HEDGE FUND INTERVIEW

Nick Schmitz and Dan Rasmussen's

of Verdad Capital Management

Nick Schmitz and Dan Rasmussen's Verdad Capital Management is not your typical value fund. The firm uses a leveraged investment strategy based on the research conducted by Dan Rasmussen and his research partner Brian Chingono, which has been described as 'the key to private equity.' This approach has produced huge returns for investors. Last year the fund gained 40.8% and year-to-date Verdad has returned 10.9%.

While working at Bain Capital as a young graduate, Rasmussen examined 2,500 private equity deals representing $350 billion in invested capital over 30 years and found that most of the successful deals had similar characteristics.

Firstly, the data showed that private equity is mostly a levered small-cap strategy. 95% of leveraged buyouts involved companies with an enterprise value of below $1.1 billion. And secondly when it came to price the magic number was seven times cash flow. Amazingly, across the 2,500 deals studied, when PE firms paid more than seven times earnings before interest, taxes, depreciation, and amortization for a company, their chance of success plummeted.

continue to page 6

HEDGE FUND INTERVIEW

Kyle Mowery and Saidal Mohmand

of GrizzlyRock Capital

Kyle Mowery is a Managing Partner and Portfolio Manager at GrizzlyRock Capital. Kyle founded the firm in 2012 with ten years of investment management experience and is responsible for the GrizzlyRock's investment management.

Kyle began his career at PAAMCO, a leading fund of hedge funds, before moving onto McDonnell Asset Management (now T.H. Lee Senior Credit Strategies) and then BMO Capital Markets' middle market leveraged finance team.

Kyle is joined by Saidal Mohmand. Saidal plays an integral role in GrizzlyRock's investment idea generation, analysis and portfolio management. Understanding that many of its clients may hold positions in other investment vehicles, Kyle and his team focus on finding only those hidden bargains that lie under the heaviest of rocks. You won't find names such as Apple or Liberty Global in the GrizzlRock portfolio.

continue to page 14

Contents

p 2
Editors' introduction

p 3
Update from previous editions

p 4
The Hidden Value Stocks Portfolio

p 5
Stanphyl Capital: One year later

p 6
Hedge fund interview: Nick Schmitz and Dan Rasmussen's of Verdad Capital Management

p 11
Verdad Capital stock highlight one

p 13
Verdad Capita stock highlight two

p 14
Hedge fund interview: Kyle Mowery of GrizzlyRock Capital

p 16
GrizzlyRock stock highlight one

p 18
GrizzlyRock stock highlight two

EDITORS' LETTER

Welcome to issue number eight of the Hidden Value Stocks newsletter. In this, our summer issue, we're going international with Nick Schmitz and Dan Rasmussen of Verdad Capital who use an interesting private equity style strategy to look for undervalued equities in the Japanese market.

Forbes once proclaimed that Dan had 'cracked the code on private equity' thanks to his detailed research on private equity deals while working at Bain Capital. We discuss how he uses his findings on private equity at Verdad in our interview, as well as two Japanese companies that meet his criteria and look as if they could achieve private equity-style returns for investors.

Our second interview is with Kyle Mowery and Saidal Mohmand of GrizzlyRock Capital. Kyle founded GrizzlRock in 2012 and has been leading the investment team ever since, picking out bargains amid the noise of the market. We discuss two of his top picks in the interview along with some other high conviction ideas.

As the market continues to edge higher, setting new highs almost every day, the number of mispriced bargains is dwindling, and as valuations continue to expand, opportunities to earn market-beating opportunities are few and far between.

However, the stocks picked by the managers we've interviewed for this publication have continued to outperform gaining a staggering 27.3% to the end of the first week of June, outperforming the S&P 500 by approximately 9.3% from year-end 2015 through May 15. Unfortunately, not all of the stocks picked have put in a positive performance, but none of the positions have produced severe losses or a permanent impairment of capital. In this issue, we have a one-year update from the second fund featured in this newsletter, Stanphyl Capital as well as our usual updates.

Passive takeover

According to ratings agency Moody's, the passive investment market will overtake the active fund industry in the US by 2024. This estimate is based on analysis from fund redemptions over the past decade versus inflows into passive equivalents. For example, last year investors withdrew $340 billion from active managers while allocating $504 billion to passive alternatives.

This strategy may be appropriate for most armchair investors but buying the market caps your returns, and there's no chance of outperforming (after deducting fees you will underperform).

The low-cost passive fund model has several drawbacks, which active value investors can use to their advantage. Passive funds have to achieve scale to be economically viable, which limits the funds to the largest and most liquid securities. As a result, illiquid small caps are being overlooked.

In the annual letter to his investors at Baupost, renowned value investor Seth Klarman speculated that this trend away from active towards passive, buying into efficient market theory, is ironically making markets more inefficient. Klarman notes that ETF activity tends to "lock in" relative valuations between securities as managers have to buy securities in an index in proportion to their current market capitalization. Therefore, high valuations are likely to persist. At the same time, those equities outside the indices may fall out of the range of investors, increasing the likelihood of security mispricing and giving long term value investors a distinct advantage.

At a time when the rest of the market is giving up on individual security selection, Hidden Value Stocks remains dedicated to hunting out the market's most mispriced securities with an asymmetric risk-reward profile. The returns that have been achieved so far by the Hidden Value Stocks portfolio show that this is possible and you can indeed still beat the market with a well-research selection of undervalued securities.

We hope we can continue to provide you with these valuable opportunities.

Sincerely,
Rupert Hargreaves
& Jacob Wolinsky

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Updates from previous editions

The hedge funds we've profile in previous issues of this newsletter have put in a mixed performance so far this year.

> *"Arquitos celebrated its five-year anniversary on April 10 and over this period the firm has returned 30.9% annually net of fees for investors, outperforming the S&P 500 by 17.2% per year and the HFRI Index, an index that broadly measures the performance of all hedge funds, by 26.9% per year.*

Following a tremendous 2016, Arquitos Capital, which featured in our Q1 2017 issue, has gotten off to an excellent start to the new year. For the first quarter, the fund achieved a total return of 17.6% net of fees, a return some hedge funds struggle to achieve even after many years of operation.

Arquitos celebrated its five-year anniversary on April 10 and over this period the firm has returned 30.9% annually net of fees for investors, outperforming the S&P 500 by 17.2% per year and the HFRI Index, an index that broadly measures the performance of all hedge funds, by 26.9% per year. Before fees, the fund has returned 38.8% annually. Despite these returns, Arquitos remains a small player in the hedge fund universe, allowing it to seek out bargains where others might not think to look. With only $11 million of assets under management, Arquitos is forced to focus on only the best opportunities with minimal downside risk and enormous potential. We will keep you updated on how Steven Kiel and team fair over the next few quarters.

The other fund that featured in our Q1 issue, Alluvial Capital has also achieved a positive start to the year. For the year to the end of the first quarter, the Alluvial Fund produced a return of 5.1%, lagging the S&P 500 by 1.0% but outperforming the Russell 2000 by 2.6% over the period. Alongside the ideas mentioned in our interview, Alluvial sees value in Ferronordic Machines, the authorized dealer of Volvo construction equipment and Terex trucks in the Russian Federation. You can find Alluvial's full first quarter letter on our site, www.hiddenvaluestocks.com

After a monster 2016 performance where the fund produced a return of 35%, the team at Bluetower will be disappointed with the fund's first quarter performance. The Global Value strategy returned -2.9% gross and -3.14% net as one of the fund's largest positions, EZCORP fell.

EZCORP was one of Bluetower's picks in our interview with the fund and the first quarter letter sheds some light on what went wrong at the company during the past few months. EZCORP is a business in transition. Late last year the company sold Grupo Finmart, its Mexican payday lending service and the group is undergoing a major hiring push and switching their workforce towards being full-time only and phasing out many part-time roles. Management hopes this switch will reduce employee turnover and improve the customer experience. At the same time, EZCORP has invested $3 million developing a new point of sale system, which "will use the individual history of each borrower to determine the relative likelihood that the borrower will repay their pawn loan. For individuals who are more likely to pay back the loan, EZCORP can give a larger loan and therefore boost the balance upon which they are collecting interest" according to Bluetower's letter. With this proprietary software in place, the company should be able to gain a significant advantage over peers.

> *"Bluetower remains convinced that these "lenders that have structural advantages in underwriting will outperform their competition" and the recent selloff "creates a value opportunity for us over the long-term as these quality companies are now trading at bargain valuations."*

Despite its sector-leading tech, EZCORP's stock has suffered from the same deterioration in sentiment towards auto loans (and lower quality lending institutions in general) that has hit Nicholas Financial – another Bluetower pick. Nonetheless, despite deteriorating sentiment, Bluetower remains convinced that these "lenders that have structural advantages in underwriting will outperform their competition" and the recent selloff "creates a value opportunity for us over the long-term as these quality companies are now trading at bargain valuations." ■

Hidden Value Stocks Portfolio

Edition	Stock Pick	Ticker	Open Price	Date Pitched	Date Closed	Dividends	Current Price (1) (2)	Total Return
1	Volt Information Sciences Inc.	NYSEMKT:VISI	7.60	28/01/16	01/28/17		8.45	11.18%
	MRV Communications Inc.	NASDAQ:MRVC	11.21	28/01/16	01/28/17		8.15	-27.30%
2	MGC Diagnostics Corp	NASDAQ:MGCD	5.94	03/28/16	03/28/17	0.70	8.30	39.73%
		NASDAQ:LTRX	0.90	03/28/16	03/28/17		3.31	267.78%
		NASDAQ:ELON	5.77	03/28/16	03/28/17		6.20	7.45%
	Broadwind Energy Inc.	NASDAQ:BWEN	2.87	03/28/16	03/28/17		7.25	152.61%
3	ProAssurance Corporation	NYSE:PRA	51.47	06/21/16		0.98	58.95	16.44%
4	CUI Global Inc	NASDAQ:CUI	5.99	09/23/16			108.94	-45.74%
	Cooper-Standard Holdings Inc	NYSE:CPS	106.03	09/23/16			847	2.74%
5	BrainJuicer Group PLC (System1)	LON:SYS1	500	10/07/16		5.5	2.35	70.50%
	Thrace Plastics Co SA,	ATH:PLAT	1.69	10/07/16			0.39	39.05%
6	Jadestone Energy Inc	CVE:JSE	0.5	12/21/16			9.00	-22.00%
	Nicholas Financial, Inc.	NASDAQ:NICK	11.1	12/21/16			8.6	-18.92%
	EZCORP Inc	NASDAQ:EZPW	10.65	12/21/16			23.30	-19.25%
	MMA Capital Management	NASDAQ:MMAC	21.45	03/15/17			1.61	8.62%
7	ModusLink Global Solutions	NASDAQ:MLNK	1.87	03/15/17			14.39	-13.90%
	Capilano Honey	ASX:CZZ	14.58	03/15/17			7.73	-1.30%
	CRH Medical Corporation	TSE:CRH	11.33	03/15/17				-31.77%
					Average return			27.25%

(1) For closed positions this price is the price at time of close.
(2) Prices as of June 07

Stanphyl Capital: One year later

Stanphyl Capital was the second hedge fund featured in Hidden Value Stocks. One year on from the first interview, we've asked Mark Spiegel to revisit the ideas he put forward. As you can see from the returns sheet on the following page, Spiegel's picks have produced some impressive gains since the interview was first published. Stanphyl was up 30.8% in 2016

Spiegel's best-performing pick has been internet of things play Lantronix. At the time of our first interview, Lantronix was trading below $1.00 per share but has since rallied by more than 260%. According to Mark, Lantronix's positive performance during 2016 was a result of "tangible operating improvements brought about by its new management team, " and while the stock has continued to rally into 2016, Stanphyl started to take profits in late 2016 "in the high $2s and low $3s." To ensure a fair playing field, all of the stocks in the Hidden Value Stocks portfolio are held for one year from initial publication. In this case, the total return for holding over the one year period is 267%.

Stanphyl's second best performing pick (and the second best performer in the Hidden Value Stocks portfolio)is Broadwind Energy. Broadwind was trading at just under $3 per share when the Stanphyl interview was published. Throughout the year the stock went from strength to strength, and Spiegel took gains when the stock hit "the high-$4s and low $5s." Broadwind continued to rally up to $9 and thanks to the longer holding period of the Hidden Value Stocks portfolio; we managed to capture some of these gains.

> *At the time of our first interview, Lantronix was trading below $1.00 per share but has since rallied by more than 260%.*

Stanphyl still holds the other positions recommended in the interview, notably Echelon and MGC Diagnostics. Last year, MGC announced it was exploring the possibility of selling itself and simultaneously paid a $0.70/share special dividend, for a yield of a little under 12% on the initial purchase price. Following the payout, the stock has continued to run higher. Limited by the one-year holding period, the Hidden Value Stocks portfolio closed the position for a total return of 39.7%. As noted above, Stanphyl remains an investor in the company.

Echelon is Stanphyl's worst performing stock rising less than 10% over the 12-month holding period. Nonetheless, according to Spiegel Echelon has "has shown continued fundamental deterioration but was cheap at the time of the original interview (priced in the low $5s, which gave it a negative enterprise value)." The stock traded lower during the year allowing the fund to "add substantially in the $4s". As it moved up to $6 Spiegel has "moderately lightened the position" but still holds "the bulk of it while waiting to see if the company can turn itself around." ■

HEDGE FUND INTERVIEW

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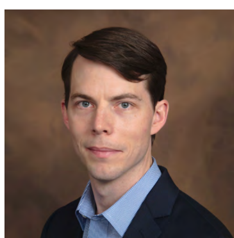
continued from page 1



Nick Schmitz

Dan Rasmussen

Verdad's strategy is built around these findings. Rasmussen and Chingono's paper on the topic of leveraged small-cap investing in the public markets would have had an average annual return of 25.1% from 1965-2013, significantly outperforming all other styles.

By investing following a PE model in public markets, Verdad can attempt to replicate the returns of the PE model but with several key advantages. First, the firm can pick up stock at better prices. Verdad's average purchase price is less than 6x EBITDA with average debt levels between 3x to 4x EBITDA. Second, thanks to the scrutiny of financial analysts and short sellers, public markets are more transparent than private markets. Third, public market investing is much cheaper than private market investing where the burden of complex transactions can really add up. And finally, unlike private deals, with public equities Verdad can exit a position whenever it sees fit without being subject to a lengthy transaction process.

In our interview, Nick and Dan discuss their investment process, how they go about finding potential opportunities and why they've decided to employ their strategy in Japan. They also discuss two Japanese stocks that they like and why they believe they can produce private equity-style returns for investors.

Let’s tart by talking about your strategy, levered small caps. Why do you believe this strategy has the potential to beat the market?

Our roots are in private equity. Look at how dramatically the median private equity manager beat the S&P500 over the three decades from 1980 to 2010. We’re talking 5% to 6% net of fee outperformance, or about 10% to 12% gross of fees. That’s for the average manager! If you assume that the average private equity manager is no better than the average mutual fund manager, you have to conclude there is something special structurally about private equity. We think that comes down to three factors: private equity deals are significantly smaller, significantly more leveraged and, until 2010 or so, significantly cheaper than the broader public equity markets.

> *We believe that we can produce returns that look like historical private equity returns by buying small, cheap, highly leveraged businesses.*

We believe that we can produce returns that look like historical private equity returns by buying small, cheap, highly leveraged businesses. We’ve done extensive quantitative research to prove this out. Our innovation is of particular importance today because the era of easy profits in private equity is over – too much money has flooded in, and PE firms have departed from their traditional playbook of buying cheap. Ironically, the purchase price is the most predictive indicator of PE deal returns historically. We think it’s much wiser to buy in public markets now at 5x to 10x EBITDA than in the modern PE environment at 11x to 12x EBITDA.

And you think Japan is the best market for this?

Japan is extremely cheap on an absolute and relative basis right now. Japan in 2017 is the most affordable market in the developed world. Indeed, the Japanese stock market is cheaper today than at the depths of the financial crisis. The country’s stocks trade at the lowest valuations in over twenty years. The gap between valuations in Japan and the United States is larger now than at any point since the peak of the dot-com bubble in 2000. Most foreign investors are familiar with the “Lost two decades” in Japan. It’s true if you invested in the Nikkei (big and expensive). However, if you had been a buyer of small-cap value buyer according to the Fama-French model since the 90s, you would have done quite well.

Levered equities in Japan are unique. The Japanese have had a zero interest rate policy for nearly 30 years, and bankruptcy in Japan is almost non-existent for various reasons. The lack of bankruptcy is crucial to us: that’s our biggest risk when we invest in leveraged firms in the US and Europe. Finding a market where there is essentially no bankruptcy means that we can execute our strategy with significantly reduced drawdowns and volatility.

Finally, capital allocation in Japan from a shareholder’s perspective has been horrible, and we find that when you screen for indebted companies, you mitigate a lot of that. Ironically, most value investors in Japan have been biased towards cash-heavy “fortress” balance sheets following conventional wisdom. The theory sounds great, but we wondered if there was any actual evidence that it works. We tested this and found that leverage has been the single most statistically significant predictor of future price returns in Japan for the past 20 years. The other way actively managed value investors have attempted to solve the capital allocation problem in Japan is through activism, an approach that’s had little success. We would much rather select the universe of stocks where this capital allocation behavior is passively mitigated through debt.

> *Levered equities in Japan are unique. The Japanese have had a zero interest rate policy for nearly 30 years, and bankruptcy in Japan is almost non-existent for various reasons. The lack of bankruptcy is crucial to us: that’s our biggest risk when we invest in leveraged firms in the US and Europe. Finding a market where there is essentially no bankruptcy means that we can execute our strategy with significantly reduced drawdowns and volatility.*

Japan looks cheap compared to US equities today, but that has been the case for the past two decades. What makes you think that now is the time to buy?

Yes, there has been a relatively persistent valuation gap between Japanese and US stock for the past few decades. However, it’s not quite that absolute. In 2009 and 2010 Japanese stocks traded at roughly 9x EBITDA (above the US). Now, the median stock in Japan trades at about 7x EBITDA while the US is closer to 12x.

While there is some empirical evidence to support mean reversion of multiples across international equity markets over the long term, we recognize that Japan is unique. Whether it’s capital allocation,

government debt, demographic trends or any of the usual consensus pessimism mantras of the nattering nabobs of negativity, there are ample anecdotal reasons one might rely on to justify the valuation gaps going forward. We aren't explicitly bullish on Japan, and we don't need to be. We simply ask, is it that bad? We could make equally anecdotal optimistic observations about Japan's prospects: Japanese profitability and business confidence are at highs. Unemployment is at record lows. Debt/GDP has leveled off, with no indications of radical policy change from either the BOJ or the government. Both absolute and per-capita GDP are at highs. We struggle to see a reason why Japanese stocks should be trading at half the level of US stocks and all-time lows. With GDP numbers out in May, we saw Japan's economy expanded for the fifth consecutive quarter for its longest growth streak in about 11 years.

Overall, we love the pessimism surrounding Japan right now and the catastrophic scenario implied by current valuations. Philosophically, we think the world is far less predictable than most people believe and when you invest where consensus pessimism is the strongest as evidenced in prices, we expect to benefit from that fundamental unpredictability in the long run.

Dan, Forbes once proclaimed that you've 'cracked the code on private equity' thanks to your research into private equity deals. What were your findings?

There are three fundamental differences between private equity and public equities.

First, private equity deals are significantly smaller than broader public benchmarks. The typical private equity deal is $258 million of market capitalization, relative to $2.3 billion for the Russell 2000 or $40.5 billion for the S&P500.

Second, private equity transactions are significantly more leveraged than the average public equity. The average net debt to enterprise value at inception for private equity deals is approximately 50%, compared to about 16% for the average small-cap public company.

Third, and most importantly, is that private equity firms have historically bought at a significant valuation discount to public equity markets. During the 1990s and early 2000s, private equity firms were paying less than 8.0x EBITDA while the broader public equity markets traded well above 10x. Since 2010, that valuation gap has closed, and PE purchase multiples have risen above 10x.

At its core, our strategy is simple: we mimic the strategy that made private equity outperform in the 1980s and 1990s, buying public equities that share the same quantitative characteristics as the best performing LBOs: small, cheap, and highly leveraged.

> *"The structural formula of the private equity industry that led to its outperformance in the 80s and 90s was very simple: buy small, cheap and levered with a high probability of debt paydown and limited bankruptcy risk.*

And you think it's possible to replicate private equity success by investing in the public markets?

Yes. We have made a lot of money doing just that over the last five years. The structural formula of the private equity industry that led to its outperformance in the 80s and 90s was very simple: buy small, cheap and levered with a high probability of debt paydown and limited bankruptcy risk.

There is a huge calibration error surrounding the private equity industry at the moment. For example, most asset managers believe, and business schools teach that private equity adds value through superior operational skill alongside deleveraging. We have found little empirical evidence in the historical data that this is true in the aggregate. Instead, when PE follows the simple formula (buy small cheap and levered), that explains roughly 90% of their profits. The forecasting track record in private equity is as bad as it is in sell side research. While the latter is public and well documented, the former is private and not subject to the same public scrutiny. However, people want to believe their returns are driven by brilliant, skilled Übermensch who can predict the future. As PE firms continue to buy today at 11x and 12x EBITDA in violation of the structural formula of success we believe has led to their historical outperformance, we expect the industry to underperform. To the extent we can buy in public markets in the 6x to 10x range (3x-6x in Japan now), we hope to achieve similar results to private equity's historical outperformance.

The fundamental difference between private equity and public equity markets is that private equity owners have much more control over the leveraged businesses they own. With public companies, the lack of control available to investors is extremely apparent. Surely this has an impact on your investing strategy?

Yes, but there are also benefits we enjoy that private equity cannot. The most significant difference is that we can buy at 1/3rd to half of the prices they are paying today for private ▶

companies. We don't pay control premiums. Additionally, when we are wrong on an investment, we can get out almost immediately and keep 80% of our money. Private equity will ride that thing down to zero.

On the control factor, it's true we give that up, and we don't even try the activist method, especially in Japan. Instead, we developed predictive debt pay down algorithms and find we can predict debt paydown with about 70% accuracy. It sounds fancy, but in reality, it's very intuitive. Deleveraging is what makes a difference to equity investors in cheap levered equities, and we would trade the safety of being able to get out of a dying name right away for a 30% reduced probability of ensuring debt pay down any day.

Do you tend to use soft stop losses or pull the plug after an equity has declined by a certain percentage?

We are rules based. If a stock we bought into continues to meet our criterion, we hold until at least a year before rebalancing. If for some reason it ceases to meet our criterion, we rebalance. We try to stay tax efficient that way, and we take short term capital losses alongside long term capital gains. Often, a handful of these names will return 2x over the course of a year and at that point we begin to sell down. We don't want the portfolio to be overly concentrated in individual names.

Are you looking for stocks with upcoming catalysts or just highly leveraged equities?

Indirectly yes, but we find ourselves more focused on negative catalysts. We think low valuations typically imply a negative future catalyst and the market's weighted confidence in it occurring. Evidence from social psychology and financial academia suggests that experts are often overconfident in both their optimistic and pessimistic forecasts. On a more general, philosophical level, meaningful catalysts are largely unpredictable but inevitable given enough time. One fascinating study from the *Journal of Finance* in 2007 looked at the impact of news events on stocks. The study found an interesting pattern: news events affected different categories of stocks very differently. For the stocks that investors were most optimistic about — the high-priced glamor stocks (think Facebook, Google, and Amazon) —news events had a high probability of negatively impacting the stock price. For low-priced value stocks which investors were most pessimistic about (newspapers, printing companies, etc.), news events had a high probability of having a positive impact on the stock. We look at a cheaply priced company, try to discern the source of consensus pessimism around it, and then decide if it's all that bad or if given the fact that the future is far less predictable than most people assume, there is potential for repricing.

> *"For the stocks that investors were most optimistic about — the high-priced glamor stocks (think Facebook, Google, and Amazon) —news events had a high probability of negatively impacting the stock price. For low-priced value stocks which investors were most pessimistic about (newspapers, printing companies, etc.), news events had a high probability of having a positive impact on the stock.*

Many investors might consider this strategy risky because of the leverage element. How would you respond to that?

This is true in the US. When high yield markets struggle in the US, US levered equities suffer.

In Japan, we've seen less volatility and smaller drawdowns in the small-value index (see Fama-French for example) than in the larger constituents of the Nikkei. This might be surprising for a US investor, but what's even more surprising is that leverage has historically added almost no additional volatility or drawdowns. In the depths of the 2008 financial crisis, the S&P 500 had a max drawdown of approximately 53%, the Nikkei 225 drew down 48%, Japan small value drew down 31.5%, and our reference class of levered small value Japanese stocks drew down roughly 32.3% (all in dollar terms).

How is that possible?

Debt markets in Japan are radically different from the US and Europe given that there is essentially no high yield market, the Japanese have maintained a zero-interest rate policy for 30 years, and bankruptcy has been almost nonexistent this millennium. Out of approximately 3,700 publicly listed Japanese stocks, the most bankruptcies in any given year since 2000 was 33, at the peak of the crisis in 2008. Since 2014, we have only seen three publicly listed bankruptcies in Japan. For these reasons, leverage has added virtually zero incremental risk historically, and we've seen levered small value exhibit very similar volatility and drawdown characteristics to small value over extended periods of time. This breaks a lot of the risk models/assumptions western investors typically have of levered equities.

It sounds as if the strategy is value and contrarian, buying out of favor highly leveraged equities trading at a discount valuation?

▶

Yes, we love consensus pessimism, and we look for opportunities to bet against it. If there were no execution costs associated with shorting, we would likewise see a strong theoretical case for betting against strong consensus optimism. However, shorting can be costly, and we have a very narrow field of expertise, so we try not to be good at everything at once.

> *Right now, pessimism surrounding Japan as reflected in valuations is extremely high, and the bottom quartile of Japanese value trades around 4.5x to 5.0x EBITDA. Companies priced like that in the US are usually on the road to liquidation or bankruptcy.*

Right now, pessimism surrounding Japan as reflected in valuations is extremely high, and the bottom quartile of Japanese value trades around 4.5x to 5.0x EBITDA. Companies priced like that in the US are usually on the road to liquidation or bankruptcy. The free cash flow yields on these businesses are often well north of 20%, so we have a hard time conceptualizing the macro-catalyst that would justify such pricing. This makes for a very ripe playing field for our strategy and our unique specialization in cheap leveraged equities given how individual Japanese debt markets are.

> *leverage has been the number one statistically significant predictor of future price returns on Japanese equities for the last 20 years.*

You could think of us as passive activists in Japan. Capital allocation if a significant problem in Japan. By targeting highly levered companies, we get a management team that is disciplined by debt and pressured to direct free cash flow to pay it down. We believe this gives us a set of corporate managers who behave much better for equity investors from a capital allocation perspective than the average Japanese management team. We don't need to engage in fancy activism that is predicated on our persuasive or strategic skill to succeed here. We just select the universe of Japanese stocks where it's much harder for management to squander the excess cash of the company through cash hoarding, overpriced M&A or pipedream CAPEX and R&D spend. Our research on 20 years of Japanese equity data suggests this approach works well. For this and other reasons, leverage has been the number one statistically significant predictor of future price returns on Japanese equities for the last 20 years.

Are you concentrated or diversified?

Diversified. We run about 35 to 40 names in Japan. Broadly, and while it may "sell" better, we don't believe in expertise, and we bet against it every day. We are quantimental. Everything we bet on is screened first by the results of our research of long data sets of equity performance and each of our factor weightings if backed by both evidence from the past and theory about the present and future conditions. We won't even look at a name that doesn't fit our screen criterion and ranking. As we move down our rankings, we find performance deteriorates, and as we go more concentrated towards the top, outcomes are more stochastic. That said, we don't just blindly follow the screen. There are some things you can't train a computer to do, and a well-trained analyst's eye is needed.

As we move down our screen, we look for the logic for the consensus pessimism and ask if it's all that bad. Sometimes we agree that it is and leave a name behind. We've found that somewhere between 30 to 40 names is optimal for performance and diversification. ■