Robotti
Value Investors

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Dear Client,

We are happy to report that in 2023 we outperformed both our benchmark and the S&P 500 again. We should also note that the S&P 500's 26.3% return for the year was almost entirely due to the performance of the "Magnificent Seven."[1] Those seven stocks represented around 75% of the S&P 500's performance. We are encouraged by the fact that we were able to outperform these indexes while investing in totally different companies from those driving the market's success. The vast majority of the companies we own aren't in the S&P 500, and some of the overlap is from companies like Builders FirstSource, which we bought when it was small cap and was only added in the last few weeks.

Recognizing the inherent challenges of discerning meaningful trends within the often noisy fluctuations of a single year, we find additional satisfaction in informing you that our outperformance extends beyond the immediate timeframe. Over the past five years and since inception, we have outperformed both our benchmark and the S&P 500. As investors who focus on 3-to-5-year time horizons for our investments, that is the metric we judge ourselves on as well. We have been able to do this by our commitment to applying our investing expertise and unwavering approach to our style of value investing. This achievement stands as a testament to the trust and confidence placed in us by you, our clients. Thank you!

"Information cannot serve as an effective substitute for thinking" - Bernard Baruch

I have found myself saying this quote a lot recently, even though this market axiom is over 100 years old. Back then, there was a dearth of data, and the analysis of what data there was, was predominantly done with pencil, paper, and the human brain. Now think about the world we're in today with floods of constant new data and huge amounts of computing power to analyze it, including the explosion of AI. We submit that the flood of data and analysis often obscures, even reduces fresh thinking.

The intersection of this information and analysis overload has many different, debilitating effects on investment decisions. Not only does it often cloud thoughtful decision making, but it also shortens investor time horizons. While much, if not MOST of the data and information has plenty

[1] Apple, Microsoft, Alphabet, Amazon, NVIDIA, Tesla & Meta

of impact on this quarter's results and today's pricing, only a small percentage truly impacts the next 3 to 5 years. That data, information and analysis drags along capital flows to speculative, short-term investments (i.e. speculation), not to be confused with thoughtful investing.

We frequently classify our investment edges as both informational and analytical. We strive to distinguish the noise from the signal and put aside those data points that don't impact the company's true intrinsic value over the long-term. That is not to say we don't take advantage when that "noise" caused by short-term negatives depresses the stock price. In those situations, we are able to purchase an unchanged intrinsic value for a steeper discount.

But that's not all folks! On top of the deluge of contradictory and misleading information and its misdirected analysis, is the fact that the world is constantly in a state of change. In fact, the only constant is change. In the years post the world's financial crisis, ever-available "free money" made it easy for investors to forget (or simply choose to ignore) the fact that the world is always changing. Many successful investors have only experienced this unique and extenuated economic environment. Even those who have experienced previous periods have had their perspectives corrupted by it. Recency bias is underrated in its power over our minds.

So, we have a ton of informational noise, recency bias and a long period where the economic environment was unique. What else can we add to this to further obscure investor thinking? A sea change in how the market is invested. The majority of equity investments today are passively invested. Investors don't pick individual companies, rather they pick indexes. Buy them all or sell them all through the index. A second large market force is algorithmic trading which is susceptible to that informational noise. All this totals up to an environment that we believe is ripe for disciplined value stock pickers to outperform. Valuation matters, and having the skills, experience and knowledge to think independently of the market allows one to perform differently from the market. Our results again highlight this.

Howard Marks recently said, "Since quantitative information regarding the present is so readily available, success in the highly competitive field of investing is more likely to be the result of superior judgements about qualitative factors and future events." This quote from Marks is the same view expressed by Bernard Baruch over 100 years ago that "information cannot serve as an effective substitute for thinking." Everything old is new again.

Charlie Munger

In November, Charlie Munger passed away. I was fortunate enough to see him at his final annual meeting in May. At this meeting an investor asked if the market was different today, and if that meant the opportunities to outperform no longer existed. Munger and Buffet disagreed on the answer to this. Munger stated that there is no more informational advantage and so outperforming is hard to imagine. Conversely, Buffet reiterated that markets are inefficient and so there will always be a chance to outperform. I'm glad I got to see one last time the power of two great investing minds debating the very core tenants of value investing.

With all due respect to Charlie, we have to side with Buffet in this argument. Often, it's fear and greed that move markets, not reality and analysis. We would go on to say that the ubiquity of information and the current market structure means that capital frequently moves on short-term information, without individual stock analysis or independent thinking. This provides an excellent environment for stock pickers with a long-term time horizon.

Investing in Cyclicals

Most investors mistakenly lump all cyclical businesses into the Ben Graham cigar butt category – mediocre companies that have one last puff left. There is no doubt, part of that knee-jerk reaction is predicated on an extended, difficult performance in an economic environment where these competitors were cost competitively disadvantaged. What the investing world largely disregards is that these businesses are different today, the economic environment is different, these industries are different, and economics 101 continues to work. Many consolidated industries are now competitively advantaged businesses situated in growing markets. Many North America based industrials are different businesses than they have been maybe since those industries' inceptions. In the past, we have referred to this as "Revenge of the Old Economy." To be more precise, we believe it's the Metamorphosis of the Old Economy.

Time Horizons

Thoughtful, independent analysis focused on the next 3 to 5 years can provide an investor with the ability to identify excellent investments which trade in markets far below their intrinsic value. Our long experience supports this thesis. This fact is supported by an observation from MIT professor Rudiger Dornbusch who noted "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could." Again, our investing experience has proven this out multiple times. One byproduct of this investment approach is the recurring misstep by bottom-up value stock pickers of being EARLY. Yup. It happens. Sometimes people incorrectly characterize these situations as "value traps" - companies that trade far below the inherent earnings power of the businesses but never reflect inherent value. Importantly, early isn't necessarily wrong, if you don't capitulate.

The identified, latent earnings power of these businesses can take longer to materialize. People hate to delay gratification. Munger noted **"It's waiting that helps you as an investor** and a lot of people just can't stand to wait."

The important lesson to be learned is, when those latent earnings finally are realized, the longer they've taken to materialize, the greater the likelihood that they manifest higher and last longer than originally estimated. You frequently get compensated for the wait. In which case, the axiom that it never hurts to take a profit is absolutely wrong. In fact, thoughtful capital focuses on price-to-value. So, when those values are realized, and become more quantifiable, the logical conclusion is to invest more. Don't cut your blossoming flowers!

How Robotti & Company Characterizes its Investment Approach

My introduction to investment thought came from the legendary value investors at Tweedy, Browne. I was introduced to this in 1975, post the crash of the Nifty-50 (the famous group of one-decision stocks of the late 60's and early 70's.) After all, that was the sounding of the starting gun for the community of Value Investing Legends: Berkshire, Tweedy, Mutual Shares/Mike Price, Mario Gabelli, Peter Lynch, Ruane Cunniff, etc. The list goes on. Tweedy, in particular, with their suite-mate Walter Schloss, were excellent Ben Graham cigar butt investors, finding a dollar for $0.50 and getting plenty enough puffs to cruise past the markets' results. Since I was a CPA, I could calculate net/net working capital and see the logic of the investment approach.

From that starting point almost 50 years ago, I've gained much experience, and it influences our investing thoughts today. For decades now at Robotti we've attracted a cadre of bottom-up, value-focused stock pickers, a resource the envy of most. This is especially true as many of those legendary investors have changed approaches, retired or gone away. Much like the companies we invest in, the competitive landscape is very different today.

One advantage of being in the investment profession is that prospective investors frequently ask thoughtful questions that facilitate thoughtful reflection. Recently, a US-based institutional investor challenged us on our representation that we were "small cap" investors. A reasonable question given the largest portion of our investments today are mid-cap and 20% are large cap companies. So, what is our investment approach? The question is, does the current portfolio snapshot reveal style drift? No, it's a rejection of letting style boxes be a substitute for thoughtful investing. Despite our current portfolio makeup, 90% of the companies we invest in that are today classified as mid or large cap were small caps when we first started buying shares. The success of those investments (in many cases returning these businesses to their historic market cap classification) did not confuse our investment decision-making. Selling is not to keep the portfolio "pure to any style" but based on price-to-value analysis. Valuation matters. Nothing else. As Munger was also known for observing, "Good ideas are rare - when the odds are greatly in your favor, bet heavily."

Of course, this realization that we're really not investing in the style box "small cap value" is consistent with the realization I had that our approach as value investors is nuanced. Our research is to find investments which trade for far below what it would cost to replicate that business (the value aspect) but, as importantly, to identify substantial growth levers in front of those companies. We are not looking to buy a dollar for $.50. We're looking to buy a dollar for much less than $0.50. As importantly, we want to invest in companies that can grow that dollar, maybe double, triple or 10-fold even. That growth is a critical element in the long-term success in investing in these companies.

Today we are the proverbial kids in a candy store! We have researched companies and industries which have consolidated down and, in the process, been transformed into better businesses. They have barriers to entry, and as a result strong financial positions, many with excellent growth opportunities, and are positioned to be opportunistic. Buffett-type better businesses. Yet the market thinks it knows better based on past results experienced by different companies in different economic environments, so they sell for Ben Graham cigar butt prices. Many of these companies have excellent growth prospects too and the capital to be deployed with owner/managers who are proven allocators. We are excited at the array of investable companies.

As you may know, we have been approached by many different podcasts and journalists in recent years to discuss our investment approach and thoughts on the current environment. Be sure to keep an eye out for updates from us as these articles and podcasts come out and check out our website to see any you may have missed.

All the best in 2024,

Bob

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