Shadowridge Value LLC

Brett Dorendorf, CFA | brett@shadowridgevalue.com
Founder & Research Analyst

Keys to Firm & Client Success

- Shadowridge Value LLC (SVLLC) was designed to capitalize on structural and behavioral advantages in three key areas:
  - People
  - Philosophy
  - Process
- Partnership mentality with like-minded investors
- And of course, the primary goal over the long-term is to earn satisfactory returns without taking on excessive risk

People – Introduction

- Brett Dorendorf
  - Founded SVLLC in 2020 and serve as sole research analyst / portfolio manager
  - Financial acumen largely developed independently (self-taught)
  - B.A. in Political Science / International Relations, UC San Diego
  - Earned the Chartered Financial Analyst (CFA) designation in 2020
- Equity Research Associate, Brandes Investment Partners
  - Value-oriented investment management firm in San Diego with $25 billion AUM
  - 5 years experience covering financial and industrial sectors
- Defense contractor for US Navy
  - 5+ years of project management experience
  - Fun facts: toured nuclear attack submarine; obtained secret clearance
- Why am I doing this?
  - The work is stimulating, fun, fulfilling and serves as an opportunity for continual learning / improvement

People – Advantages

- One man operation, no investment team
  - **Accountability** – Investors know who is responsible for investment ideas, portfolio decisions and ultimately, generating returns
  - **Asset base size / agility** – Ability to focus on most compelling opportunity at any given moment, able to change direction quicker than most
  - **Aligned** – Personal stake / family has "skin in the game" and comprises a material portion of the firm's total capital base
  - **Independent** – No pressure / career risk in saying "I don't know" and/or passing on ideas at any point in the research process
  - **Conviction** – Concentration avoids idea dilution and the social proofing common in teams and/or investment committees
  - **Low-cost** – Overhead extremely low (no office, employees) vs. most asset managers
  - **Partners (investors)** – Like minded, long-term orientation allows me to implement the strategy to the best of my ability
  - **Temperament** – Patient, disciplined, independent, creative
  - **Time Horizon** – Investing for myself & my family on multi-decade time frame

People – Disadvantages

- Absence of track record
  - I'm not yet rich myself and perhaps I should be prior to managing client's capital
- Lack of industry or geographical specialization
  - Could miss things niche or local investors commonly know
- Personal blind spots / biases
  - We all have them, and they impact investment returns
- Portfolio management brings a new dimension to previous roles where the emphasis was solely on research & analysis
  - Experience to date largely in evaluating companies / industries
- One man operation
  - Jack of all trades for things such as compliance, marketing, operations, etc.
- <u>Outperforming passive indexes over long periods of time is difficult</u> and there's no guarantee I will be able to

Philosophy – Public Markets

- Stocks represent fractional ownership in an underlying business
  - Long-term stock performance is driven by the per share compounding of business value
  - Usually means a combination of cash flow / earnings growth & valuation multiple expansion or contraction
- Fluctuating market prices are there to serve you, not dictate trading activity or evoke emotional reactions
  - But they can, and from time to time, they will (resist the urge)
  - The markets occasionally misprice securities for temporary / behavioral reasons
- Always have an appropriate margin of safety
  - Achieved predominantly by not overpaying – the source of most risk – but can also come in the form of favorable business characteristics, management, strong balance sheets etc.
  - Goal is to prevent permanent loss of capital, not avoid near-term price gyrations

Philosophy – Investing Approach

- Absolute returns orientation
  - Investing with the intent of achieving positive results over time vs. speculating
    - Seeking asymmetrical opportunities where the upside is significant, and the downside is hopefully limited
    - Not concerned with constantly comparing to a relative benchmark
  - Positions will be taken only in securities perceived to have adequate return profiles based on an assessment of intrinsic value
    - Intrinsic value is the underlying value of a company based on a careful analysis of earnings, assets, dividends, liabilities, future growth prospects, & management quality
    - Not a precise figure; a range of values under various scenarios and valuation techniques must be considered
  - Bottom-up, fundamentals driven approach
    - Evaluate each company on individual merits from the perspective of a business owner
    - Ignore the macro noise / refrain from making investments based on predictions related to macro-economic growth, foreign currencies, inflation, interest rates, etc.
    - Willing to hold cash if opportunity set is not compelling enough

Philosophy – Investing Approach

- Generalist – go anywhere mandate as opposed to specialization
  - Not limited to specific geographies, market caps, or sector exposures
    - Wider research universe = more opportunities to discover investment opportunities
  - Flexible & opportunistic to seek out the best bargains while avoiding expensive and overpriced companies / industries
- Seek out areas of the market where competition is limited, forced-selling occurs, or boredom and neglect tend to take hold
  - Higher probability of undervalued stocks and consequently, a bigger opportunity for outsized returns
- Clients are the priority and viewed as partners
  - Utmost integrity and discretion with client's capital
  - Fund manager & family investing alongside outside partners
  - I envision a two-way relationship where investors can assist me by sharing their experiences as consumers and/or by advising on their respective industries

Philosophy – Investing Approach

- Long-term, multiyear time horizon enables opportunistic mindset
  - We are interested in returns generated over many years while most managers are concerned with outperforming short-term benchmarks
    - Investors who make mistakes due to a focus on monthly or quarterly returns provide opportunity for long-term investors
  - Typical holding period of a position may range anywhere from 1-5+ years
    - A “double” in a 5 year time period translates ~14% annualized returns
  - Determining factor will be the intrinsic value of the security and management execution
    - If a discrepancy between price and value corrects in short order, profits will most likely be taken (especially on lower quality businesses)
    - By contrast, if intrinsic value continues to increase and the business exceeds expectations, the position may be held for longer or even increased in size over time
  - Expectation is that most developments will materialize over a longer time period
    - An extended investment horizon allows investors to focus on the underlying value of the business, not short-term market volatility
    - Longer holder periods also reduce trading expenses as well as tax consequences

Philosophy – Investing Approach

- Independent thought, research, and analysis
  - Attempting to avoid the herding mentality cycle of fear and greed
  - Primary and qualitative research emphasize, no reliance on sell-side research
- Searching for value where few others are
  - Size advantage with a small capital base
    - Smaller companies have less competition / coverage from many institutional investors
    - Smaller companies are simpler to understand and sometimes have far longer growth runways than established companies
  - Contrarian positions
    - Cheap, ugly, discarded, and unpopular securities or industries
    - Motivated sellers, misunderstood, and undiscovered companies, etc.
- The future is unknown and forecasts are unreliable
  - Events rarely unfold as expected which can be a significant detriment to an investment thesis based on too many predictions
    - Assets tend to be more reliable than earnings in the short term
    - Cash flows are more reliable than earnings

Philosophy – Risk

- Risk means more things can happen than will happen
  - Think about risk first and try to envision / limit the downside scenario
- Contemporary portfolio management theory equates risk to price volatility
  - A stock that has simply appreciated / depreciated in price is considered riskier
    - Not intuitive all else equal
  - Risk and return are positively correlated
    - This is not always the case, remember there are sources of asymmetric returns
    - Satisfactory returns can be achieved with lowered risk in the right circumstances
- In the context of investing, risk describes the likelihood of permanent loss from an investment
  - Overpaying for an asset is the primary means of impairing capital
  - Consider how much can be lost and the chances of losing it
  - By appropriately diversifying, only purchasing securities with a substantial margin of safety, and buying quality assets the chances of loss can be reduced

Philosophy – Risk

- Margin of safety is often defined as the difference between the estimated intrinsic value and the stock's market price
  - But it can manifest in many ways outside of strict valuation figures (quality of the business/management team, balance sheet strength, or a combo of these)
  - Future growth of the business is also an important part of the equation
- Risk management techniques
  - Avoiding activities that have been cause for disaster historically
    - I don't short-sell, use margin, and am weary of financial leverage at the company level
  - By buying securities at a discount to intrinsic value, risk of permanent capital loss is lowered
    - Provides downside protection against unforeseen events or erroneous analysis
- Securities with an appropriate margin of safety / return profile are not always readily available in the markets
  - Patience and discipline required
  - Hold cash when opportunities are lacking

Philosophy – Disadvantages

- Absolute returns focus
  - Can look out of step for extended periods of the market cycle and any cash balances can act as a drag on returns
- Global generalist approach
  - Lack of expertise in all regions / industries
    - Business culture, English filings, rule of law etc.
  - Foreign currency exchange rate impacts against US Dollar
- Fundamental approach
  - Could be wrong about future business performance or investment opportunities
  - No incorporation of technical, momentum, or sentiment indicators
- Long-only and long-term oriented
  - May have to endure / hold through severe downturns without offsetting hedges
  - Could be years before I know whether an investment is or isn't working
- Concentration
  - Portfolio swings may be more volatile than other investment managers

Process – Overview

- The process is relatively controllable, but any specific investment outcome is not
  - Luck can and does play a role unfortunately
- Primary components to the overall investment process:
  - Idea generation
  - Research & analysis
  - Portfolio construction
  - Hold / sell discipline
- A consistent approach in research & analysis is paramount while flexibility and creativity are appreciated in idea generation, valuation, and portfolio construction
  - Open schedule and freedom to work on whatever appears most compelling at any given moment
  - Plenty of time for reading, thinking, and reflecting

Process – Idea Generation

- General reading – be curious about, and observe the world
- Investor network (letters, podcasts, online forums, in person discussions) serves as idea pipeline
- Reverse engineering other investors holdings
- Working through sets of stock databases / screening
- Improve the odds of discovering mispriced securities by looking at:
  - Small (and micro/nano) market capitalization stocks
  - Over the counter (OTC) stocks
  - Illiquid and/or highly priced securities
  - International stocks
  - Capital dislocations / crises in specific industries and regions
  - Earnings overreactions / temporary issues at great companies
  - Underappreciated champions
  - Special situations: spinoffs, liquidations, thrift conversions, post-bankruptcies etc.

Process – Research & Analysis

- Quantitative operating KPIs & financial results are crucial, but
- Qualitative assessments on intangibles like customer behavior, competitive positioning, incentives, leadership, & culture more so
  - Not everything that matters can be measured, and not everything that can be measured matters
- Utilize a checklist developed over the years to help avoid mistakes
- Specifically, the research process involves learning about the:
  - Customer value proposition
    - Best to speak with them directly to learn who, what, when, why, where, and how they purchase
  - Business model & quality
  - Industry structure
  - Management team
  - Balance sheet strength
  - Valuation / implied returns, as well as risks

Process – Valuation

- Valuation serves as a pillar for building conviction and estimating a range for what a business (stock) might be worth
  - Helps answer how much capital am I laying out, how much can I expect to get back, and when?
- Choosing the valuation technique is as much art as science and depends on the subject company
- Three primary approaches
  - Asset based valuations
    - 1) **Liquidation value** – the business is not a going concern, but how much might the assets net of all liabilities yield to me
    - 2) **Replacement cost** – how much would it cost to replicate this existing asset
  - Income based valuations
    - 1) **Discounted cash flow** – what is the value of cash flow I expect as an equity owner discounted into perpetuity and what returns does that imply for me as an investor
  - Comparative valuations
    - 1) **Relative multiples / private market sales transactions** – give a sense of what others would pay for a similar asset

Process – Portfolio Mgmt.

- Portfolio Construction – categorize positions into two main groups:
  - Valuation gaps (turnarounds, cyclically depressed, asset-based valuations, liquidations etc.)
    - Often an overreaction to headline news or simply an overlooked, ignored, or obscure security selling for too cheap a price relative to inherent value
  - Quality businesses capable of compounding earnings power
    - Potential to be portfolio stalwarts for years on end as long as business is executing
- Relatively concentrated, typically 12-25 portfolio holdings
  - Many other investment firms are unable or unwilling to concentrate their positions
    - 83% of market risk (systemic risk, aka “Beta”) reduced by selecting eight stocks, 93% reduced with selection of 16 stocks
  - Portfolio maintenance becomes more feasible, avoids idea dilution
- Risk parameter: no single position above 15% of portfolio at cost
  - Can go over this limit if via share appreciation however
  - Have yet to initiate a position of this magnitude to date but would like to if the opportunity presents itself

Process – Portfolio Mgmt.

- Layout thesis and key metrics to monitor for portfolio holdings
  - Seek out confirming & disconfirming evidence as time passes and story unfolds
  - Consistently aim to improve quality / return potential of portfolio over time by rotating out weakest holdings
- Maintain a watchlist to help dictate research priorities as well as keep an eye out for businesses to acquire during market turmoil
  - Speak with other investors about companies they like
- Given absolute return orientation, cash is a portfolio residual and may be held in material proportions at various times
  - Cognizant of the balance between the optionality value of cash vs. opportunity cost of returns forfeited
- Various portfolio positions will be discussed in my semi-annual investor letters
  - Clients are always welcome to reach out any time to learn about various positions

Process – Hold / Sell Discipline

- Truly extraordinary returns are only achieved by holding quality stocks long enough to allow them to compound exponentially
  - If value creation drivers remain intact, opportunity has a long runway, and the business / mgmt. team is executing, hold even if valuation becomes expensive
- Three primary reasons to sell
  - Stock price appreciates to your estimate of intrinsic value and/or becomes grossly overvalued
    - Could become excessively overweighted in the portfolio (usually good problem to have)
    - Application will vary depending on the specific merits of the subject investment
  - Recognition of a mistake in analysis and/or an unexpected, adverse and permanent development in the business
    - Thesis proving not to be correct, aka I was wrong to invest
    - Management proves unworthy of stewardship for one reason or another
  - A significantly more compelling opportunity becomes available elsewhere
    - Reallocate capital from one idea to another
    - Newer names are not known as well so there is some risk in allocating to them over a current holding you know well

Firm Quick Facts

- Firm structure
  - California Registered Investment Advisor (RIA) to separately managed accounts (SMAs)
  - Discretionary trading authority over client accounts, but capital remains held by individual clients
    - SMAs are transparent, safe, cost-effective, and convenient with back-office functionality provided by the custodian
    - SMAs available for wide variety of account types – individual, joint, organization, trust, traditional or Roth IRA
  - Broker / Custodian: Interactive Brokers LLC
- Investment class
  - Long-only, global equities
    - No short-selling or using margin
- Leverage
  - None, but options could be used in rare situations
  - Market hedging, covered calls for tax purposes, extreme asymmetry etc.

Firm Quick Facts

- Asset cap
  - $100 million AUM
  - Ensures opportunities at the small and/or illiquid end of the spectrum will always remain in play
- Minimum investment: $100,000
  - Would also advise clients to initially only allocate a fraction of investable capital
- Management fees - percentage of AUM, paid monthly
  - 1.00% for accounts >= $1 million
  - 1.25% for accounts < $1 million
- Performance fee
  - 0.50% management fee + 20% of returns over a 5% absolute threshold
  - Includes high water mark as well
  - Only available to those deemed "Qualified Clients"
    - Net worth excluding primary residence of $2.2 million or more
    - Willing to invest $1 million or more with SVLLC

Thank you

- Questions?
- Next steps
  - Setup a time to speak about becoming a partner
    - brett@shadowridgevalue.com
  - In-person meetings can be arranged if preferred
    - Only available in San Diego, CA currently