Askeladden Capital Partners Update – 10/31/2016

Dear Partners,

Two months ago, I cautioned you that we were benefiting from luck and favorable timing, and requested you to expect down months along our journey. Well, here we are – September and October brought a stealthy sell-off in small-caps. In the two months since my last update on 8/31, we're cumulatively down roughly ~4.6% (gross) vs. a roughly ~3.4% decline in our benchmark, bringing our YTD performance to ~+48.5% gross vs. +17% for the S&P 1000 Total Return index since our first day of trading (January 11th). Of this recent decline, ~100 basis points (1%) was accompanied by fundamental deterioration in a portfolio company's prospects, while the other ~360 basis points (3.6%) was actually accompanied by fundamental strengthening in portfolio companies' prospects (so we've been buying more.)

Let's start with the ~100 basis points. Although I've decided not to specify the company since it's election season and the company is in an industry likely to elicit equally strong and negative reactions from both sides of the political aisle, suffice it to say that recent changes in the regulatory landscape have caused challenges for the company and resulted in a materially negative revision to my estimate of fair value. (I try to keep politics out of my investing – my job is not to pine for how the world should be, but rather to invest our capital in a manner likely to deliver robust returns in the context of the world that is.)

This development falls more in the category of "existential issue that changes the business going forward" than the sort of "temporary setbacks" that affected companies like CSW Industrials (cyclical softening in energy-related markets) and Fogo de Chao (slightly fewer people visiting restaurants) earlier this year.

Obviously it's never pleasant when this sort of event occurs; frankly, given the Fund's still-exceptional YTD performance (>+47% gross), it would be easy for me to point to my >.900 batting average and brush this one event off as bad luck. However, that's not my M.O. My goal with Askeladden is to refine a repeatable, sustainable investment process that, absent severe market chaos, will reliably generate strong (double-digit, and hopefully teens) returns to investors over any given rolling three-year period, net of all fees. Most investors would like to achieve such returns, but if you talk to ten of them, you'll get ten different approaches on the best route thereto. Some investors view investing as a game much like poker – you're gonna win some and lose some, but if you bat a little above average over time, the results will add up.

My philosophy is much the opposite – *any mistake, in my book, is one too many.* Investing is an inherently probabilistic endeavor – that is to say, we're making best guesses about the future, and there is a wide range of possible outcomes. However, a large body of empirical research demonstrates that even extremely well-trained experts typically predict the future with poor accuracy; put another way, humans typically have a very hard time, *ex ante*, predicting the probability of future events. So when you see an investment case with logic that goes something like "the probability of the base case is 50% and the probability of the bear case is 20%," those numbers are typically pulled out of thin air with little to no relation to fundamental reality.

The tangible implication of this is that you can divide the investment landscape into two buckets. People trying to play poker – i.e., looking for situations where they have slightly better-than-average odds, and trusting that over time they'll be right often enough to make returns – or people trying to look for situations where *you don't have to know the probability distribution to win.* That is to say, betting only when the cards are so obviously in your favor that you're not going to win 51 or 52% of the time – you're going to win 90%+ of the time. The reason I prefer the second approach is that in the real world, unlike in poker, you can't mathematically know your odds ahead of time, so if you think there's a 60% chance you win and a 40% chance you lose, in reality it might actually be 60/40 the other way and it's a bad bet rather than a good one. However, when you buy shares in good businesses with good management teams and clean balance sheets at "can't-miss" valuations, even if things go horribly wrong relative to your expectations, things are likely to work out okay over a multi-year ownership horizon.

Circling back to the specific investment at hand, the thesis was more in the former rather than latter category – if it paid off, it would have paid off big; if it didn't pay off, it was likely to earn no or negative returns. It looked like a good risk-reward when I placed the trade, but in hindsight, I had no particular advantage in evaluating the probabilities of it working out or not – and consequently, despite the significant amount of research I'd put into the stock, I should have just moved on to greener pastures. Over the long-term, this small setback may actually be more valuable than a good outcome, which would have encouraged me to repeat that sort of decision-making. I wrote up a comprehensive post-mortem with 5 – 6 key takeaways to be applied to future investment decisions, including both behavioral and analytical lessons.

Here's the good news: my investment process still contained the damage; while the situation is still to fully play out, my best guess is that it will, at worst, result in a permanent loss of 50 – 75 basis points of our capital (i.e. 0.5 – 0.75% of the portfolio), and may still result in a modest gain (though not one commensurate with the time and effort I put into the name, which could have been better allocated to working on other ideas.) The company has lots of cash and a valuable technology platform that has elicited interest from potential acquirers at prices significantly above that at which the stock currently trades; I believe the most likely scenario is that the company gets acquired for a significant premium. Moreover, as I was cognizant of the risks, I sized this position much smaller than its seemingly attractive return potential would otherwise have dictated.

To this end, I'm in the process of developing a comprehensive risk-management framework to help mitigate the impact of future mistakes (which will inevitably occur despite my best efforts). This decision was inspired by a new mentor, who is an SEC-registered manager of a mutual fund and hedge fund with a 15-year track record of outperformance vs. relevant indices, while bearing substantially less risk (measured in terms of net exposure.) He is considered a value investing legend, our approach to analyzing securities is extremely similar, and I'm extremely grateful to be collaborating with him.

Moving on to brighter topics, despite price declines, our portfolio companies' businesses are fundamentally strengthening:

- Korn/Ferry reported in September that their executive search business has rebounded from a summer soft patch, a trend corroborated just this week by peer Heidrick and Struggles.

- TIER REIT continues to dispose of non-core properties at favorable valuations, and our conversations with local real estate brokers indicate that the Dallas and Austin real estate markets continue to be robust.

- Liquidity Services launched a new e-commerce marketplace, *IronDirect*, that is disruptive to the construction-equipment dealership model and will enable cost-focused users such as municipalities to save up to 50% in total cost of ownership over the life of the equipment. The launch attracted significant industry buzz (see here and here). Meanwhile, competitor IronPlanet was sold to Ritchie Brothers for a valuation over twice that at which LQDT currently trades.

- LGI Homes continues to handily beat its guidance – gross margins, ROEs, and sales velocity are all holding up well as they continue to expand their unique direct-sales homebuilding model outside the South into new markets like Seattle.

- In the face of a significant price decline on softening restaurant sentiment, Fogo de Chao's CFO purchased shares with his own money in the open market during September. Usually a very good sign.

- CSW Industrials continues to identify efficiencies, and is introducing seemingly well-regarded new products to sell through their extensive distribution network.

I take downside volatility more seriously than upside volatility: I'm always questioning, stress-testing, and reconsidering my investment ideas, making sure the market isn't seeing something I'm missing. However, periods like this should be viewed with gratitude rather than trepidation – they provide the opportunity to deploy capital. I noted in my last letter that we were down from the \$19s to the \$16s on Charles River Associates (CRAI) soon after our initial purchase of those shares earlier this year. Check out a stock chart – after two quarters of what we expected and one quarter stronger than what we expected, the stock now trades hands at >\$29. While we trimmed CRAI for more attractive opportunities along the way, I think it's a helpful mental model for what we're going through with some of the names listed. Price declines on no fundamental weakness are quite attractive to us and we fully expect that two years from now, all the stocks mentioned above will be trading at significantly higher valuations than they do today, while having grown intrinsic value through robust cash flow and growth.

Our cash levels are now in the neighborhood of 12 – 13%, slightly below my long-term target range of 15 – 25%, but appropriate given the abundance of attractive investment opportunities that have presented themselves over the past few weeks. I expect cash levels will drift back into the targeted range as we utilize new capital inflows to tax-efficiently trim some positions that have traded up toward fair value. Worth noting: 40%+ of LQDT's market capitalization is in cash, and only FOGO, LGIH, and TIER (representing a combined total of 21% of the portfolio) have more than very modest debt on their balance sheets, so on a look-through basis to the portfolio company level, we're running an extremely clean balance sheet.

On the business-development front, I'm happy to report that capital raising continues to accelerate. We signed our first 7-figure commitment along with numerous smaller commitments, including some from well-respected, long-tenured value investors. Given the large pipeline of "warm leads" to talk to and an abundance of research projects to work on, I'm not planning to do much lead generation (whitepapers etc) in the near term – but given strong results, will likely return to this early next year.

As always, I truly appreciate your investment and remain intensely focused on honing my craft, while, of course, striving to become the second-most-poised young 20something in Dallas. (I don't seem to have much of a shot at knocking Dak Prescott out of first place. But no complaints there – how 'bout them Cowboys!)

- Samir