The algorithm surely helps to identify that moment in time.

So here we are

If I had to set up a new fund today, it would have almost the same characteristics as the Brown Capital Management International Small Company (BCSVX). That’s actually the fund where I “cloned” my latest investment in XPEL from.

Finding tomorrow’s star growth stocks today is not easy. What to look for are “exceptional growth companies”, with four qualities: solid revenue growth, a competitive, sustainable position in its industry, executives with a vision of the future and an ability to make it happen, and profitability to fuel and sustain earnings growth. That’s how Brown Capital defines it and I agree.

Many of the BCSVX holdings tilt toward e-commerce, electronic payments, smart logistics, cloud adoption and innovative health care solutions. German health care firms Evotec and Stratec and Canadian logistics company Kinaxis are amongst the fund’s top holdings.

The new fund I am thinking of would look for these type of Hyper Value Creators (HVCs) early in their competitive life cycle, when they are still small. The fund would be a stocks only fund. No leverage, no derivatives, no shorts, no bull shit.

Actually, I am looking for one or more entrepreneur(s) or strategic partner(s) with the courage to give it a go and who provide a critical mass of capital in exchange for economic participation in the fund. I am open to discuss a seed model based upon revenue sharing.

There is an Investor Presentation available. Let’s set up a ZOOM meeting to discuss it in a 10 minute presentation. Just send me an email: peter@thevaluefirm.com. For professional investors only.

Stay safe!

All of those risk models…
They are great, until complete chaos happens.

Peter

Peter Coenen
Founder & CEO
The Value Firm®
28 March 2021

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Everybody makes mistakes now and then. If you find any, let me know: peter@thevaluefirm.com. Always do your own research!

Attachment

Company	2015	2016	2017	2018	2019	2020
Zynex				x	x	x
Endor		x	x	x	x	x
Xebec					x	x
Appen						x
Fortnox	x	x	x	x	x	x
KORU/ReproMed						
ChemoMetec			x	x	x	x
Games Workshop	x	x	x	x	x	x
Genovis						
Xilam	x	x	x	x	x	x
Five9						
Jumbo				x	x	x
Hypoport		x	x	x	x	
Boohoo Group			x	x	x	x
Phoslock Technologies						
Clover						x
VOW ASA						
Bactiguard						
Pro Medicus			x	x	x	x
Intelligent Systems						
Semler Scientific		x	x	x	x	x
Keyword Studios	x		x	x	x	x
Hub24 Ltd						
Secunet	x		x	x	x	x
Future Plc					x	x
Casella						
Simulation Plus	x	x	x	x	x	
Frontier Developments	x				x	x
Altium Ltd	x	x	x		x	x
Biotage			x	x	x	x
Alliance						
Data3	x	x	x	x	x	x
Skyline Champion		x	x	x		x
Mensch und Maschine Software SE			x	x	x	x
Service Stream				x	x	
AB Dynamics	x	x				
Soitec		x	x	x		x
YouGov				x	x	x
Novanta						
Chegg	x					
Bouvet	x	x	x	x	x	x
GlobalData						x
Eckert & Ziegler						
Fever-Tree		x	x	x	x	x
Quidel						x
Exelixis		x	x	x	x	x
BioLife						
Mercury Systems						
VitroLife	x	x	x	x	x	x
Evi Industries	x	x	x	x		
EOS	x	x	x	x		

Company	2015	2016	2017	2018	2019	2020
BioVentix	x	x	x	x	x	x
Tristel		x	x			
MedCap						x
Enlabs						
Solutions 30						
LUNA						
Medistim ASA						
AMBU B						
Learning Technologies Group	x	x		x	x	x
Note				x		
Dicker Data				x	x	x
Aphria						
CargoJet						
Kitron				x		
XPEL	x	x	x	x	x	x
JD Sports Fashion	x	x	x	x		
Invisio	x		x	x	x	x
Kinaksis				x	x	
RWS Group						
Eldorado Resorts						
FOX Factory	x					x
Beijer Ref						x
Bachem						
ETSY				x	x	x
Biotelemetry			x	x	x	
Hexatronic			x	x		
Arrowhead						
Medios AG						
Amedisys				x	x	x
Design Group						
Ideagen				x		x
Sectra			x	x	x	x
Tomra						
ATOSS Software	x	x	x	x	x	x
Esker	x	x	x	x	x	
Bechtle						
LGI Homes		x	x	x	x	
Globalscape						
Datagroup				x		
City Chic Collective						x
Gamma		x	x	x	x	x
National Research Corporation	x	x	x	x	x	x
Troax		x				
Neogenomics						
S&T AG			x	x		
Salmar	x	x	x	x	x	x
Vitec						
IVU Traffic Technologies	x					x
Inphi		x	x	x		
Entegris			x	x		
Norway Royal Salmon			x	x	x	
Also						x