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Dear Investor,

Hindsight is 2020.

As such, we feel compelled to share our *Confessions of an Unrepentant Value Investor*. We have long admitted that we are powerless over the market but continue to believe in a force greater than ourselves and, more importantly, greater than Mr. Market - the power of valuation. In a year when we have been forced to examine what truly matters, we steadfastly cling to the belief formed by our 40+ years' experience, that *valuation is key*.

Robotti & Company is, always has been and always will be, unabashed value investors. It is an investment approach that has proven to be a successful methodology time and again. We have seen many cycles, but what has remained consistent is the investment approach we employ. This consistency is what has led us to outperform over the long-term.

Why? As with all our investments, it comes back to the valuation and the amount that the market is discounting a company and how public trading prices can often be completely disjointed from intrinsic value. In fact, we posit that value investing is somewhat of a misnomer that lacks full definitional clarity: it is valuation investing. Valuation is a key part of every one of our investment decisions. The price you pay is a controllable variable that has a tremendous effect on your investment returns.

During this past year, we believe that the markets started to realize that too. There is no doubt that the decade's top performers continued their winning streaks. Bonds continued their relentless push to eliminate almost any yield, despite credit quality deteriorating from many borrowers. The global pandemic provided a mixed bag to the businesses of the so-called "FAANG" companies (this decade's "one decision" stocks) and regardless of any symptom of headwinds, the market uniformly excited investors. However, as the year came to a close, the winners and losers began to show signs of change. Different questions were asked and alternative outlooks were considered.

Valuation Investing

Since *Security Analysis* was penned by Graham and Dodd in 1934, there have been regular periods of underperformance from the strategy the book championed. These periods inevitably bring with them the regular chorus that "value investing is dead." Each time, without fail, we witness talking heads reduce the trailblazing lessons of the 725-page book into just buying stocks with modest valuation metrics such as low price-to-book or low price-to-earnings ratios. This simplistic form of

value investing solely based on one or two historical valuation metrics will inevitably lead one to invest in businesses in terminal decline.

We wonder how many of those publicly screaming “value investing is dead” actually read the book. The main precepts of our vision of value investing are as follows:

- **Intensive individual bottom-up stock research on individual companies** with the intent of making conservative estimates of the “intrinsic value” of the business. The intrinsic value of any business is the present value of the future cash flows that accrue to the equity owners.
- **Margin of safety is a must.** Opportunistically buying securities provides an investor the opportunity for outsized returns while also mitigating the risk of unforeseen negative developments and other inherent risks associated with all investments. A simple concept in theory, yet in practice, it is not so easy to have clarity on the future. That’s why the estimates need to be conservative to provide a margin of safety.
- **A belief that the market frequently misprices securities.** While there are many reasons for this, one of the biggest is that, as humans, market participants are driven by emotion. The influence of market participants is fundamental in determining capital flows and therefore valuation. However, as more and more capital flows are determined by passive models and algorithms, the role of the market participant is less and less pronounced, and valuation’s role diminishes thusly as a determinate of a security’s pricing.
- **Fear and greed still rule the market.** As Graham labeled it, investor greed and fear influence the flow of capital as much as economic reality. Undue fear in the spring followed by greed in the fall and winter highlighted how the markets’ valuations can misestimate economic reality. Sentiment driven irrationality is alive and well today and leads to security mispricing which is why we stress the importance of behavioral discipline.
- **At the heart of it, we are stock-pickers** focused on intensive research to select mispriced securities. Bottom-up research of public companies enables a skilled, experienced investor to identify securities that are mispriced.
- **In the long-term, the markets are a weighing machine.** A critical element of our research is to estimate the future direction of cash earnings. In the short-term, the markets are a voting machine, which can cause the market price to diverge greatly from the value of what is being traded. The disconnect between the two presents an opportunity for an experienced stock picker to take a contrarian stance and invest in good businesses that are misunderstood and thusly cheaply priced.

All these core tenets of our style of investing come back to our mantra that valuation really is key and, as such, value investing should more aptly be called valuation Investing.

So Where are We Today?

Across the markets, long standing trends are incorporated into security prices. High multiple valuations are deemed reasonable due to the expected continuation of past events. Low valuations are also justified by disappointing and volatile earnings in the rearview mirror. But what’s the warning traditionally painted on the rearview mirror? “Objects in the rearview mirror may appear closer than they are.”

So how do we upend this seemingly self-sustaining and improperly aligned cycle? By examining what should be in focus. Remember *hindsight* is 2020. We can take lessons from the past, but they do not directly dictate the future.

Where do we look for mispriced securities? A recurring place to look is where businesses are undergoing periods of difficulty – often cyclical companies. But we probe deeper to find those companies that are differentiated with good managements, strong financials and barriers to entry.

Our investments in homebuilding provide an excellent case study.

Historically, going back to 1968, the U.S. has built 1.1 million single-family homes on average. Astoundingly in the 11 years post the financial crisis, we have built on average 640,000 homes per year. That 640,000 homes per year is fewer homes built in America than in any decade since numbers were first reported in 1968. Cumulatively, that means there are 3-5 million homes under-built over a decade. That under-building happened while demographic trends should have been increasing housing demand. Habitat is not discretionary - people need a place to live.

There have been many transitory factors and consumer preferences that have obscured the demographics for an increasing demand. From millennial lifestyle changes, the student debt burden, further urbanization of America, and a "hangover" from a real-estate fueled recession. All of these trends have moderated single family housing demand for an extended period of time. *I say moderated, not eliminated.* What is obscured in these trends is that there has also been demographic growth. The population has grown, and the next class of home buyers has aged up. The demand is there. Lifestyle preferences only dissipated that demand for a while.

The onset of COVID has radically changed the direction and accelerated the momentum of these prior trends. Suddenly, the idea of having your own home, your own backyard, having a study, having to work from home — all those things matter. These are all dormant trends that were set in motion by recent events. We think that there's an extended period of recovery, which is just unleashing what we believed has been an underlying opportunity for over a decade. This is further bolstered by the increasingly likely possibility of working from home becoming more prevalent.

So what really changed in 2020 was not so much the facts, but the perception of those facts. Another prime example of this comes in our manufactured housing investments. It has been known for years, that manufactured homes are better built, much cheaper and faster to build than site-built homes. These companies have steadily consolidated, increased efficiencies, and grown their businesses as well. What changed is the perception of these facts. 2020 provided a bump to orders for new manufactured homes and caused investors to fully review what had been happening in this industry. It may have been the (likely temporary) gap in supply/demand that grabbed investors' attention, but it was the decade long track record that attracted their investment. Valuation eventually attracts investor attention.

Lollapalooza Effect

Charlie Munger is known for using the term 'lollapalooza effect' to describe the phenomenon when several small-scale factors acting together lead to a certain and often very significant outcome. We believe single family homebuilding in America is currently in the midst of such a

lollapalooza event. More than a decade of underbuilding has resulted in low levels of essential building materials inventory - very limited supply. Meanwhile, demographics have finally awoken the dormant demand for single family homes – growing demand. In response to COVID demand is booming. What happens when booming demand is met with limited supply?

Long Cycles – Industries Evolve

We often discuss various cycles and their recurring nature over periods of time. While we tend to focus on similarities between cycles, it is also interesting to focus on what changes. Sometimes, these cycles bring about such radical changes that it can dampen the cyclical aspects of an industry or its underlying businesses. We believe the history of building products distribution provides a prime example.

Not so long ago, there were lumberyards spread across the country with the purpose of buying lumber and selling it to two primary customers: new home builders and repair & remodel consumers. The industry was fragmented with each lumberyard akin to a “mom-and-pop” shop catering to a local market. During this downcycle phase, there has been consolidation within the repair & remodel suppliers, especially the “Do It Yourself” segment. That part of the industry is no longer so disjointed, with mom-and-pop being replaced by mega name brands; Lowes and Home Depot dominate that industry and maintain huge barriers to entry. Pause for a moment and think how close you are to either store and then also ask yourself, can you think of a more local entity that provides you with the same goods and services.

In our view, due to the severity and length of the most recent cyclical downcycle in homebuilding and in part because of the consolidation within lumberyards, the same dynamics are playing out for the segment of the industry that distributes building materials to professional homebuilders and contractors: mom-and-pop are once again acquired and aggregated. Starting with Paul Levy’s 1998 acquisition of Builders FirstSource from Pulte Homes and continuing through 2007, the industry had consolidated down in large part to five players.

We are the fifth Largest Building Products Provider⁽¹⁾ in an Estimated \$304 Billion Industry⁽²⁾



	2007 Pro Sales (Millions)	Primary Business
1 Pro-Build	\$ 4,500.0	M
2 Stock Building Supply	4,417.0	M
3 84 Lumber Co.	3,007.0	M
4 BMHC	2,285.0	M
5 Builders FirstSource, Inc.	1,560.2	M
Total Top 5 Distributors	\$ 15,769.2	
Total Top 5 Market Share	5%	

M - Professional Dealer/Lumberyard with Manufacturing Capabilities

(1) ProSales magazine's 2007 ProSales 100 list

(2) National Association of Home Builders single family residential construction as of December 31, 2007

Source: Builders FirstSource Q1 2009 Presentation

Fast forward to today, Builders FirstSource’s recently announced merger with BMC starts off 2021 having now consolidated into one dominant company: Builders FirstSource.

Such radical industry consolidation within ongoing industry cycles is the type of event that can fundamentally change how the cycles continue to operate. The consolidation trickles down. Not only is there consolidation among distributors, known as “one-steppers,” but also some of the main competitors to these one-steppers have dissipated. These competitors are known as “two-steppers” as they stand between manufacturers and distributors, and as a result of such drastic changes to the industry landscape, homebuilder supplier distribution networks have all but vanished.

The two-step segment of the industry is much smaller today and continues to have difficulty competing with one step distributors such as Builders FirstSource. The two-step distributors once had huge geographic scale advantages to one-steppers, but today the scale and scope of Builders FirstSource allow them to go directly to mills and cut out the two-step distributors from most of the products they historically distributed.

There has also been an important shift in the actual role of distribution itself. Historically, many building products manufacturers had their own distribution segments. By 2010, almost universally, these companies found internal distribution systems were too expensive to continue operating. Now, many/most of the homebuilding products companies are reliant on the distribution from one-step distributors such as Builders FirstSource.

With the newfound position in the industry, one-steppers have changed their role to homebuilders. Builders FirstSource’s “value-added” service, where they make various components offsite, is changing the way homes are built and is bringing efficiencies in materials and labor. These value-added products are increasingly expensive and in limited supply, along with providing cost savings and reduced cycle times to homebuilders. After all, home builders *don’t actually build homes*. Construction of the home is outsourced, and Builders FirstSource is a differentiated, critical element with tremendous economies of scale, access to product and differentiated offsite component manufacturing (where they are the clear industry leader).

We believe that today Builders FirstSource is operating in a radically changed distribution industry, and that its barriers to entry have grown more identifiable and clearer. It is much like the barrier to entry to compete against Home Depot or Lowes. These combined dynamics will fundamentally change the cyclicity and the profitability of the New Builders FirstSource. *The New Builders FirstSource is not your neighborhood lumber yard anymore*. Its barriers to entry are dramatic. We believe its earnings power is very different this side of the cycle.

Closing Thoughts – A Stock Picker’s Nirvana

We have spent most of this letter talking about homebuilding as it provides a timely example of the confluence of events and opportunities impacted by COVID in which we are invested. However, and importantly, homebuilding is just one segment in which we are currently invested. We are seeing similar cascading fact patterns and resulting opportune entry points for investment in other sectors and throughout our portfolio. The consistent theme is that we are seeing long-term trends continuing to play out, albeit with renewed acceleration and momentum because of the dynamics that have resulted in reaction to the pandemic. This is a repeatable pattern we see, especially in the cyclical industries in which we invest.

As you have heard us say, history does not repeat although it often rhymes. As such, the past is a prologue to the future but frequently not a straight-line projection. We've been through a unique decade, the decade of 2010. Recency bias, especially when prolonged, persists with the notion that what happened over the last ten years is here to stay still permeating the investment community. We have a different lens. Buying businesses at modest levels of what our research gives us conviction is a conservative estimate of normalized earnings provides us many ways to win, *because* valuation matters.

For these reasons we continue to do intensive, bottom-up research on businesses to estimate their future cash flows all with the intent to invest in businesses the market is mispricing. A proven way to generate strong returns rarely practiced today. Understandable given the last unique decade, but the market in the end is a weighing machine that measures the value of future cash flows.

Valuation is Key

Is this a true renaissance for value investing? A re-birth?

We resoundingly say no. Because *value investing never died*.

As unabashed value investors, we may have been mislabeled, poked and prodded at, made fun of and all but cast aside. However, our strategy – the basic tenets of investing in good businesses with barriers to entry – we believe is still the most rational way to invest. We continue to do just that with a differentiated focus on the confluence of market, industry and business cycles and an active and ongoing engagement with the managements of our investee companies which has been tremendously advantageous in such unprecedented and uncharted COVID times.

As was said in our recent 2020 Annual Meeting, we believe we are witnessing a critical juncture in history on so many fronts. Given the extraordinary opportunities abound, we believe we are experiencing a true stock picker's nirvana for rational, fundamental value... err...valuation investing.

We appreciate your continued support, and wish you and your family a happy, healthy and prosperous 2021. Please continue to follow us on our website at advisors.robotti.com, LinkedIn and on twitter at @BobRobotti. We have enjoyed connecting with so many of you virtually.

All the best,



Bob

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