Excerpts from our 2019 annual letter

Below is an excerpt from our 2019 annual letter (I posted excerpts from our 2018 letter last year here). I have removed two sections about the portfolio and position sizing due to #compliance, but you can always contact my colleague Rob (his email is rsterner@rangeleycapital.com) if you're interested in seeing the whole letter or learning more about us.

Looking Ahead

On a more personal front, I got married in a small ceremony in mid-November. A popular rule of thumb among institutional investors is to avoid managers getting married or divorced, as the distraction of the big event leads to less time devoted to research. Having been through planning a wedding, I can certainly see why the rule of thumb exists: it's a really time-consuming process (my wife and I may disagree on the how much time we each committed to the planning process). After a great year for the fund, I hope we look back at 2019 and say that my wedding was a drag on the fund's performance, as that would imply our performance going forward will be substantially better. Of course, this single year represents a sample size of one; to really determine if our results were negatively affected by the wedding I would need to get married and/or divorced several times to build up a statistically significant sample set. While I'm all for rigorous research, I think I'll avoid trying to build out any more data points for this particular experiment….

In all seriousness, I think the quality of our work output and research process remained high throughout the year and has improved over time. Our strong results in 2019 were mainly the fruits of our work on the cable sector that began in 2017 and our work on the alternative asset managers that began in 2018.

We saw significant misunderstandings and mispricing in both of those sectors when we were working on them and thought we were buying them at significant discounts; in 2019, the market began to agree with us that each of those sectors were undervalued and had much brighter futures than the market had previously implied. My hope and expectations are that the work we did in 2019 will continue to bear fruit going forward and will drive our results in 2020, 2021, and beyond.

Speaking of go forward results, I want to discuss why I'm so bullish on our strategy and the fund going forward. But before I can do that, I want to take a step back and talk about the first four years of our fund's history.

Overall, I'm incredibly proud of the work we've done and excited about the opportunities ahead for the businesses we own, but I'm of a bit of a mixed mind about our fund's historical returns.

Our goal is to meaningfully outperform the equity market over a full market cycle while taking on less risk. Over the past four years, after fees and expenses (the only results investors should care about!) we have slightly outperformed the various equity market indices. On the positive side, we are aspiring to outperform over a full market cycle, and I suspect that this particular part of the market cycle has been less conducive to our strategy than most. In general, we're attracted to businesses that have some combination of less economically sensitivity, are more asset based, spit off lots of free cash flow, and are on the smaller side. The current market cycle has generally rewarded stocks that are the exact opposite of those types of businesses: larger tech companies, more economically sensitive companies, asset light companies, etc. The large cap growth index returned 27% more over the past 4 years than small cap value. That preference can't last forever; if we can slightly outpace the market when the stocks we tend to favor are out of favor, I think we'll be really well positioned to significantly outperform if and when the market environment ever changes.

So we’ve met our funds goal over the first four years of its life, and we’ve done so despite a market cycle that’s probably a bit unfavorable to our style of investing. So why am I of a mixed mind about our performance?

It’s because I can’t help but look at the past four years and be disappointed in a few of the investments we made (please note: I am using the term “we” here, but the mistakes fall completely on me). We’ve made a few mistakes and unforced errors that have kept our fund from drastically outperforming.

Investing is a probabilistic game; unexpected things can happen and we will be wrong sometimes. That’s normal. So why do these particular mistakes from the past few years bother me so much? Because several of them are investments I would not make again today if given the same opportunity. Over time my process for judging the quality of a business, the caliber of management and the type of risks I’m willing to take has evolved, and the historical investments that we got wrong frustrate me so much because they all had investment characteristics and risks that would cause me to size them much smaller today (or, in a few cases, simply pass on them completely).

My frustration with these unforced errors is also a key reason I’m so bullish on the fund going forward. I’m a much better investor today than I was when we launched the fund four years ago. I’m a better investor today than I was when I wrote you our annual letter last year, and I hope and expect when I write you our annual letter next year I’ll be better than I am today.

If we can slightly outperform the market over the past four years despite 1) a market that generally isn’t completely conducive to our style of investing and 2) the fact that a much worse investor than the current version of me was managing the fund, imagine how much better we can do going forward!

An investment in the fund is basically an investment in our team. The good news for you is our team and investment process continue to grow and get better. If we can outperform historically with a worse version of ourselves, I’m very confident the gap between the market and our results will continue to grow over time as we continue to improve.

Another thing that I think will drive our returns going forward? Larger size / more assets under management. An unfortunate truth of managing money is that, at some point, your size starts to become a limiting factor on fund performance because larger fund sizes begins to restrict the fund’s investment options. The good news for us is that our fund is far, far away from the point of our asset size being a worry for us. In fact, we continue to see positive results from growing our assets because doing so allows us to be more relevant to corporate management teams.

When we invest in a company, we often offer our constructive thoughts to the management team about what the company could do to improve their valuation (I spent much of my early career doing precisely this kind of work). We find most management teams respond very positively to our thoughts, as we try to offer them in a constructive and friendly manner; however, a few rogue teams will dismiss us due to our smaller size (in this regard, it appears size does matter!). Additional assets would cause these managers to take us more seriously when we approach them. Perhaps more importantly, larger scale opens up a range of financing options when talking to management teams; we can not only go to them and suggest they buy another company if we think the merger would be value enhancing, but we can tell them they should do so with cash and that we’ll backstop a share issuance or other type of financing. By doing so, we can create attractive economics for ourselves and help a facilitate a merger that creates a lot of value for other stakeholders. Over our fund’s life, we’ve invested into two private offerings (deals where we buy stock directly from a company) to help companies complete M&A that we thought was attractive. Both of those financings have been absolute homeruns for us: in one case, the stock was up 50% within six months of the financing, and in another the stock had almost doubled basically the moment the ink was dry on our financing. Will our luck be quite that good going forward? Probably not. But growing assets will present more of these opportunities to us, and I think we have the skill set to make the most of them.

Another example where growing asset size could help our fund is in our distressed credit investments. This year, a company we had followed for a long time filed for bankruptcy. Post filing, we bought a significant amount of their debt for less than 90% of face value and joined the company’s creditor committee. While I do not relish the prospect of joining another creditor committee (it can be quite time consuming!), the whole experience should prove well worth the investment: our debt will be paid off at par in the next few months. Given we bought it at less than 90% of face value, this will result in a >10% return in well less than a year from an investment with no correlation to the overall market. Increasing our asset size should present us more distressed opportunities like this one and open up additional options in distressed opportunities (for example, with large enough scale, we could offer the company financing at attractive terms to help them come out of bankruptcy).

The bottom line: there are some great opportunities that we are finding which we could take full advantage of with a modestly larger scale, and I think that additional scale would be a good thing for all our stakeholders. If you are or have considered adding to the fund, I think it’s a great time to do it, and Rob or I would be happy to speak with you about it. Moreover, if you know other investors who may be interested in our strategy, we’d love to meet them.

Somewhat cheesy sales pitch aside, I hope that at this point in the letter you share the same confidence in our fund’s outlook as I do. We’re better investors today than we were when we launched, and combining that increase in skill with an increase in opportunities that comes from a slightly larger asset base, we should be able to build on an already solid track record going forward.

As always, please reach out if you have questions about the portfolio. We will be hosting our annual call in early February to go into more detail on the portfolio. Please reach out to Rob or me anytime if you have questions before then (or after!).

I am honored to have you invested alongside us, and I am excited for what the next year holds.

Sincerely,

Andrew P. Walker, CFA