Dear Partners -

I had to rewrite a decent chunk of this letter given recent news from Pfizer and Moderna, but I've never been happier to do so.

Through much of this year, we've focused on buying stocks that were beaten-down because of COVID-19 exposure, real or imagined. Basic research indicated that COVID-19 was a crisis with an end date, one that was likely to come sooner rather than later, whether via natural herd immunity or through a successful vaccination campaign. Yet many small-cap stocks did not even come close to reflecting this reality.

Despite the fact that many of our stocks are down significantly since the start of the year, the value of our portfolio is now (roughly) back to where it was pre-COVID, setting us up very well to more than make up the remaining underperformance gap to our benchmark as we head into 2021.

Interestingly, our portfolio and watchlist have not responded uniformly to the vaccine news in an internally consistent manner - in other words, some stocks responded with violent rallies, reflecting that economic activity will rebound sooner rather than later. Conversely, other stocks responded in a more muted fashion (and some almost not at all.)

We believe this is the type of environment where our strategy can shine - we'll discuss this more later, but we are redeploying capital into names, particularly illiquid micro-caps, that have been left behind despite the fundamental environment and stock prices of their peers improving substantially.

This quarter's public letter will be relatively brief (I hear sighs of relief already.) Please refer to the private portfolio commentary for our performance table and individual analysis of material positions.

Here, there are three main topics I'd like to discuss:

1. Some thoughts on our strategy's performance year-to-date,
2. Some thoughts on our portfolio management year-to-date,
3. Some thoughts on our research process.

First, a sentence or two on the recent election, one of the most contentious in modern history. As we have seen this year, government policies, such as COVID-19 restrictions, can indeed have a tremendous impact on individual businesses, for better (see: Amazon and Zoom) or for worse (see: airlines).

However, most of the time, the impact of policy is much more muted, and regulatory risk is merely one of many that we evaluate and weigh in our investment process. I've applied a value investing approach through multiple administrations and legislative power assortments, and remain confident that a bottom-up, value-oriented approach will continue to deliver superior risk-adjusted returns no matter whether the U.S. is run by Republicans, Democrats, or little green Martians (which some Americans might find preferable to either of the previous options).

Now, onward…

1) Learning and the Long Term

A while back, a friend sent me some posts from a popular value investing forum, which, as I recall, went something like this:

> *value investors have spent years bashing "overvalued" hot stocks such as TSLA, AMZN, etc, all while they've continued to dramatically outperform the market… at what point do you stop and ask yourself if you care more about intellectual purity or making money?*

It is an argument worth considering. I've benefited from acknowledging that I don't have a monopoly on good ideas, and absorbing lessons from others who approach investing very differently than I do. My investment strategy has evolved over time, both before Askeladden and during its now almost five-year existence.

I have previously discussed our shift away from purely multiple-focused "classic Graham value" to more of a middle ground that focuses heavily on business quality, and I believe I have done so enough times that it's not worth discussing here. Indeed, although it's unlikely that we'll ever purchase certain very popular high-multiple SaaS stocks, understanding the factors that make their businesses so resilient and strong have taught us lessons that we've applied elsewhere.

This year, a situation much like that in the forum post above has played out. After a multi-year period in which owning the kinds of stocks that we do led to substantial outperformance, both vs. the market and vs. most of our small/micro-cap fund peers, we found ourselves in the opposite situation this year, meaningfully underperforming both our benchmark and many of our peers whose letters we read.

In fact, some of our peers are having spectacular years despite the circumstances, for which we congratulate them - notwithstanding our strong conviction in the intrinsic value of our portfolio, money now is always preferable to money later. Even if our portfolio massively outperforms from this point forward, it certainly would have been nice to own a few more of the stocks that have done well this year, so that we could redeploy the winners into the laggards and achieve the best of both worlds. There's no glory in suffering and no points for difficulty. So we spent some time trying to figure out what worked well for our colleagues, to see if there was anything we could learn.

Looking at some of the specific winners in our peers' portfolios, not all of the companies are necessarily direct beneficiaries of COVID. For example, three names we know very well, including two that we previously owned at (much) lower valuations:

1. An unprofitable SaaS vendor in a vertical that has been hit hard by COVID, that trades at over 30x recurring revenues with a relatively pedestrian (sub-30%) growth rate

2. the reseller/marketer of a highly discretionary, high-priced, non-essential, "vanity purchase" consumer product whose demand should theoretically be extremely cyclical, but has proven (at least this year) not so

3. a relatively sleepy company in a historically low-growth niche, which has recently exploded in a fashion that industry experts have called "head-scratching" and "having a moment" - it remains unclear whether this is a long-term structural trend, or a short-term Beanie Baby fad

At least in these three specific cases, we believe that many of the businesses we own are of equal or higher quality, while usually trading at lower valuations (sometimes substantially so). To some degree, one could argue that the three businesses listed above have done better in the short-term, in the sense that whether or not their intrinsic values have changed more or less than our companies, their reported short-term results are better.

But in our view, this has happened in ways that were not predictable *ex ante* from our understanding of the business - i.e., hindsight is 20/20, but we would've bet on all three of these companies doing quite poorly in this environment rather than well, based on our understanding of their business models (which is quite likely flawed). Conversely, we've also seen one of our companies that has reported *spectacular* 2020 results fall back to roughly the same level it started the year at, despite being a *massive* beneficiary of COVID restrictions and reaping windfall cash flows.

To be very clear, we're not saying the companies owned by our colleagues are bad investments at current prices, let alone bad businesses: it just means, unfortunately, that we don't see a consistent theme that we can learn from or utilize in our own individual process. Not every idea or *type* of idea is for us, and we'll do more harm than good by trying to invest in situations we don't understand or believe in, and trying to be everything to all people all the time.

One of the reasons that many people find it hard to stick with a temporarily-underperforming but structurally sound investment strategy is the phenomenon of hyperbolic discounting, or bias for the present. It is very, very easy to look back at a stock chart, see a year-long dip preceding a multi-year rally, and say "oh, I would've bought lots of that then, and made tons of money."

In reality, of course, life is experienced in minutes and days - not years. Standing at the bottom of that stock chart, when maybe some legitimate concerns hang over the company/industry, or maybe fundamental results are perfectly fine but the stock just languishes as days turn to weeks turn to months, you obviously have no insight into when the stock will be revalued - or to what extent. For many people, hundreds of consecutive market days of frustration are too much to bear - making it hard to stick with, let alone double down on, something that's "not working."

A healthy degree of stubbornness (albeit not too much - dose-dependency) is necessary to be a successful long-term investor following the sort of strategy that we do. You're not going to outperform every year, let alone every quarter.

Even Bill Belichick's Patriots, one of the most consistently successful cap-constrained sports franchises for the past two decades, didn't win every game, every season. We're not comparing ourselves to Belichick, to be clear - the point is just that when you have a system that works well but you lose a game, you study the film and try to get better, but you don't rip up the playbook or fire the entire coaching and scouting staff. We've studied the film, but sometimes the ball just bounces the wrong way.

There are certainly a few things we could've done better, particularly early on, but we think this was just an unlucky year for us, moreso than a fundamental failure of our process. The current environment suits us very well, and we're optimistic about very strong returns over the next 12 - 24 months.

2) To Turn, Or Not To Turn

Some investors may have noticed the relative lack of turnover in the portfolio, i.e. that the names in our portfolio (albeit not necessarily the relative weights) haven't changed much this year. I understand the rationale for the question, i.e., the world (at least in the short term) looks very different today than it did at the beginning of the year, so why does our portfolio look so much the same?

A 50/50 Zoom/Moderna portfolio does look pretty nice in hindsight, but our turnover, or lack thereof, is consistent with our investment process. I've addressed, in previous letters, the question we used to get before this year - i.e. *why is your turnover so high?* - the answer being our watchlist. We are familiar with many companies, and try to use a reasonably consistent valuation process. Although there are other considerations, such as affinity and risk exposure, at the simplest level, if we currently hold a security that is 10% undervalued and we have the opportunity to sell it and purchase another security that is 30-40% undervalued, then we should be doing that.

Indeed, we did that this year - we partially or totally sold down our stakes in some companies whose stock prices rose to, or at least closer to, their fair value, such as Magic Software (MGIC), Sprouts (SFM), and Duluth Trading (DLTH). Those proceeds were then redeployed into existing portfolio positions, or watchlist companies, where we saw bigger gaps between price and value, and we feel good about those decisions on a multi-year basis.

However, at least until recently, most of our portfolio names - unfortunately - did not trade up enough such that there were clearly more attractive opportunities on our watchlist. Their fundamentals continued to improve while their stock prices lagged. In some cases (albeit not all), the price-value gap actually *widened* since late spring and early summer, as prices stayed flat or even declined while business performance continued to rebound and the medium-term macro outlook grew more certain.

This appears to be a little bit of a security-specific phenomenon; as discussed in the previous section, other somewhat similar businesses on our watchlist have rebounded faster. Try as I might, I can't identify a good solution here other than patience.

We've looked at some new names as well that might be interesting, but generally we've found that we're more comfortable with the names we've already followed, where we have a good handle on how their businesses will (or won't) be affected by the current situation, and how the management team will respond.

As our portfolio has begun to cooperate - and hopefully, this will continue as the world marches back to normal - our turnover will accelerate, and we look forward to a future in which we're once again asked why our turnover is so high. At the moment, we're fully utilizing our size advantage to aggressively add to positions in several highly illiquid micro-caps with strong balance sheets whose future cash flows are not in much dispute, but whose current stock prices reflect profound apathy or pessimism rather than the reality that the world is going back to normal - the *old normal* - sooner rather than later.

3) Return on Time Invested

> *"Well, risk is -- sometimes there's more risk in not taking risk.*
>
> *And I use the analogy that when we were growing up, my mother took us to the Sears store, we bought our stuff going back to school, clothes. We bought everything there.*
>
> *You never would have thought in your wildest imagination there wouldn't be a Sears store, but you didn't have Amazon then, you didn't have Walmart now.*
>
> *So things change. You have to change with the times. And even though sometimes you don't want to take on certain risks, you've got to take on a little bit of risk or you fall, you find yourself falling behind, irrelevant sometimes."*
>
> - David Zalman, CEO of notably risk-averse Prosperity Bank

Our research documentation and watchlist-driven investing process has generally worked extremely well for us. However, its primary failure as we've grown has been its speed (or rather, lack thereof). Given the relatively high rate of M&A among small companies, as well as companies we have to remove from the list for other reasons, we haven't added as many "net" names over the past several years as we would have liked.

Whenever I look at a situation, I'm always focused on the levers or inputs that are controllable. We really don't have much control over the watchlist "losses" - i.e., if a company is acquired, or undergoes some other macroeconomic or corporate event that removes it from our watchlist, we really can't do anything about it. What we do have control over is "gross adds" - i.e., how many names we're adding.

In turn, "gross adds" can be thought of as a function of three variables.

1. Interesting names available to work on. Usually there are plenty, but at times we've struggled to find interesting ideas to work on, and obviously we can't do productive work if we don't know what to work on.

2. Time available for new research. We have other responsibilities besides new research. For example, through much of this year, we've had to spend far more time than usual monitoring existing portfolio companies and understanding how they are affected by current events. More recently, while the need for this work has greatly abated, we've been spending significant time trading and researching names already on the watchlist, as that is the highest ROI on our time given the meaningful shift in *known fundamentals* and the rare opportunity to broadly deploy capital at valuations that doesn't reflect those.

3. Length of time it takes us to research a given name. Historically, our process has been very time-intensive, with it often taking up to a week (sometimes two) to fully research a new name.

We've taken steps to address each of these variables. Here are some (non-exhaustive) examples. For the first, we've used our increased resources to subscribe to a number of research services, which has allowed us to have a better pipeline available to work on; in one case, we also engaged a contractor to identify research candidates matching a specific investment profile that has worked for us.

For the second, we've reduced some unnecessary documentation in other places - for example, since we now write fairly comprehensive quarterly updates to partners on our portfolio, we aren't duplicating this effort to create additional internal memos as well.

For the third, we're using our learnings from many years of research to "80/20" our work. Let me offer some color. One thing I've found is that our research documents - which can sometimes reach 20 - 50 pages in length - often get hung up on various small due diligence items, or researching items that seem relatively important at the time, but later prove irrelevant.

As a few theoretical examples, the performance of one modest division may prove less important in a few years if the company's organic and acquisitive growth make it a smaller portion of the mix. Similarly, which outside "macro" issues are most important to a company's performance in the short term may change, so spending a lot of time trying to understand something (say, labor pressures or tariffs) that may work itself out or become obvious in a few years, doesn't really make a lot of sense if we're not going to be making the investment for a few years anyway.

Broadly, we've found that even for names on our watchlist, when we come back months or years later to actually make an investment, we often have to do significant incremental work to get comfortable. Recognizing this, and also that many of the names we research will *never* make it into our portfolio (whether due to M&A, or due to simply never reaching a price we're willing to pay), it seems to make more sense to me to allocate somewhat less time to researching modest-probability long-term candidates, so that we can have more of them (and eventually spend more time on high-probability near-term candidates.)

These approaches were working very well for us early this year (pre-COVID), and have allowed us to ramp up our research pace over the past few months despite significant work to do in other areas. We're optimistic about 2021 being a much more productive year on the new-research front.

Conclusion

This year has certainly been challenging and stressful, but in the spirit of Thanksgiving, I would be remiss if I didn't thank each and every one of you for your continued support of Askeladden. While several clients have withdrawn capital for personal reasons or changes in investment strategy, inflows from existing clients have vastly exceeded the modest outflows, such that per broker records, our total assets under management are higher now than they've ever been. I, too, invested significant additional capital into the Partnership at the end of August.

Hopefully, by the time I write you next, we'll be heading back to normal and COVID will be almost entirely in the rearview mirror.

Westward on,

Samir