TOLLYMORE
INVESTMENT PARTNERS

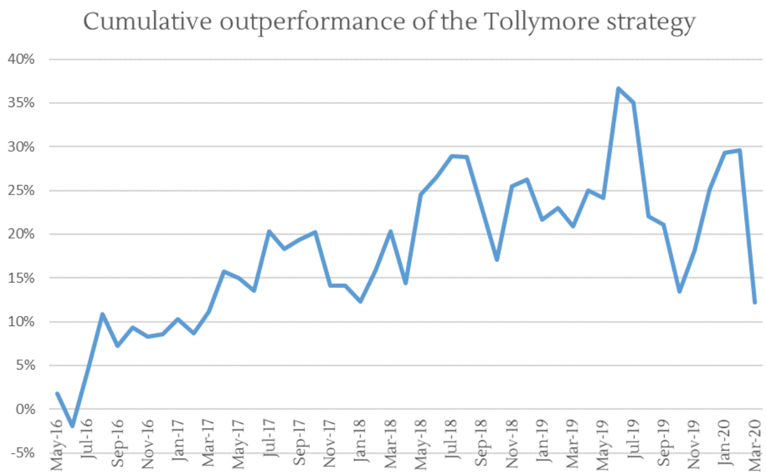
A letter to partners, March 2020

Dear partners,

Tollymore generated returns of -22% the first quarter of 2020, net of all fees and expenses. Investment results since inception are shown below[1]:

GBP	Tollymore (gross)	Tollymore (net)	MSCI ACWI
2016	35.2%	31.4%	26.6%
2017	16.6%	14.4%	13.3%
2018	3.5%	2.5%	-4.6%
2019	17.2%	15.0%	21.4%
2020 YTD	-21.7%	-21.9%	-17.2%
Cumulative	49.8%	38.4%	37.6%
Annualised	11.0%	8.7%	8.6%

Inception 12 May 2016, unaudited.



Tollymore gross - MSCI ACWI

Introduction

The COVID-19 pandemic has caused the sharpest share price declines in history. In the first quarter of 2020 the average US stock fell by 36% and declined 46% peak to trough[2]. We do not know the timing, duration or magnitude of further market declines nor subsequent recoveries. To offer an opinion on this is market timing and anyone claiming ability in this field has self-awareness issues. While many public market commentators and investment bank strategists were calling for a correction in markets, no one stated a respiratory virus and a Saudi-Russia oil price war would be the cause. Corrections are caused by things we have not anticipated. There is clearly a lot of uncertainty today. But there is always uncertainty. There was uncertainty in 2007.

[1] Source: MSCI, Interactive Brokers, managed account performance in GBP, unaudited, net of all expenses, 1% management fee and 10% incentive fee in excess of a 5% hurdle, as of 31 March 2020.
[2] Source: Value Line Geometric Index.

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We just ignored it until 08/09 came along and the uncertainty was suddenly reflected in asset prices.

We could conjure reasons to justify why markets have overreacted to the pandemic, not least social media's role in the more rapid and subjective dissemination of bad news. But to do so is just marketing, and predicting the economic, political and social consequences of such events is well beyond the scope of our abilities. To do so would be inconsistent with a focus on what is important and what is knowable.

Future investment decisions should be made on data, not emotions. The median market performance after a correction suggests investing into corrections is the mechanism through which long term investors outperform market speculators. It does not mean that if you invest today the market will not go down further. And if the market declines further it does not mean investing today was the wrong thing to do – process vs. outcomes. It means you didn't pick the bottom. But trying to pick the bottom is a tiny ROI game to play.

Investing is at times uncomfortable. If it doesn't feel uncomfortable you are acting conventionally, and you are destined for average investment results. The only way to navigate these periods with sanity and resilience is to have a very long-term view. Those who have the temperament, mindset and patience to invest countercyclically over the long term do the best.

This letter reminds our investment partners of Tollymore's risk framework; we explain how we have used that framework to re-underwrite our investment holdings, with a special focus on capital structure and liquidity. We discuss the investment merits of our four largest holdings, now comprising more than 55% of assets under management. We conclude with a discussion of decision making in bear markets and the importance of not being a bystander.

Risk, capital structure and liquidity

Tollymore's risk framework

We invest in companies with low business, balance sheet and valuation risk to mitigate permanent capital erosion. Business risk is low when a company enjoys lasting unfair advantages which protect intrinsic enterprise value. Balance sheet risk is low when the company's capital structure is appropriate for its business model and cost structure, resulting in enterprise value growth accruing to owners rather than lenders. Valuation risk is low when we pay a purchase multiple of current owner earnings which does not cause the IRR on our equity investment to materially lag the intrinsic value growth of the business. In a nutshell, we own prudently financed high quality assets at modest multiples to their normal earnings power. In assembling a portfolio of investments, we do not use diversification as a tool to dampen volatility and tend investment results to average, we do not employ leverage and we do not short securities.

Tollymore's process in a crisis

In many ways our investment programme is unchanged in periods of economic distress and market dislocation. We still believe in the utility of independent thinking, in the power of deep work and the pitfalls of forced collaboration. We still seek to own companies that score highly across our vectors of business quality. We still think of risk in terms of business quality, finances and valuation. We still believe in exploiting a set of constraints facing most active money managers in executing a long-term investment strategy. We still believe our investment partners are a competitive advantage. We still believe stock market volatility is a reason to prefer public market vs. private business ownership.

But admittedly this is no ordinary crisis. One quarter of the global population is under lockdown. This means many businesses will need to navigate a period of zero revenues. This reality caused us to re-underwrite our investments with a special focus on liquidity runway. In our 'survive and thrive' analysis we estimated how long each business could survive without revenues; protections mitigating revenue loss, such as contractual agreements; and what forms of cost relief may be available to our companies, due to the natural variable cost structure of the business, the curtailing of capital reinvestment, or government support. We compared the estimated cash burn to liquid assets and ranked our businesses according to those most likely to survive these extraordinary circumstances. While acknowledging the uniqueness of this crisis, and despite espousing the merits of interrogating business prospects from first principles, we have not worked hard enough at overcoming the faulty heuristic that low levels of net debt are synonymous with balance sheet strength. A company with zero net debt may nonetheless collapse if it has high fixed costs, sells discretionary services and no access to short term financing. Even if this finance can be found, lender concessions may permanently destroy the wealth of the company's owners through equity dilution.

This capacity to survive massive revenue disruption formed one part of our analysis. The second step involved a consideration of the opportunities to flourish at the other end of this period. Do the restrictions placed on populations in quarantine aid or inhibit our companies' ability to serve their customers? Do our companies sell products or services which have replacement characteristics, or for which demand is likely to build up over time, leading to lumpier rather than measurably lower cash inflows? Assuming ample liquidity runway, does the operating leverage in the business work in our favour when revenues pick up again? Does the business benefit from structural trends that may be accelerated by the behaviour of customers confined to their homes? Do the cost and capital structures of competitors increase the potential for competitive rationality or consolidation?

The first two steps of this survive and thrive analysis are insufficient to help inform sensible portfolio management decisions. We have changed the weightings of our holdings in the small number of situations in which our expectations for the company's staying power and ability to flourish in more normal times are at odds with those implied by the quoted price change. We have lowered our cost basis, sometimes very meaningfully, where we have determined this to be in the overwhelming interests of our partners. This has included purchasing more shares of smaller, less liquid companies where there may have been non-fundamental selling pressures exaggerating stock price declines. Capacity constraints are an important safeguard against permanent capital erosion; they facilitate the ability to exploit mispricings and safeguard against being a bystander, a costly but common sin of many investment managers. The paucity of appropriate capacity constraints is a function of widespread greed, something we hope to exploit.

Tollymore's own liquidity runway and aligned investment partners have allowed us to remain calm throughout this period. This is part of being a public equity manager; stock price volatility, which in March reached its highest level ever[3], is the price of the potential to earn superior long-term results.

Portfolio holdings

The portfolio management decisions taken in the first quarter have increased portfolio concentration, with the four largest holdings representing more than 55% of assets under management. Our largest investments, in alphabetical order, are Aspen Group Inc, Franklin Covey Co, Gym Group plc. and Sea Limited.

Aspen Group Inc (ASPU)

ASPU is an education technology company operating two universities, Aspen University and United States University. 80% of all students are degree-seeking nursing students. ASPU is committed to the cause of making education affordable. As such, it aims to offer among the lowest tuition rates in the sector, which means that only a quarter of students take federal financial loans to fund tuition. Students are incentivised to enrol and graduate by an incremental salary payback of less than one year. The principal mode of instruction is online distance learning. A web-based portal stores and delivers course content, provides interactive communication between students and faculty, and supplies online evaluation tools. Programmes are therefore targeted to self-directed learners.

ASPU is a cost leader in a defensive industry, enjoys outstanding unit economics and operates in an addressable market 80x group revenues. There are almost five thousand US colleges and universities serving traditional college age and adult students. Competition is fragmented and varies by geography, programme offerings, delivery method, quality, and admission criteria. No one institution has a significant share of the total postsecondary market. ASPU's primary competitors are online universities. Publicly quoted peers include American Public Education, Adtalem Global Education, Grand Canyon Education and Strategic Education. ASPU also competes with privately owned Apollo Education Group, which includes the University of

[3] The Cboe Volatility Index, known as the VIX, hit a record high of 82.69 on 16 March 2020, surpassing the peak level of 80.74 on 21 Nov 2008.

Phoenix and is considered the market leader based on total enrolments. These competitors have degreed enrolments ranging from approximately 40-90k students, vs. ASPU's student body of 9k.

Public institutions receive substantial government subsidies, and public and private institutions have access to government and foundation grants, tax-deductible contributions that create large endowments and other financial resources generally not available to for-profit schools. As such, public and private institutions may have instructional and support resources that are superior to those in the for-profit sector.

The for-profit education sector has shrunk by 40% over the last decade due to: (1) A poor value proposition driven by reliance on financial aid. That is, admitting students who were not academically ready, delivering poor outcomes and performance, and high pricing leading to substantial student debt. This seems to have been the result of substantial reliance on federal student aid and loans. In the absence of federal student loans, a normally functioning free market would facilitate competition between educational institutions. Prices would tend to an equilibrium, market clearing, point. A point beyond which students would not be willing to pay, and private loan companies would not be willing to underwrite. The undisciplined provision of financial aid seems to have created an imbalance that ultimately resulted in several lawsuits and investigations into many colleges and increasing scrutiny on accreditation procedures. And (2) The growth of the online program management (OPM) industry. OPMs have helped traditional non-profits launch their degree programs online in direct competition with the online for-profits. With similar tuition rates the name-brand university has a material customer acquisition advantage. The realisation of these challenges has prompted some for-profits to convert to non-profit status.

Despite this industry backdrop, ASPU is rapidly growing market share. ASPU enjoys several barriers to profitable participation:

- Accreditation provides external recognition and status. Employers rely on the accredited status of institutions when evaluating an employment candidate's credentials.
- High student satisfaction scores and graduation rates.
- Cost advantage one: online distribution - Except for the recently launched pre-licensure BSN hybrid (online/on-campus) nursing program and USU's hybrid (online/on-campus) MSN-FNP programs, courses have been designed entirely for online delivery, and faculty are recruited and trained for online instruction.
- Cost advantage two: lower customer acquisition costs - When Michael Mathews became ASPU's CEO in 2011, he developed ASPU's proprietary, internal, internet marketing program. ASPU does not use third-party online lead generation companies to attract students[4]. ASPU's CRM system has also been designed to achieve lower CAC and higher student persistence[5]. ASPU management contends that this CRM does not exist in the higher

[4] For-profit online competitors utilise multiple third-party online lead generation companies to obtain most of their student leads. Third-party leads are typically unbranded and non-exclusive. Lead generation firms sell student leads to multiple universities; the conversion rate for those leads tends to be appreciably lower than internally generated, Aspen Group university-specific branded, proprietary leads.
[5] ASPU's CRM includes an algorithm that recommends to enrolment advisers in priority order what follow-up cost should be made in each day to complete the enrolment process for prospective students in that given EA's database.

education market and will drive industry-leading persistence rates and LTVs. There is evidence to support such claims. Aspen pays $300-$1,000 to acquire a student, while competitors typically have acquisition costs that are three times higher. Aspen converts more than 10% of the students that have interests in enrolling on average because it is selective in its student selection process, whereas the traditional competitors have mid-single-digit conversion rates.

Given that Aspen's cost of enrolment is significantly lower, the company can lower tuition costs and offer a monthly payment plan. As a result, Aspen is reporting 40%+ enrolment growth, while the industry's largest nursing school with over 30k students, Chamberlain, reports mid-single-digit enrolment and revenue growth. Tuition costs are therefore 25-50% lower than industry averages for nursing degree programmes. It is management's contention that Aspen is "arguably the most affordable nursing school in the country", while maintaining well above industry completion rates. The replication of these advantages by peers would require them to aggressively lower tuition rates, slowing their already modest growth.

The for-profit education sector has proven itself unable to overcome the incumbent advantages of not-for-profit education providers, or to provide a reasonable ROI to students. Since Michael Mathews assumed the role of CEO in 2011 ASPU has grown enrolment almost 30% per year and has navigated the business through a period in which its scale disallowed profitability.

But we expect that to change. ASPU operates in a niche industry with secular tailwinds and a $4bn addressable market, via a business model with extraordinary unit economics. Half of nurses are older than 40, and 20% of Americans will be older than 65 by 2030. The pursuit of the Magnet Recognition Designation from the American Nurses Credentialing Centre (ANCC) requires 80% of nursing staff have a BSN degree or higher; 40% of nurses only have a 2-year associates degree. It is against this backdrop that ASPU's target is to be the largest nursing school in the US.

Modest student acquisition costs compared to the revenues generated by these enrolments, together with the scalability of faculty costs could bode well for improving operating margins. A single adjunct faculty member can work with as few as two students or as many as 30 at a time. There is evidence of operating leverage in the company's expanding gross margins, which have been increasing c. 10ppts pa, and admin costs which are falling as a percentage of sales. Half of cost of sales relate to instructional expenses, which are unlikely to be scalable, and the other half relate to sales and marketing, which are growth costs. As the blended cost of acquiring students has fallen due to the higher mix towards superior unit economics courses, sales and marketing as

The algorithm was created by studying the daily habits and activities of the three most productive EAs in Aspen's history. This recommendation engine then automatically updates in real time after each follow-up or action is conducted by an EA. These advanced features are not offered by any CRM software company in the industry, leading to the highest lead conversion rates in the country. The biggest persistence challenge amongst the growing population of fully online students in the US is the lack of timely student support. Students struggle with many challenges including academia, finances, personal issues and time management. ASPU's CRM provides real time data on these aspects of a student's career. 30 at-risk events have been determined; those which, without intervention, could lead to voluntary course withdrawal. The CRM is intended to turn the student services department into a proactive student support group, by alerting an academic adviser when an at-risk event occurs in real time so the adviser can contact the student to discuss ways to mitigate or solve the issue.

a percentage of sales has fallen from a quarter to a mid-teens level. Below gross profit, admin costs have also fallen strongly as a percentage of revenues, driving operating profit improvement from $mid-single-digit losses a couple of years ago to a breakeven position today. These financial results lend credence to management's goals: *"we expect to deliver increased value to our shareholders by achieving three important financial targets: continued strong revenue growth, rapidly improving profitability and a path to substantial positive free cash flow".* Big picture: in the most recently reported results revenues increased by $4mn, and net losses declined by almost $2mn; c.50% of revenue growth is falling through to the bottom line. On a sequential basis the leverage is even more impressive: revenue rose sequentially by $1.7 mn while net losses dropped sequentially by $1.4 mn – 83% leverage on the bottom line.

The cost per enrolment of these programmes ranges from $340 to $1.1k, and the LTV[6] per enrolment ranges from $7.4k to $30k. The contribution margin per marketing dollar spent across these programmes ranges from 4x to 26x i.e. between 300% and 2,500% incremental return on capital.

Nurses probably have the greatest job security in the world at this moment. Aspen University's pre-licensure BSN clinical degree program and United States University's MSN-Family Nurse Practitioner clinical degree program require in-person teaching as well as online instruction. They are relatively unaffected by this crisis because the in-person simulation/immersion activities have, with regulatory guidance, been developed to work in a virtual environment. The demand for ASPU's services accumulates. Course starts in Aspen's traditional 100% online post-licensure nursing degree programs are typically seasonally affected in the summer months as these nurses tend to take time off in the summer. However, given these nurses are in an all-hands on deck situation in response to COVID-19, ASPU is likely to experience more seasonality than is typical.

ASPU has the liquidity to comfortably manage such cash flow lumpiness, thanks to a debt refinancing and equity raise in January 2020. Meanwhile, we expect ASPU to thrive as we approach more normal social conditions as the crisis may catalyse a structural acceleration towards digitally delivered education and likely impending recession may accelerate a preference for low cost education options.

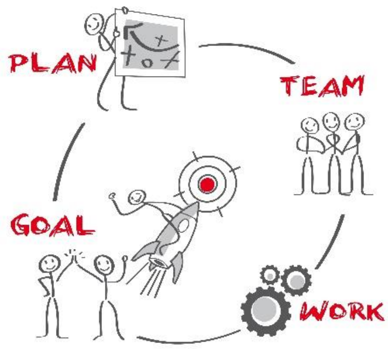
We increased our ownership in ASPU as its stock declined by 50% in just five weeks in February and March. Today ASPU's enterprise value is $135mn, c. 2.8xthe expected (mostly trailing) revenues of the business in FY20 (Apr y/e). Expected bookings over this time are c. $100mn; the business is valued at the market at 1.4x the revenue run rate. Revenues that are currently growing c.40% pa.

ASPU's owner earnings are above reported levels due to reinvestment of discretionary profits into additional income statement costs, such as new enrolment advisors, associated with the expansion of their education programmes. The excellent unit economics associated with these programmes make this the obvious capital allocation choice to maximise long term SVA of the

[6] ASPU defines this as total revenue per enrolment.

business. Given increasing LTV/CAC and contribution margin per marketing dollar ratios, either marketing dollar reinvestment rates can be maintained in order to accelerate revenue growth, or revenue growth can be maintained or moderated, but marketing dollar reinvestment rates should decline over time. As such we expect our equity in ASPU to compound at 25-40% pa.

Franklin Covey Co (FC)



FC offers training courses, consulting services and training-related products focused on solving organisational problems through changes in human behaviour. Prior to 2015 FC sold engagement-by-engagement training and performance solutions to companies seeking to develop leadership, improve employee productivity, develop internal and external trust, augment sales performance and build customer loyalty. Clients can purchase complete offerings such as The 7 Habits of Highly Effective People and The 5 Choices to Extraordinary Productivity, or use individual concepts to create a custom solution. To increase customer lifetime value, FC began the process of converting to a SaaS model, called All Access Pass (AAP). AAP allows FC customers unlimited access to all of FC's content. This content can be delivered though a broad range of modalities in 16 languages. The cost per population trained is equal to or less than single competitive courses delivered through single modalities. FC did therefore not undergo this business model change to inflate price per population trained, but rather to maximise customer lifetime value[7]. Retention rates under the subscription model are superior because: decisions to renew are passive rather than active; commitment bias may play a role given the more arduous initial approval process; and customer value is superior – more content is available for the same price.

Five years into the business model transition FC is better positioned to weather event driven macro crises such as these. More than half of revenues are now subscriptions. This subscription model provides clients with the ability to access FC content and solutions across a wide variety of delivery channels, including digital and live on-line, allowing FC to help clients who are now working remotely. The company recently reported that AAP revenues in North America increased year on year in March. Significant income statement expenses are associated with client and revenue growth, such as client partner variable compensation. We estimate that FC could fund its monthly cash burn for over a year, even if all non-recurring income stopped immediately.

The goals of improving performance in the areas of leadership, execution, trust and productivity have been enduring business objectives regardless of time, geography or industry. And the human behavioural flaws at the root of these challenges seem equally perpetual in nature. The goal of achieving permanent human behavioural change is a long lasting one likely to need

[7] More people trained initially and subsequently, lower customer acquisition costs/higher retention rates, greater capacity to sell add-on implementation services

ongoing, multi-year support. A typical AAP subscription is in the region of $200 pa per employee. At this price point, it really doesn't take much in the way of employee productivity improvement for an investment to be worthwhile. This low cost/high utility proposition[8] makes switching unlikely once a client chooses to partner with FC; FC's techniques and processes are deeply integrated with the way that clients conduct their business. High retention rates are evidence of this.

FC recently acquired the licence rights to intellectual property based on the works of Clayton Christiansen. Creators of compelling content seek to monetise that content further than the obvious avenues of book sales and keynote speeches (think Jim Collins licensing Good to Great and Built to Last to FC). As a global leader FC seems to be an obvious company with whom to have a conversation about licencing that content. FC then turns it into learning modules, classrooms and course components, and helps companies establish facilitators to teach the content internally. The transition to AAP enables a potential platform business model opportunity. Previously, under an engagement-by-engagement model, the introduction of new content served largely to cannibalise the available options, of which companies typically chose one solution. Under AAP, with access to all available content for an annual subscription, there is room to licence world-class content and differentiate vs. competitive offerings.

The US training industry is estimated to be worth >$90 bn, >$350bn on a global basis. In the US $6-7bn of training spend is currently outsourced. FC's largest competitor is therefore the client base itself. The outsourced providers are fragmented, with few large competitors. Industry fragmentation is testament to the low barriers to entry allowing potential new entrants to participate. FC's target market is companies with >200 employees, of which there are nearly 100k in the US alone. Of these, just over 10% are assigned to current client partners, and of those 4% are clients. The remaining 83k companies will be assigned to new client partners as they are hired. We estimate that, in normal times, the business can grow revenues at a mid-single-digit pace without hiring any new client partners, due to the ramp up in profitability and maturity of existing sales staff. Incorporating the company's hiring ambitions, we think the business could enjoy low double-digit growth with high incremental profit margins and low capital intensity.

Management is not content to rest on its laurels but is clearly willing to make uncomfortable strategic decisions to improve the long-term prospects of the business. Despite the large opportunity to deploy capital into value-accretive growth, management's number one capital allocation priority has been balance sheet strength. FC has almost $50mn of deferred revenue on the balance sheet, all of which will be released with minimal associated cost to the income statement. In addition, the company has $35mn of unbilled deferred revenue due to multi-year contracts with its clients. These economic characteristic result in a business in which more than 90% of revenue growth flows through to EBITDA. So, while customers delaying the renewal of contracts will inevitably slow new sales and depress margins, this operating leverage will work in reverse as FC benefits from clients getting their bearings. It took four months after the Global Financial Crisis for the pace of bookings to return to normal levels. FC suffered from clients

[8] Say an average employee earns $50k pa and generates 2x revenues for her employer. If FC improves productivity by 5%, her employer has earned an extra $5k of revenues for a $200 investment, an ROI of 25x.

postponing purchase decisions, but the company did not lose significant business – training and consultancy revenues declined 17% in 2009, when there was no subscription product. Yet in one month FC's quoted share price declined 63%, and the stock has lost more than half is quoted value in the first quarter.

Today FC trades on 1.2x EV/reported sales. The enterprise value is c. 85% of sales including billed and unbilled deferred revenue. We expect the current cash flow of the business in normal times to be c.$30mn, a 9% yield to the current quoted price, and we think this could compound at rates of c.20% p.a. for a long time. We purchased more shares, lowering our cost of ownership, and therefore our risk of permanent capital impairment, and improving the IRR we expect to earn on this investment.

Gym Group plc (GYM)

The Gym was founded in 2007 and is today the second largest low-cost gym operator in the UK. It is a simple one service, one market business, offering services with enduring utility. It employs a recurring revenue model with a predictable cost base and strong FCF generation, but high operational and financial gearing.

Despite prices 60-70% cheaper than traditional gyms, GYM's margins are materially higher, weakening peers' ability to compete on price. Cost advantage is facilitated by superior asset utilisation. This is driven by fewer staff, more equipment stations and fewer wet facilities, tennis/squash courts and 24/7 opening. Economies of scale relating to equipment purchases as well as property developer relationships and site flexibility are lowering average site investment costs as the estate grows.

GYM has multiple shots on goal to deploy capital into high returns projects, including market share take from public and traditional private gyms, increased penetration of UK gym memberships, lower entry prices and lower minimum age requirements increasing the addressable market. These volume drivers are expected to lead to 15-20% site growth per year. There are also multiple avenues to increase gym yields, including estate maturation, ancillary revenue development including potentially targeted advertising and customer data monetisation, and better amortisation of marketing spend lowering customer acquisition and retention costs.

GYM's business will be strongly adversely affected by the lockdown in the UK. Gyms have been ordered to shut down and will therefore earn no revenues from customers, none of whom are on contracts. GYM has frozen all memberships for free. 100% revenue loss during periods of shutdown is therefore a reasonable assumption and one we have assumed in our 'survive and thrive' analysis. In addition, two other factors will make this period challenging: (1) this is a business with high fixed costs, and (2) GYM will not enjoy pent up demand for its services[9]. The market (over)reacted swiftly in recognition of these challenges; GYM stock lost half its quoted value in the first quarter, enduring a peak to trough decline of 75% over a one-month period.

Given the operating leverage and off-balance-sheet financing in the business model, our original research on the company presented scenario analyses which stress tested the point at which GYM could no longer service its maintenance capex and operating lease commitments. The following excerpt from our December 2018 letter to partners describes some of this work:

"Leverage/recession risk: In the event of a recession prices and memberships may erode. GYM has high financial gearing in the form of operating lease obligations. Given GYM's operating leverage mature site profitability would fall significantly should the business experience a marked revenue decline. We estimate that a 20% drop in revenues would reduce the owner earnings to £17mn from £40mn in a no-growth scenario. This is still a 5% yield to the current market cap. Current adjusted net debt/EBITDAR = 3.5x; assuming the maintenance profitability of the estate this is 2.5x. This would be 6x with a 20% revenue decline assuming zero capacity to cut 100% fixed costs, or 3.8x based on maintenance profitability. Under these assumptions GYM's EBITDA margin would be 13%/ and maintenance EBITDA margin 35% vs. the current 30% rate (and 47% mature gym rate). It is difficult to envisage a 20% revenue decline due to the immaturity and increasing penetration of low-cost gyms, as well as the 60-70% price discounts vs. mid-tier competitors. When US membership growth was negative in 2012, Planet Fitness still grew its memberships by 28% yoy. This might suggest that the large discount lowers the price elasticity of demand for budget gyms."

Admittedly we did not go far enough; we did not envisage a circumstance in which GYM would, overnight, lose 100% of its revenues. We tweaked our original assumptions as part of the re-underwriting of our ownership of GYM shares. Assuming GYM continues to earn no revenue, ceases all maintenance capital investment programmes, and obtains business rates and furloughed staff relief from the UK government, we estimate GYM could fund its rate of cash burn for five months, or ten months should it draw on its existing accordion credit facility. This gives no credit for GYM's ability to renegotiate rental agreements with landlords to obtain deferrals or discounts, despite this being likely due to the paucity of creditworthy tenant alternatives. We think more broadly that access to low cost health and fitness for all is a mission the UK government is likely to support. In short, we think the business has adequate liquidity to survive. Meanwhile we see several opportunities to thrive once gyms re-open. The transition from mid-tier to low cost may accelerate if recessionary conditions follow. Smaller scale, more levered and less financially sound independent gyms may close.

More so than any other stock we own, we moved aggressively to purchase many more shares, substantially reducing our cost of ownership. Unfortunately, because we conducted the above calculations swiftly, we purchased more shares too readily; we would have served our partners better by waiting. But frankly we could not have anticipated the market would present the outstanding opportunity it did in the middle of March. When we finished averaging down at

[9] When gyms reopen, customers will not be paying more than 100% of their previous monthly membership fees.

79.6p, the stock was trading at an owner earnings yield of 35%. The company is investing practically all these owner earnings into new site development yielding cash on cash after tax returns of c.20%. At any reasonable cost of capital, we expect these additional purchases to generate an annual investment return of c.60-70% for our investment partners.

Sea Limited (SE)

SE operates three platform businesses in gaming, ecommerce and digital payments, primarily in seven Southeast Asian markets. Garena distributes mobile and PC online games in its markets. Shopee is a platform for connecting buyers and sellers of long tail products across fashion, health and beauty, home and living, and baby products. SeaMoney is a digital payments provider; consumers use it as an e-wallet to pay for products and services. SeaMoney is integrated into the Garena and Shopee platforms. All three businesses are platform business models which take much investment to drive scale and barriers to entry but have winner-take-most potential economic outcomes.

Shopee is the largest ecommerce platform in SE's markets. As the number of buyers increases, Shopee attracts an increasing number of sellers, resulting in increases in SKU variety available on the platform, which increases the purchasing opportunities, and therefore monetisation potential, or value, for each of those buyers. Ecommerce penetration is materially below global averages in almost all Shopee's markets. But ecommerce and m-commerce engagement in Indonesia, Shopee's largest market representing almost half of GMV, is the highest in the world. The GMV of the internet economy is c.3% of SE Asia's GDP, almost 10 years behind the U.S. Shopee's take rate (revenues/GMV) is currently suppressed by efforts to build scale and market leadership, entrenching the network effects' barriers to entry of the business. But the take rate has been consistently increasing due to higher commissions and advertising fees. In addition, sales and marketing efficiency has been suppressed by efforts to build platform scale and liquidity. Shopee has heavily subsidised the cost of shipping for its sellers in order to build supply scale. The extent of these subsidies has been declining without any noticeable impact of GMV growth, resulting in sales and marketing expenses declining as a percentage of revenues.

Garena is a platform business with network effects dynamics due to the social, multi-player nature of the games distributed and self-developed. Each new gamer increases the value of the platform for existing users. Garena's success in distributing games for local game players facilitated relationships with international game developers, which has allowed Garena to source high quality games from world class developers, many of whom work as exclusive partners. Southeast Asia is the fastest growing games market in the world; growing 20-25% p.a. Despite 65% internet penetration, the region has the most engaged mobile internet users in the world. Video gaming has been growing its share of consumer time and entertainment spend for years. In 2019, consumers spent $120bn on video games (excluding hardware), up from $35bn fifteen years ago. This makes the category more than three times larger than the global box office (two times if including home video and SVOD revenues) and four times the recorded music industry. It is also growing 2.5–3.5x faster and on a larger base.

A wide variety of merchants are on the SeaMoney platform. SE is focused on increasing the number or type of merchant to increase the number of users on the platform, principally through the growth of the Garena and Shopee user base. SeaMoney has thus far mainly served to lower the costs of doing business for Shopee and Garena. By launching this business in 2014, SE reduced payment channel costs for Garena and Shopee and captured value that previously flowed to third-party payment services.

SE's stock price increased 10% in the first quarter. Its weighting in our portfolio therefore increased by virtue of substantially outperforming all our other investments. With more than $3bn of liquidity and gaming and ecommerce markets unlikely to be materially negatively affected directly by quarantine, we feel very comfortable with SE's capacity to weather this crisis. We also see ways in which SE might bloom as the world's governments and citizens get to grips with COVID-19. Coronavirus has led to a 12% increase in digital video traffic and a 20% increase in web traffic. While Nielsen reports total TV time (digital and linear) is up 20%, video gaming is up 75%. Gaming is one of the few ways to socialise today. During a time in which hundreds of millions of people are forced into physical isolation, the ability to co-experience content from a safe distance becomes particularly important. Players play immersive multi-player games primarily to spend time with their friends. Games such as Fortnite and Free Fire are immersive social networks. COVID-19 may also accelerate the migration to digital gaming by forcing physical game retailers to shut down. Esports may also benefit from coronavirus. Several sports leagues, from the NBA to America's NASCAR and Europe's F1, have sought to replace their cancelled seasons with purely digital events. As for ecommerce, this is now the only way to shop for non-essential items for many of the world's population. Supply may also increase as retailers rely entirely on online purchasing and delivery vs. store browsing. This period may therefore ignite a 'kink' in ecommerce penetration that is a temporary accelerant.

Decision making in bear markets

Don't be a bystander

Credit conditions of recent times have possibly allowed weak companies to thrive. This event-driven macro crisis may expose those firms who have been swimming naked. Likewise, investors, seduced by a decade of low finance costs, have geared up their investments, leaving them ill-equipped to invest countercyclically. Both dynamics may exacerbate quoted price declines. We must not be a bystander. Knowing what to do in a crisis and being able to do it are two different things. Our companies are appropriately capitalised, we do not employ leverage at the portfolio level, and our investment process, capacity constraints and working environment allow us to act decisively when the odds are overwhelmingly in our favour.

We are optimists. We think that makes us sound less smart than pessimists, but we are not in the business of convincing others of our intellect. As optimists, we believe in the forward progress of humans and humanity. But we believe that bear markets present special opportunities to make money, although it may not feel that way at the time. Decision making in periods of collapsing share prices determines long run investment success; such environments offer up choices which can materially alter the course of future investment results. In times of economic stress and market dislocation, sound judgment has the potential to be most lucrative. Stress biologically shortens one's horizon[10]. Myopic loss aversion increases in crises[11]; our ability to exploit the institutional constraints of our competition matters now more than ever.

We present in the Appendix a transcript from a presentation and Q&A with students and alumni from London Business School in February 2019. We presented a context for investment managers to judge their prospects for success, a context that may allow investors to stay the course in periods of self-doubt. We discussed the behavioural constraints facing the investment management industry and some of the tactics and tools investors can employ to create long-term value. The video can be found here and a copy of the presentation here.

We wish all our partners and their families good health. Your support at this time has been outstanding, for which we are most grateful.

Yours sincerely,

Mark

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[10] Stress causes the release of hormones, such as adrenaline and cortisol, in all vertebrates. These hormones evolved to help facilitate behaviours that help vertebrates survive when they were about to become dinner.

[11] Myopic loss aversion occurs when investors take a view of their investments that is strongly focused on the short term, leading them to react too negatively to recent losses, which may be at the expense of long-term benefits (Thaler et al., 1997). Loss aversion refers to the disproportionate responses to wins and losses. Specifically, we regret losses two and half times more than we celebrate similar sized gains. Myopia refers to how often we evaluate our portfolios. The more frequently we check, the higher the odds we will find a loss and experience loss aversion. On the other hand, the less frequently we check, the greater the likelihood of finding gains. As investors check their security prices more frequently in periods of high volatility, this behavioural bias bids up equity premia and bids down equity prices, reinforcing myopic loss aversion and creating a downward spiral intensifying price declines.

Appendix: Tollymore presentation and Q&A at London Business School

Mark Walker: *The title of this talk is "Investing is not as Hard as We Think." That's a bit tongue-in-cheek; it's a provocative title. This is not a presentation about how easy investing is. It's hard. And if any of we professional fund managers would remotely pay attention to the base rate of success in the industry, we wouldn't do what we're doing. Thankfully, a healthy level of hubris prevents us from being rational about that decision. What I want to do is share a bit of my experience in providing a context to help us judge our decision-making and investment management and to assess our prospects for success in the industry.*

Tollymore Investment Partners is a private investment partnership here in London. It invests in a concentrated portfolio of global public equities with the goal of compounding investors' capital over the long term. I spent five years in generalist global equity mandates on the buy side, and before that, five or six years on the sell side working on pan-European telecoms research for Redburn Partners and Goldman Sachs. It's that experience which has given me an overview of the institutional money management industry, how the actors in that industry behave, how they're incentivized, and about several of the behavioural constraints they face in making good investment decisions.

Investing is not easy. Only one in 13, one in 19, and one in 23 managers, depending on your investment universe, outperforms their benchmarks. However, what we need is a framework to be able to stay the course in periods of underperformance or other source of self-doubt. We already know investing is hard. I spend time in a reflective, introspective, and self-aware group of value investors across the globe, and we constantly remind ourselves how difficult this industry is. Indeed, spending time with those types of thoughtful, talented investors can lead one to feel like a fraud and to doubt our own beliefs and our capacity to add value for our clients. Therefore, we need a broader context in which to judge our prospects for success.

Through my experience of speaking to key decision-makers in institutional money management firms on the sell side, I want to present a collection of observations from that experience. There are eight observations. For each one, I'll give you a flavour of my personal experience. I will discuss why I think certain behavioural constraints are antithetical to good investment practice. I'll highlight some of the literature and the research which provide the outside view of that particular constraint, and then I'll suggest some measures we can take to avoid, and hopefully, exploit those behavioural errors.

My first observation concerns a pursuit of informational edge. I saw investment processes led by corporate access where investment managers travel the world trying to find the best investment ideas. They speak to the managers at the companies they own and the companies they look at. And frequently, that's right at the front of an investment process. The first time they are introduced to a company is from the words of a talented salesman in the form of a CEO. What I also saw was this focused effort on building complex and detailed financial models of companies which were predicated on knowing everything about everything, and therefore, having a broad knowledge rather than a deep understanding of some of the key factors that matter in understanding business drivers. This led to an inability to calibrate some of the forecasting errors *back into improving our investment processes. What's the problem of this approach? It's that information gathering I saw led to increasing confidence in fund managers' expectations of the future and into sell side capacity to forecast businesses but not leading to any better accuracy. And whereas the sell side and their buy side counterparts undoubtedly have clearly above average IQs and are well motivated and are well incentivized, there's a lot of misdirected intellectual effort in terms of trying to play this difficult game.*

What does the literature say about this pursuit of informational edge leading to overconfidence? It can have profound consequences. In the investment management industry, it can inflate our perceived valuation of the investments we own, and it has several ramifications outside of investing. Several studies have shown little correlation between confidence and accuracy. One of those is related to a study in which professional horse handicappers estimated the outcome of a series of 10 horse races, with each race having 10 horses. In each subsequent round of the game, they were given more information about the jockeys, about the horses, about their form. And initially, when they were given a small subset of information, they were asked to predict the outcome and to give an estimate of their confidence in the outcome. They closely matched. A random guess would give an outcome probability of 10%. They were accurate about 17% of the time, and their estimation of their confidence was also around 17% of 100%.

As the rounds of games went on, they were given more information. Their accuracy stayed roughly flat at about 17%, but their estimated confidence went up massively to 40% to 50%. That study suggests that there are, at best, flat returns to increased information. This problem manifests itself in position sizing in a portfolio. It causes us to dramatically increase the size of our bets. James Montier popularised a study which shows there are diminishing returns to extra information through the mechanism of overloading our cognitive capacities. In his book, Value Investing, he shows a study in which participants were asked to estimate or choose the best car, which can be objectively measured. When they were given just four aspects of the car, they guessed correctly 60% of the time. When they were given 12 aspects, that dropped to 20% of the time.

How can we avoid this or exploit it? In terms of corporate access, we need to be cognizant of the sales pitches from CEOs. Consider the role corporate access plays in the investment process. I suggest right at the front of the investment process is not the best place. Give yourself time to carve out independent thinking and study around the business and the industry so you can shape the meeting with management and are more insulated from sales pitches. Conduct work on the handful of drivers you've identified rather than striving to know everything about everything. And construct an investment program with a large opportunity set and a concentrated portfolio. That avoids the temptation to be precise about your estimations of intrinsic value for the companies you own or would like to own. Consider a mental model of equal weighted portfolios. As investment managers, we like to think our portfolio management skills are strong. But if this overconfidence tendency causes us to inappropriately outsize our bets, then consider a constraint in which we have an equal weighted portfolio.

The second observation is the pursuit of analytical edge. I observed how large money management firms tend to be specialists, either geographically or by sector rather than have generalist mandates. Therefore, sector teams are forced to pick winners and losers within narrow universes. This creates the perception, real or otherwise, of deep intellectual expertise which leads to hubris and a level of certainty which might not be appropriate and is a barrier to probabilistic thinking. It's probabilistic thinking that might help us to reason to be accurate rather than reasoning to be right. This deep self-perceived expertise potentially makes us unreceptive to conversations with people with dissenting opinions. That's a barrier to decision-making. Large asset managers tend to organise themselves in terms of analysts and portfolio managers, where analysts do deep fundamental work on companies and portfolio managers typically do not. Therefore, there's a conviction difference between those two groups. When share prices move around a lot, portfolio managers may lack the conviction to know how to act optimally in the face of that volatility because they haven't organically done the work themselves. In these kinds of large teams in the pursuit of analytical edge, hierarchical structures in larger organisations introduce authority bias. Committee-led decision-making typically slows decision-making and is a form of loss aversion because we cannot act decisively when odds are clearly in our favour.

What you often see is investment managers and their counterparts on the sell side who need to sound smart to justify high fee structures. You rarely hear the words, "I don't know" when "I don't know", is, in most instances, the correct answer. It's a barrier to epistemic humility, which is necessary for good decision-making. These fee structures create the temptation to conceal ignorance rather than to openly acknowledge it. The large teams create the perception of intellectual expertise, which makes us less receptive to perceived non-experts.

Large teams increase the complexity of organisations. As you arithmetically add individuals to your investment team, you're geometrically increasing the number of relationships and communication lines between those individuals. You're also making it more difficult for individuals to be more accountable for their work. There are more places to hide. Your ability to discern the difference between luck and skill goes down. The bad news for everyone in this room is that smarter people are worse at combatting these behavioural biases. They are better at assembling the information, assembling the narrative in their minds that fits their preconceived ideas.

Does the literature support this personal experience? Milgram conducted experiments on authority bias in which participants were asked to administer electric shocks to actors. Half of those participants, in response to a person in a white coat with a clipboard asking them to increase the level of electric shocks, administered what would be fatal electric shocks. This conflicted with participants' personal conscience. Authority is useful in social systems, but it can clearly be a barrier to decision-making. Michael Mauboussin suggests that a quarter of the time, professional decision-makers, including investment managers, calibrate their processes and learn from experience. The rest of the time they do something which feels more like progress, like gathering and analysing information.

There's something called a HiPPO effect, which is the highest paid person's opinion. That can be a barrier to evidence-based decision-making. A couple of high-profile examples come from Apple and Amazon. Ron Johnson was a guy who headed Apple retail; he was responsible for the successful rollout of the Apple stores. He left to become CEO of JC Penney. In a nutshell, he created this culture in which people were disincentivised to be sceptics, to dissent. And therefore, no one was willing to question his unsuccessful strategy of rolling out JC Penney stores without testing the retail strategy first.

At Amazon, Jeff Bezos became obsessed with a feature of the Fire Phone called dynamic perspective. Like Johnson at JC Penney, he created an environment in which engineers were unwilling to air their concern about the tactical and financial viability of this feature.

If you're in large groups, you could succumb to something called group think. There were some Asch conformity experiments conducted, one of which was called "face the rear." Imagine a scene in an elevator. Of course, nearly everybody faces the door when they ride an elevator. However, in this illustration, four actors entered an elevator in which a non-actor, a naïve person, had already entered and took their position facing the door. The four actors all faced the rear after they entered. The naïve person tried to maintain his individuality. But little by little, he turned slightly more to the wall.

In a second illustration of conformity, a naïve person had occupied the elevator facing toward the door, then four actors entered the elevator and faced the rear wall. The naïve person conformed by facing the rear wall. During the elevator ride, the actors all turned facing the same side wall. When the elevator door opened to reveal its occupants, everybody had changed positions to face the same side wall, including the naïve person.

The point in these elevator illustrations is that group pressure is subconsciously strong. Groups are like mind-altering substances. Other studies asked subjects to do a simple task, like to choose which line of three lines is the longest. When the experiment is performed with subjects in isolation, 99% of people get it right. When they're put in a group setting where everyone else is planted and chooses a different option, that rate drops to about 50% or 60%. When those people are interviewed afterwards, they did not say they felt pressure to conform to the group. They said they genuinely believed that was the right answer.

How can we exploit this? Investment teams should be constructed with small numbers. Mine is small. I'm a single-person investment committee. Small teams help to retain the accountability of decision-makers and provide for simple communication structures. It should be diverse. If the collective decision of a group is to be wise, individual decisions should be independently reached. The solution for a number of these constraints is to have a large investment universe and a concentrated portfolio, which obviates the need for precise valuation mechanisms. Embrace uncertainty. Be willing to say you don't know. Consider the exercise of being asked to bet on something. If you express an opinion and you were forced to bet on it, to what extent would that calibrate the certainty with which you expressed that opinion?

Embrace the spirit of intellectual generosity with peers. In this business, I have ongoing relationships with peer investment managers. There is no sentiment for shielding our intellectual property. We're there to help one another. We share the belief that execution of a long-term investment strategy is our competitive advantage, not the mere fact that we are long-term investors. Consider the usefulness of anonymous voting mechanisms to avoid authority bias when reaching decisions. Portfolio managers should be analysts, and analysts should be portfolio managers. Everyone is doing the work, and you can have a shared conviction. Consider the incentives of people outside your organisation giving you advice.

Number three is pitchbook mentality. Large asset managers have marketing-led investment strategies. They're trying to create an investment strategy they think will sell. That tends to lead them down a path of having niche investment universes predicated on analytical edge using scuttlebutt or primary research methods which are potentially into better investment returns. But often, they reduce to marketing presentations. I also see all the time proprietary idea generation funnels into marketing presentations in large research teams to advertise their analytical edge. There's also a bias to action. Managers need to feel they are earning their fees by doing stuff.

What's the issue? There's an asset gathering imperative in the asset management industry. This is a scalable model. It's tempting to grow assets and rapidly increase the profitability of the business model. This imperative can misalign with the providers of the capital you manage. Our strategy is tailored to the investment manager's temperament and what you think will work rather than what you think will sell. The outside view supports this tendency for action. Goalkeepers facing penalty kicks will dive almost every time, which is at odds with what they should do given where the ball goes. But they just can't stand the potential situation in which they stand still and the ball whizzes by them. If only to avoid embarrassment, there's a bias for action. In some other examples of action bias, some research suggests trading frequency is negatively correlated with returns. Warren Buffett certainly aims to profit from that action bias.

If you have an investment management business owned by shareholders or equity owners in a business, there's clearly an obligation to those owners to maximize the profitability of the investment management business. There are ways to enrich the owners of an asset management business that are consistent with compounding the capital of your investors, and there are ways that are inconsistent. An asset gathering imperative is mostly inconsistent. Having managers with high levels of insider ownership and their own funds is consistent. Having a performance fee-led structure is consistent.

Number four is the folly of forecasting. When I was on the sell side, there was a strong focus in having the most accurate numbers. StarMine collects all the analyst estimates for the companies they cover, and it ranks analysts and investment banks according to the analysts with the most accurate numbers. My firm had the most accurate numbers, but our numbers are still horribly inaccurate. The Ashton Partners study showed virtually everyone in the asset management industry thinks that consensus estimates are important.

What's the issue with this? We're not operating in a linear system. In meteorology, if someone opens an umbrella, it doesn't affect the accuracy of the weather forecast. Markets and economies are reflexive systems. They're not like meteorology. If a macroeconomist advocates for raising interest rates because of his expectation that inflation will increase, to what extent is he incorporating the feedback loop of employees asking for higher wages in response to that expectation of high inflation? And the volatility of stocks in the near term certainly makes predicting share price movements exceptionally difficult. The outside view, in a nutshell, suggests strategists cannot predict markets. Macroeconomists can't predict economies. They predicted two of the last 150 recessions. Chess, which is a reflexive game materially simpler than an economy or a financial market, has 10 to the 120th possible moves.

Dick Thaler popularised a game, which was a version of Keynes' beauty contest. He asked participants to guess a number between 0 and 100. The person who guessed closer to 2/3 of the answer of the average would win a prize. This is a reflexive model. There's a wide variety of guesses, and there are certain spikes in guesses. A spike occurs at 33; this is a first level thinker guessing the average guess would be 50 and the 33 guess would be 2/3 of 50. Another spike occurs at 22; this is a second level thinker. He thinks everyone else will guess 33. Another spike occurs at 15 by third level thinkers. Finally, there's the Nash equilibrium at zero.

Guessing share price movements is difficult. Stock market volatility in the near term is extremely high. If you just play at the end where you lengthen your investment horizon and you're estimating the long-term prospects of businesses and not the short-term movements of their quoted prices, your prospects for a good outcome are better.

I suggest that trying to understand and analyse a reflexive complex system such as the financial market is a low return on investment exercise. Better directed intellectual effort is in independent research on the fundamentals of companies. Having a large investment universe and a concentrated portfolio lets you focus on the large gaps between price and value. In this approach, you don't need to find a company with 10% upside and be guessing EPS estimates.

My fifth observation is manager/investor misalignment. The observation is that fund managers don't invest in their own funds. Management fees are typically high. Performance fees seem to be justified by this legacy expectation that strategies drive fees rather than any consideration of the power of incentives. The issue is that managers' and investors' fortunes are not aligned. Particularly, managers without insider ownership are much less incentivised to limit the size of their fund or even consider the capacity of their investment strategy, which is a barrier to the time-weighted returns on their portfolios. Two observations emerge from the research. There are potentially no statistical indicators of future performance. Maybe there is one, which is insider ownership. Evidence supports the conclusion that companies, not just investment management firms, outperform businesses that are not founder led in the long run.

How should we avoid the constraint of misalignment? Have skin in the game. Your incentive structure should enrich and reward the managers of capital and for doing a good job with that capital. Your enrichment should, in no small part, come from the compounding of your own capital. It should come from a thoughtful performance fee-led fee structure. Consider the *employment of hurdles, so charging a certain performance fee over a hurdle which has the effect of making the early performance cheaper for investors and strong performance more expensive. If the manager does well, the investors do well.*

There's a debate whether management fees should be charged at all, or whether it's your Buffett partnership fee structure of not having a management fee. The Mohnish Pabrai fee structure is the ultimate alignment of interest. I'm a subscale emerging manager, and the management fees certainly help me to make stress-free business and investment decisions. If I didn't have a management fee structure and re-mortgaged my house and made all kinds of personal financial decisions, I would not make good decisions for my investors. Also, tell your partners what's in the portfolio. Be transparent with the economic prospects of the portfolio holding companies. You ultimately want an LP base that can invest counter-cyclically. They can give you money when the markets are down. The vast majority of investors invest pro-cyclically, and that is a barrier to the sustainability of the money management business model.

My sixth observation concerns career risk and loss aversion. There is no shortage of rhetoric in the conversations I have with fund managers and large global asset managers about being a long-term fundamental stock picker in one breath, and with the next breath, asking you what Vodafone's Q3 EPS will be. These fund managers may well have a similar investment philosophy to long-term investors, but their capacity to execute that investment philosophy, their capacity to have an investment process consistent with that philosophy is inhibited by all of these things, by career risk, by short-term capital. All of these fund managers have a big budget, so they spend their big budgets on Bloomberg terminals, which encourages them to look at share prices, to look at near-term news flow, to look at markets, and ultimately to try to predict share price movements. This essentially leads to benchmark hugging.

The European Securities and Markets Authority (ESMA) discovered one in six funds overcharges clients because of benchmark hugging. The Financial Conduct Authority (FCA) estimates over £100 billion of investors' money is in benchmark-hugging funds run by apparent active managers. This study essentially shows that by being selective, having a high active share and being long-term, you're already on the path to outperform your benchmark-hugging short-term peers. But you need capacity for periods of dislocation from the benchmark.

How can we exploit career risk and loss aversion? As an independent emerging management firm, Tollymore has a disadvantage because we're subscale. However, we have an advantage because we can organically build a limited partner base sympathetic with the investment strategy that's intellectually generous, who can have conversations with us about business prospects at the underlying holding companies and not challenge us on why we underperform or overperform over short periods. In a nutshell, our job as investment managers is to tread this line between conviction and dogma. We want the conviction to average down. That helps us outperform if we execute correctly. But we want to have the humility to acknowledge our mistakes. We don't want an environment causing us to conceal our mistakes or our ignorance.

The seventh observation concerns short-term capital. Large asset managers with an entrenched LP base are not positioned to improve the quality of the LP base organically. They're stuck with *it. Asset gathering mandates have typically led to unidirectional marketing processes; that is, the manager pitches his fund, pitches his ideas to prospective allocators and current investors. That potentially leads to situations in which the investor and manager are incompatible. That can lead to sullied reputations in the investment management business and what is typically the case, procyclical capital flows. You haven't made your loss on your investments permanent until a redemption forces you to crystallise that loss. What's the issue? Short-term capital leads to short holding periods, and again, pressure to predict share price movements. Annual incentives at large investment management firms cause fund managers to try to lock in their bonuses, to make short-term investment decisions, and to trade frequently. Average holding periods are now around eight months.*

Having a performance fee-led structure avoids the temptation to risk substantial assets. We smaller managers have an opportunity to create organically an aligned LP base. That aligned LP base allows us to buy securities from sellers who are selling for non-fundamental reasons. That could be because they have procyclical investors, and therefore, they're funding redemptions, or because they think the news flow will be negative over the short term. That's because they have eight-month holding periods. Avoid these two situations by having a sympathetic, aligned LP base and the capacity to invest for the long term.

Communication style is my final observation. Attention spans in this industry are incredibly short. There's constant competition for attention. When I was writing research on the sell side, no matter how long the research note was, the most important part was a three- or four-line eloquent investment thesis on the front. That's what my clients, if anything, read. I have limited time, either on the phone with my clients, at meetings with fund managers, or within the investment bank, to communicate my thesis, to convince other people of my ideas, to have them believe me.

In a trading firm in an investment bank, there's a podium with a microphone. When a company reported results or when I wrote a piece of research, I jumped on the microphone. I literally shouted over a massive room of hundreds of sales traders to get their attention.

Analysts on the buy side also try to get the attention of their PMs. They have limited time to do this. The typical practice in the industry involves writing monthly letters offering a backward-looking introspection of what happened to markets and why. The letters reduce complex systems to simple eloquent theses.

There is a problem about stories in this industry. In life, stories are useful. They help us to make sense of the world. Perhaps you've read the book, Built to Last, by Jim Collins. It's a nicely written, entertaining book in which he dissects the sources of several outperforming companies. The conflation with the historical causality of that analysis with its predictive power would have caused you to potentially make some grave investment errors because around half of those companies, since he wrote that book, have suffered an enormous fall from grace. Making stories compelling might be entertaining, but it's a barrier to finding the truth. Stories are simple. The world is complex. Stories tend to describe outcomes to talent and stupidity while they ignore luck.

The literature refers to this as "narrative fallacy." It's our constant strive to attribute a cause and effect chain to historical events. This is useful in everyday life, but it can cause us to think in terms that violate logic. In his book, Thinking Fast and Slow, Daniel Kahneman gave an example in which he posed a question to several participants. The subject of the question was Linda, age 31. She was single, outspoken, and bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice, and she participated in anti-nuclear demonstrations. We asked which alternative is more probable? Is Linda a bank teller, or is Linda a bank teller active in the feminist movement? Despite the second alternative including all the information of the first and additional information, therefore being the illogical choice, 90% of undergraduates chose the second option. That's the power of stories.

How can we avoid and exploit this? Try to write involved, detailed, long shelf life letters to partners. We investment managers try to create not only an investment track record, but a decision-making track record, a journal of our decisions. Letters can show our current investors and our prospective allocators how we think. They can give them comfort that we're doing what we say we're doing. They can give them comfort that our process is consistent with our stated investment philosophy.

There's little value in writing retrospectively about market or stock price movements. It's reductive. Ideally, write infrequently or irregularly. Write when there's something to write about. Avoid pitching. This is incredibly difficult, but write in almost a bland way. Here are the facts. Here are the strands of logic. Here's the data that support a set of conclusions. A reader of those facts, data, and logic, if they come to the same conclusion as you and you presented that information objectively, is more powerful than pitching them an eloquent thesis that leads them to merely believe because of your sales skills.

How do we profit from this? Actively seek out stocks with bad stories. They might be opportunities the market is extrapolating from negative news flow. For me, the essence of value versus glamour investing is what James Montier discusses. It's finding the stocks, the opportunities where the investment merits are attractive, but where the stories and the news flow is negative.

The following are excerpts of the Q&A:

***Participant:** Mark, you just started your own fund. What advice would you give to someone who's just starting his own fund? What should he make sure of before jumping into this?*

***Walker:** One is to recognise the capacity to do well is limited, so you've got to love this for the intellectual exercise. To build a fund, you need to build an investment track record and a decision-making track record. You need to build trust with a series of hopefully aligned investment partners, and you need to embark on a journey of building relationships with those aligned investment partners. For me, it was important to enjoy that journey and enjoy those conversations for what they were so that I wasn't going to look back in five years and regret having spent all my time in building these relationships. Enjoy them for what they are. When you're a subscale investment manager, the temptation to take on assets through potentially the* *wrong type of capital is high. Try to be disciplined about the capital you take on, about the claim on your resources those investors might take. Think about what they might add to your investment organisation in addition to capital. Some thoughtful investors and family offices have a value philosophy and investment teams who, for me as a single-person investment committee, their time and their intellectual generosity is valuable to me outside of the capital that they can offer me. In the early days, I would suggest any desire to be rich is not a good source of inspiration. You will typically earn a lot less doing this than you can by being part of a large fund. It's a hugely scalable business model.*

Participant: *Why did you choose to start your own fund rather than work for a small fund you admired?*

Walker: *What you'll find is that it's important that everyone develops their own investment philosophy and their own principles and process that you think are consistent. No matter how aligned you are with a small fund, there will always be some inconsistencies. Temperamentally, I'm someone who enjoys collaboration but not a level of forced collaboration. Working in even small teams, I find it can be frustrating for me as a barrier to progress either in the investment management business or in investing in the portfolio. Aside from that, for the type of investing I wanted to do, for the investment philosophy I had, there's an incredibly tiny number of suitably aligned investment firms I would consider. Those firms are small firms with low levels of churn, long tenures of experience, and talented people. Getting opportunities are not always there. Several of my peers are open about the fact they don't like marketing. They're horrible marketeers, and they love business and investment, or they love the practice of investing. I quite like the process of building relationships with potentially aligned partners, of building something, building a brand, building a business, like a project outside of an investment portfolio as well.*

Participant: *I completely agree with your approach about not looking at the market price, the noise, and to completely focus on the business. But then, given that most of the funds across the board are focused on that, how do you suggest we present our facts and figures? How do you suggest we go about it, because not everybody can start their own fund, like yourself, and succeed?*

Walker: *It's not right for everyone. I'm just sharing my experience and the way smaller independent managers potentially have an edge over larger asset managers. There are smaller independent managers that sympathise with this approach. It's about being cognisant of the differences in the investment approach, about simply asking a question in your mind or explicitly to someone that you're interviewing with about how they think about aligning their interest. It's about how they think about decision-making, how they think about the elements of the process that are consistent with an investment philosophy. Closed funds are generally more able to do this. They have fewer marketing pressures, and they intend to have a quite sticky investor base. I encourage you to try to find compatible investment organisations to work with, to ensure there's a two-way dialogue in the relationship building process, and that you're not* *just trying to pitch yourself as a good employee without asking any difficult questions about how they conduct themselves.*

It took me quite a long time, if I'm being honest, to be introspective enough to interrogate my own personality and temperament. Typically, in the early days of my career, I worked for big organisations, and I was an introvert in an extrovert's business. I was shoehorning my personality into something that would fit the mould of a large organisation, adorning this gregarious, charismatic personality and then finding myself in working environments that suit gregarious personalities with open plan, noisy, trading floor environments. I found myself increasingly going to a quiet room to try to carve out time for independent thinking. I'm not suggesting one is better than the other, but a few people are genuinely introspective about what makes them tick and how many people are caught up in this process of building a shiny CV. Warren Buffett refers to this as an inner scorecard versus an external scorecard. The sooner you recognise that, the more useful it is in your career choices.

Participant: *Instead of wasting time trying to get the right price by forecasting, what else do you suggest? What are the tools you suggest we use to make our case?*

Walker: *We are in the business of understanding the long-term prospects of businesses. That is, for us, a forward-looking exercise. When I talk about the value of forecasting, I'm talking about the futility of precisely estimating a complex range of outputs. Rather than build a financial model where, line by line, you're going through volumes, and pricing, and variable and fixed cost, capital intensity, and tax rates, capital structure in 50 different markets for a company, and you're trying to do that in a quarterly basis and getting to an EPS estimate, then you're putting in a multiple on the EPS estimate. I suggest that is a low ROI exercise.*

I prefer to do a lot of fundamental work to answer a handful of questions. In terms of a business's financial future, I tend to try to understand what I call "owner earnings" or the "maintenance-free cash flow" of the business. If the business were to stand still today and invest what it needed to invest to maintain its unit output and its competitive position, how much cash can you put in the pockets of owners of that business today? That's a starting point that reflects a normalization exercise of reported earnings. For free cash flow, it reflects an understanding of what the normal working capital intensity or maintenance versus growth capex of a business is. It's a reflection of the cyclicality of the business. That's the normalisation process. Then I try to understand the sustainable economic returns on capital and to what extent we reinvest that capital into valuable projects for a long time.

If you have these owner earnings of 100, how much of that 100 will be reinvested into projects? What will they earn? Will they earn the cost of capital? Will they earn materially more than the cost of capital? Does the business enjoy lasting unfair advantages offering super-normal high profit capacity and profit sustainability? That ultimately gets me to what is a prospective IRR on an equity investment today. What are owner earnings as a percentage of the market cap? That's the yield. Say that's 10%. Say management will reinvest all of that into projects with incremental yields of 20%. I should be able to get a 20%-plus IRR on an equity investment barring any material derailing of the owner earnings of the business. It's a simple framework, but there's a lot *of fundamental work required to understand those numbers. If my opportunity cost of investing is, say, 10%, I want something materially higher. Tollymore has a concentrated portfolio. It holds 10 to 15 securities. It has a global remit, so I could invest in 50,000 companies. Therefore, I'm typically fully invested. I don't have cash because I should be able to, at any point in the cycle, find 10 to 15 of these securities with an IRR materially higher than an opportunity cost at any one time.*

Participant: *Can you talk about the companies which screen well? They've got great return on capital, great earning growth historically, but, fundamentally, they might be a bit weak.*

Walker: *I don't do a lot of screening. I'm a fan of the opposite of what you were asking about. Companies that might screen well are cyclical companies a lot of the time. Cyclical companies might be cheap when their earnings multiples are high. That's one reason I don't use screens. Cyclical companies have high returns on capital at the top of a cycle, but in the absence of sustainable competitive advantages, those returns on capital revert. That's a value trap. I suggest a good majority of screening based on returns and cheapness throws up those types of companies. It's the corollary I've been interested in and several companies in the portfolio exhibit, which is companies that screen terrible generally because their reinvestment rates are extremely high. Companies with negative free cash flow but attractive operating cash flow yield and enterprise value are attractive. Their capacity to invest in projects is high. I want them to have as much growth capex as possible if the capital structure of the business can support it.*

High reinvestment rates can explain why they screen poorly. It could be accounting measures, the accounting treatment of amortisation of quasi-permanent assets, for example. It can be the reason they screen poorly and the reason the economic, financial picture of a company is different than the reported accounting picture of a company.

We're in a world where you typically see some proprietary screening process. This is how we generate ideas. They look like a funnel. By and large, they're not proprietary, and by and large most people in the industry do screening. Maybe, unfortunately for me, having a more serendipitous process, which is like engaging with management teams, reading filings, engaging with my peers on the buy side and opening myself up to serendipitous conversations with companies and industries, isn't a mechanism to find ideas. That is perfectly fine if you're passionate and competent. It's not marketable, I can't put that succinctly and eloquently on a slide and show it to an investor, but it's a good source of investment edge.

Participant: *Mark, you spoke about focusing on a handful of questions in an investment idea. How do you get to this handful of questions? How do you identify them?*

Walker: *The difference is they're not the same handful of questions other than when it comes to valuation. I want to understand the normal earnings part of the company. I want to understand the reinvestment rate and the potential economic incremental returns in capital. When I conduct due diligence on a company, I have a number of headings where I go through filings, speak to management, speak to competitors, speak to peers, read industry investing publications, and try to gather facts and data to help me form a conclusion on a number of* *aspects in a research report. Those aspects are business simplicity. What is the business model? Can I get my arms around this business quickly? Is it complex? Does it have a simple organisational structure? Does it have complicated associates and minor interests?*

Second, what is the capital structure of the business? How does it finance its activities? What are the uses and sources of capital? Is the capital structure appropriate? Are there a lot of off-balance sheet items? Does it carry the leverage given the recurring nature of the revenues? Another is competitive positioning. Is there evidence for a moat? What are the potential sources of the moat? Is the moat widening or narrowing? Another is growth opportunity, a decent return on investment. What is the addressable market of the business? For how long can it keep reinvesting in projects? Does it have adjacencies it can invest in and expand the addressable market? There's stewardship. How are the decision-makers in the company aligned to make decisions consistent with value creation for owners of the company? Is there insider ownership in the company? Does the long-term incentive plan reflect management's ability to make potentially near-term difficult decisions for long-term value creation? Or do near-term decisions make a company's reported financials look weak but create value on the surface?

It's a fact-finding mission. I might get to a point where I just don't understand the business; it fails immediately at the business simplicity standard, and I just move on. I might get to a point where I'm uncomfortable with the stewardship of the company or the competitive positioning of the company to an extent that I don't think it's merited to continue doing research. I might get to a point where I write a complete research report and love the company and love the management and its stewardship and its prospects, but the recent valuation, the recent owner earnings yield doesn't give me a good shot at an attractive IRR; therefore, it might go on a watchlist over time. Those things change.

Participant: *What is the limit to the number of holdings while also maintaining an information advantage? Related to that, how long does it take you to get to know a company well?*

Walker: *It depends. For me, I feel if I have a portfolio of 20 to 25 names, I would struggle to know those assets well enough to make optimal portfolio management decisions. Diversification to me is not a mechanism to lower risk. If that diversification is inadequately resourced – take it to an extreme example, if you're one manager managing a one hundred-stock portfolio, your ability to know a lot about those businesses is limited. Therefore, your ability to have conviction in what they're worth is limited. Therefore, your ability to act based on share price volatility is limited. In terms of getting to know the businesses, that depends. I've invested after a couple of weeks of work on one business. Some unique circumstances caused the asset to come to market at an unduly distressed level. It was a simple business to get my arms around.*

Sometimes, like the last company I invested in the portfolio, I looked at it for about six months. The stock price declined by about 50%, and I did a little more work. Nothing had changed. It didn't require too much more work before investing in the company. It's unusual for me to go straight into an average-sized position. For me, an average-sized position is 7% or 8%. The smallest equity positions typically approximate 5% unless I feel exceptionally comfortable with the business model. Usually, I invest in negative stories and carry with them the potential for *further share price declines. For that reason and because six months is still a short time to get to know a company, and because of the long holding periods my portfolio has, getting to know these businesses is important in a multiyear, potentially multi-decade context. As I grow comfortable with the business and its potential and its management, I can potentially increase the size of that holding.*

Participant: *Do you go in with your desired sizing? Or do you scale in? How do you do that?*

Walker: *The last portfolio addition was at a 5% position.*

Participant: *Did you scale that over time? Or did you just go in?*

Walker: *I went straight in at 5% because it's concentrated, but that's the smallest position in the portfolio.*

Participant: *It doesn't create any market impact?*

Walker: *No. When I say going in at 5%, I'm not necessarily going in in half an hour. What I mean is, I'm not going in at 1%, and then a year later, maybe increase it to 3%. When portfolios are concentrated and you have a global or a large opportunity set, the question is, is this so massively undervalued that it should be in the portfolio? If that's the case, put it in and put it in meaningfully. Or if it is not, don't put it in.*

Participant: *Do you lock your investors' access for a period because you're so concentrated?*

Walker: *No. My investors can have access to their capital whenever they want. I don't want to create unhappy investors. There may be external circumstances outside of Tollymore that lead investors to sell positions. I want them to be able to have access to it. There is a process of education and relationship-building about the merits of long-term investing, and investors get it. They don't always act consistently with what they say. That's just part of being an investment manager.*

Participant: *You mentioned short attention spans and communication style. Could you give us examples of how you manage to capture people's attention in your letters?*

Walker: *I was suggesting you avoid the temptation to try to grab people's attention. The incentives in this industry are to create sound bites that truncate messaging and communication. They're meant to grab people's attention. The incentive to pitch is overwhelming for investment managers. That is a barrier to good decision-making. There's a lady called Annie Duke who wrote a book called Thinking in Bets. She was a professional poker player. I met her recently, and she gave me simple advice about how to make better decisions. If you want to open your work up to intelligent interrogation and analytical inquiry, you should not impart your opinion on whoever's receiving the information. It will influence their perception of the problem. It will make them less inclined to give you their dissenting opinion, which might be valuable. Their dissenting opinion might cause you to do more work. The additional work might lead you to* *acquire more conviction in your opinion or change your mind. You should be able to change your mind.*

When I wrote research for the sell side, I created eloquent theses. I'm not saying that's all there was. There was proper fundamental work underlying the research, but the focus was on grabbing people's attention. The focus on the microphone was on grabbing traders' attention. You're in competition with several other sources of stimuli devoted to the goal of grabbing others' attention. I suggest having a self-selection mechanism for the right types of investors by writing involved letters. I have a lot of information on my website. My last letter was 17 pages. I include many interviews, articles, and presentations. Therefore, if I have a conversation with investors who have gone through all that material, that is a higher intention conversation and potentially a more valuable relationship. By making people do the work and jump through hoops, you're almost creating this self-selection solution to creating the right relationships with the right investment partners.

***Participant:** Mark, from the investor's point of view, you've got into a lot of points about what to be wary of. Do you have some red flags when you're receiving pitches or looking at firms for us as potential investors to managers?*

***Walker:** Here's the barrier: When I speak to investors, high net worth people, their family offices, or their advisers, we have a conversation about the things to look for and how they allocate the liquid public market capital of their portfolios. There are things we have discussed that they're thinking about like alignment of interest, thinking about under what circumstances the investment manager is getting rich. They're thinking about under what circumstances the investor is getting rich. What are the incentive frameworks for them to make decisions? Do they have someone tapping on their shoulder, warning them that their deviation from a benchmark is not tolerated by the internal risk policy of the company?*

Technically, they get all this, but my barrier is the IBM effect, or the McKinsey effect. No one will get fired for recommending McKinsey to do a consulting project. If they do a bad job, they won't get fired. If they recommend an unknown consultancy firm or if the company hires an unknown auditing firm and is a fraud, that person will get into a lot of trouble. If they hire Deloitte, they probably won't. My problem is that even though they recognise a thoughtful way to think about enriching the providers of capital over the long term and there's a less thoughtful way that is a by-product of some of these behavioural constraints that we've discussed – despite recognising that – they're open about this McKinsey effect, the idea that allocating Tollymore Investment Partners capital is a career risk decision for them. It's my job to get their attention and be patient about building a multi-year relationship and trust profile that gradually overcomes that McKinsey effect.

***Participant:** How did you get over the infrastructure barrier?*

***Walker:** Infrastructure requirements and the compliance requirements are onerous in the U.K. compared, for example, to the U.S. My challenge was in trying to develop a proposition and an infrastructure that is the right trade-off between credibility and cost effectiveness. On one hand,* *I want quality, credible counterparties. On the other hand, I want to be able to survive as long as possible in a position of being subscale and coming back to not being under pressure to make stressful investment or business decisions about Tollymore and who you're partners with. Tollymore is effectively an appointed representative of a directly authorized FCA firm. That firm has a board of directors with career compliance people who fulfil my regulatory compliance obligations and help me to stay on the right side of the FCA. That's one option. The other option involves hiring a full-time compliance person. That's a costly source of fixed expense for a newly formed independent manager. Another option is that you go down the road of becoming directly FCA authorized, and I will then manage that myself. I'm not a lawyer, and I don't want to be spending all my time managing compliance. The FCA's handbook is enormous. I set it up by outsourcing several operational functions. I have legal counsel, accountants, and a compliance firm. My primary responsibilities are managing the portfolio, marketing the fund, and building relationships with other peers. This is no small undertaking, but it is incredibly enjoyable.*

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