Robotti
Value Investors

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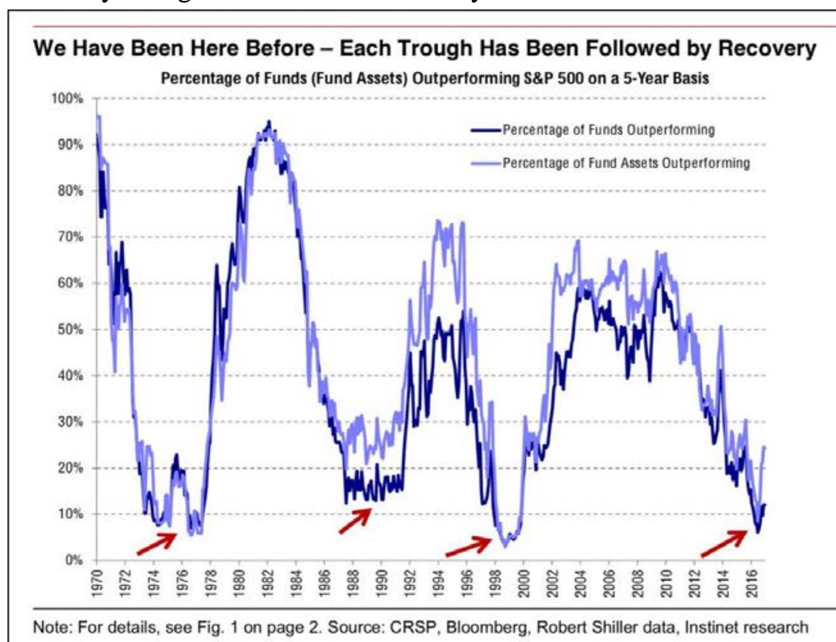
Dear Client,

Our composite returns for the second quarter were ahead of both the Russell 2500 Value's return of 5.80% and the S&P 500's return of 3.43%. Our performance for the first half of 2018 also bested the Russell 2500 Value and S&P 500, which returned 3.00% and 2.65% respectively.

Celebrating a Milestone

On Monday, July 9 we celebrated the 35th anniversary of Robotti & Company. This is no easy accomplishment in a constantly evolving industry and is further complicated by a constant flow of new theories and strategies promising to radically change the investment industry for the better. More often than not though, they just turn out to be another short-term speculative fad cloaked as a better, faster, safer way of making money. I have lived through declarations of the death of equities, the death of value investing, the death of stock pickers and most recently the death of active management, yet here we are 35 years later, which seems like an appropriate time for reflection.



Note: For details, see Fig. 1 on page 2. Source: CRSP, Bloomberg, Robert Shiller data, Instinet research

Anyone who believes that a successful career as an investor depends entirely on the skill of the manager is really just kidding themselves. I'll let you in on a secret – there is a lot of luck involved. Before you ask what you are paying me for, I do believe that hard work and the ability to stick to a set of investment principles through the inevitable ups and downs can help you create some of your own luck, but circumstances still need to break your way.

My good fortune began soon after I graduated from Bucknell University when I was assigned to the audit of legendary value manager Tweedy, Browne. Talk about being in the right place at the right time! My introduction to investing, or what I like to call the first part of my 'on the ground MBA,' was spent observing investors such as Howard Brown, Ed Anderson, Will Browne, Chris Browne, John Spears and Walter & Eddie Schloss. Most importantly, I was able to have frequent conversations with Joe Reilly, who was a retired partner of the firm once called Tweedy, Brown & Reilly. He used to come in every day and sit in the same room with the auditors. After the day ended, I was lucky that Joe would sit with me for hours sharing his insights into businesses and people gleaned from decades of experience. (The people part cannot be over-appreciated.)

The accounting firm I worked for also audited Gabelli & Company – more luck. I ended up spending the second part of my 'on the ground MBA' as the CFO of Gabelli's fledgling firm where I sat through every morning meeting listening to Mario dissect his favorite investment of the day. That means I spent 240 working days a year over 3 years listening to roughly 720 investment case studies!

How a Timeless Framework Accommodates Change

Both Tweedy, Browne and Gabelli & Company are well known adherents of value investing – the investment philosophy introduced by Benjamin Graham in the 1934 classic, *Security Analysis*. So it should come as no surprise that I began my career using the same philosophy to pick stocks. After 35 years we continue to adhere to the very same underlying principles of Ben Graham's philosophy to form the framework for our entire approach to investing. This is the crux of being a disciplined investor, which in our view, is crucial for success.

A lot has changed over the past 35 years. Back then you had to pick up the phone to order annual reports and wait for them arrive in the mail. Luckily the speed of delivery is of little importance when you are focused on a 3 to 5+ year timeline. Reaching into your pocket to check a stock quote no matter where you happened to be standing was the stuff of science fiction movies. You could put money in the bank and expect to receive interest in the neighborhood of 15%! This was also a time when it was still possible to uncover a stock that traded below its working capital, net of all liabilities, or what Ben Graham called a "net-net." These days are long gone.

As you know, we spend a lot of time discussing the importance of strictly adhering to a timeless investing framework. We hope that hasn't left an impression that visiting our office would be like transporting back in time. The financial markets in which we invest are in a constant state of change / evolution requiring us

to remain vigilant that the mechanics of how we apply our value-oriented investment philosophy to pick stocks stays relevant to the current realities of the financial markets.

The More Things Change, The More They Stay (*Almost*) The Same

> The underlying principles of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate. *The Intelligent Investor* (Benjamin Graham, 1973)

Interestingly the media has been replete with headlines lamenting the continued underperformance of active management in general and value investing in particular. Recent years have left many wondering why value investing no longer seems to work and whether a reluctance to change has left value investors using outdated methods that are out of touch with reality. Has value investing become irrelevant? I'm sure you won't be surprised to hear us answer that value investing is just as relevant as ever and arguments to the contrary are based on a common misunderstanding of what value investing really is.

Somewhere along the way, the term *value investing* became popularly associated with the type of stocks similar to the ones that met Graham's net-net parameters. Looking at his application through the lens of today's markets makes it appear that Graham was often leading his troops into the proverbial buggy whip companies on their way to extinction. Yet it remained a rule of thumb that stocks selling at a low price-to-book or price-to-sales multiples are value stocks. From here it would be a logical leap to assume this defines value investing. It would also be wrong.

Ben Graham's framework was not about a mechanical set of rules. His thinking was deeply nuanced and was based upon three ideas that were novel at the time (and are still novel to quite a few investors day): (1) the idea that an investor must be the master of Mr. Market[1] and not the other way around, (2) the concept of investing only when there is a sufficient margin of safety to offer protection from unpredictable events, and (3) that a stock is not just a piece of paper that trades back and forth but that it represents a real fractional share of an actual business.

After 35 years I remain certain that these 3 principles are certainly not outdated nor out of touch with reality and, in fact, remain timeless.

[1] For an explanation of Mr. Market, see the appendix at the end of this letter.

A Personal Reflection

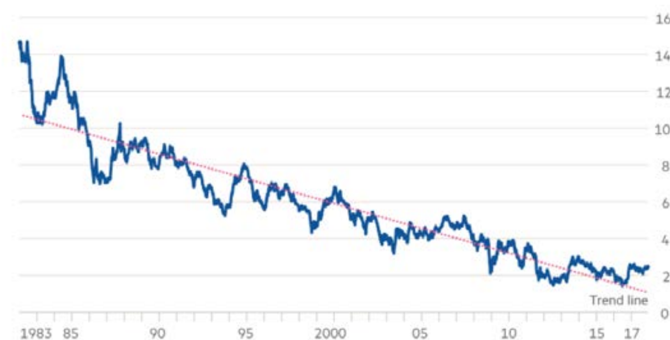
> …Graham also talks about; 'always change a winning game.'... There is no investment rule that remains immutable except the margin of safety. There are always breaks and the trick is to begin to anticipate, if you can, where the break points will be and shift. Not the disciplines and not the framework but the tactics that are involved. - Peter Cundill

So, 35 years ago I was a young pup at the age of 30 anxious at the idea of starting my 'own' business in a profession I was smitten with - investing in public companies. Ah, the brashness of youth! This month I will also turn 65 = 30 years old at the start + 35 years in business = 65! How the years do fly by.

Just the other day Alan Weber, who has been my colleague for over 25 years, asked if I had ever drawn up a business plan. I do recall my original business model focused on pink sheet stocks, something Tweedy had outgrown due to their enormous success, was driven by my passionate belief that a limited base of capital could still be intelligently invested in this niche. We were buying cheap stocks, companies that traded below net-net working capital which the market had passed by. Looking back I'd admit our plans were sparse, the projections often wrong and the process not fully developed. But we were fishing in the right pond with patience and a hunger to learn.

So what's different today?

First, valuations are different. As David Kessler (who along with Theo van der Meer supports our quarterly effort to communicate these thoughts in writing) observed, the wealth of data and information available today has significantly reduced the opportunity set that was once available. I would suggest the availability of information and the amount of capital looking for suitable investments are not the only reasons that opportunities are less abundant. Of equal, if not greater importance, is the long, constant and continuous decline of interest rates that occurred over the past 35 years.



Second, I'm different! I am absolutely still smitten with investing in public companies - it's mentally challenging, keeping me enthusiastic about the investment process and young at heart &

mind, not to mention that it is great fun! But now I have significantly better judgment - the advantage of 35 years of experience investing in winners and losers galore – learning important lessons from each of those experiences. I still have all the passion of my youth and 35 years of broad and extensive experiences, which is a powerful combination.

Third, today the company is so much more than just me. Over the decades we've been a haven for like-minded investors all steeped in the same core tenets, passionate about deep fundamental research and focused on finding public companies at a discount from intrinsic value (equal to the present value of all future cash flows of any business). Today, the depth and breadth of the Robotti community forms a critical aspect of our investment thought. The decades have shown us that there are multiple reasons for market myopia that often leads to a disconnection between how the market prices a business and its fundamental economic value. Robotti & Company is a great place to be - a 'think-tank' of professional investors across a range of ages and experiences in an open environment forming a collegial community working together. As I highlighted in the beginning - I am truly lucky!

I look forward to the many more years still ahead and to many future investment successes together.

All the Best,

Bob Robotti

Appendix: The Parable of Mr. Market
(Source: Warren Buffett's 1987 Berkshire Hathaway Annual Letter)

"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions, he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence…"

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