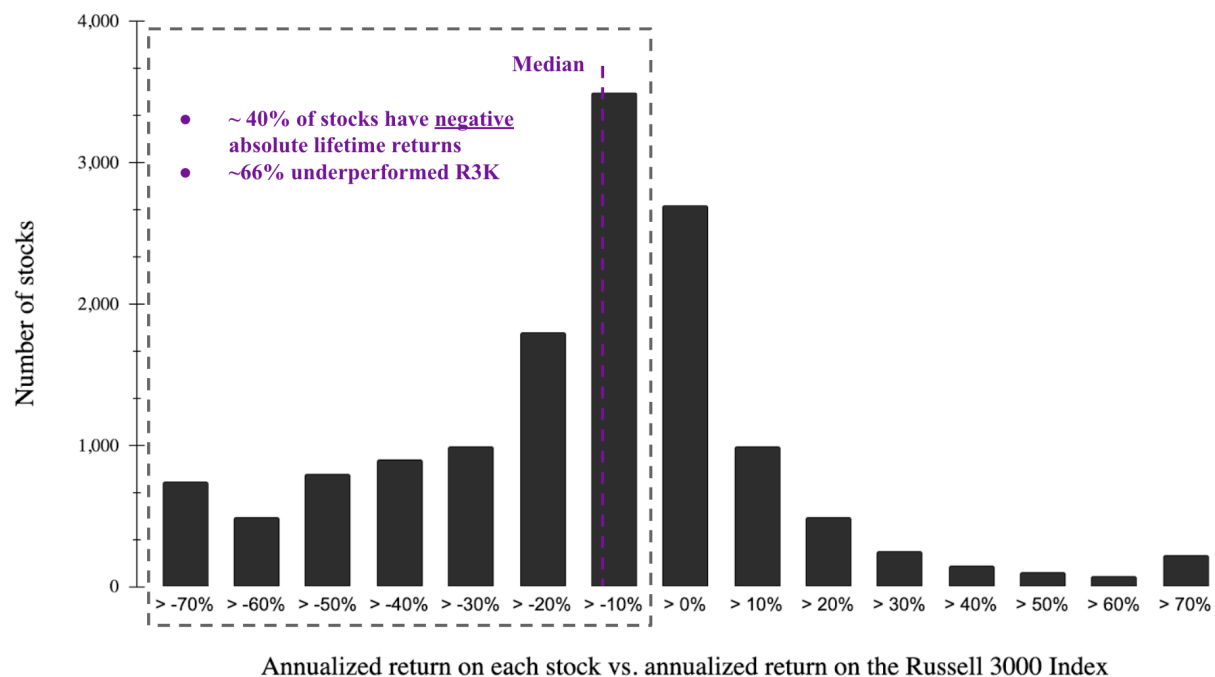


Letter II - Value & Growth: Becoming a Style Generalist

Dear Partners, Family, and Friends,

In our previous letter, we discussed the importance of being a sector and country generalist investor in what is a dynamic, volatile, and unkind stock market subject to regime shifts. With such a backdrop, it's important to put probability in one's favor to minimize mistakes. This is easier said than done, however, since 40% of US stocks have negative total shareholder returns post IPO and 66% underperform the Russell 3000 index (the largest 3000 US stocks).

Distribution of excess lifetime returns on individual stocks vs. Russell 3000, 1980-2020



In order to identify the outperformers, many investors turn to historically attractive investment styles such as “value,” small caps, or spinoffs. As per our last letter, we prefer to understand the fundamental drivers of such outperformance rather than dogmatically prescribing to one school of thought.

In this letter, we will discuss how investors blindly apply stock-market base rates favoring particular styles without holistic understanding of why the approaches work. After debunking a few of these common investment tropes we will show why being a “style generalist” is superior to any particular niche.

¹ JP Morgan Asset Management, September 2020

Value vs Growth.....

Since the Great Financial Crisis, it's been common to hear value investors complain that “value is underperforming growth” with the assumption being that performance should revert to the mean. Below we observe the oft-quoted underperformance (2008-Present):



While many attribute this outperformance to low interest rates, the real driver is the Russell 1000 Growth Index tripling its earnings per share (EPS) with Russell 1000 Value EPS only up 75% (both started with similar valuations). We conclude that the outperformance over this period is very warranted.

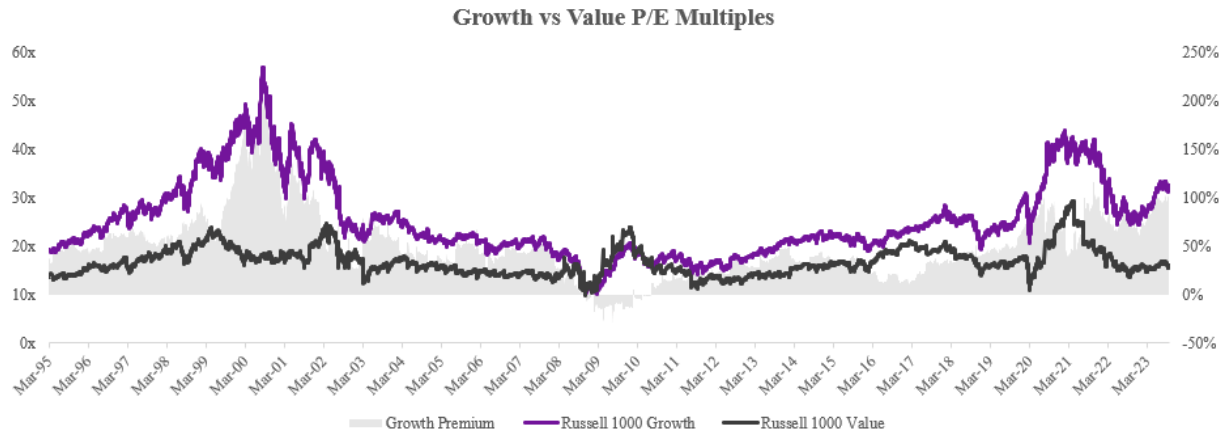
When extending the comparison back to 1927, it's clear the performance of the value index (11.5% CAGR) has indeed exceeded that of the growth index (8% CAGR) and we want to understand why:



From a valuation perspective, growth almost always trades at a roughly 50% premium to value:

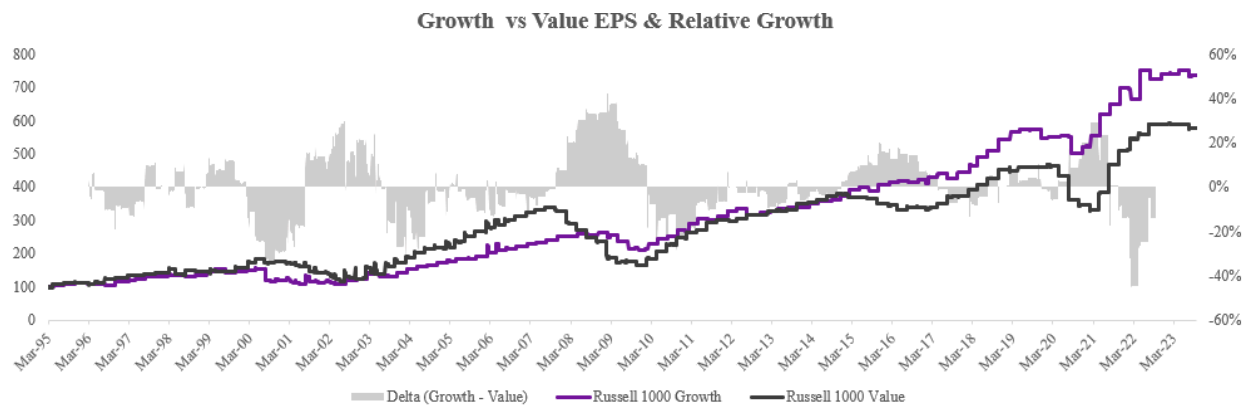
² A Wealth of Common Sense: “The Growth-Value Cycle”, Ben Carlson, April 2021

³ Kenneth French, Anchor Capital Advisors LLC



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Due to this premium, one would expect that growth stocks grow significantly faster than value stocks. However, this is not always the case. Growth stocks grow earnings quicker in robust economic periods but show slower growth during periods of economic distress, leading to a minimal CAGR advantage of only 0.8% per annum (6.7% vs 5.9%).

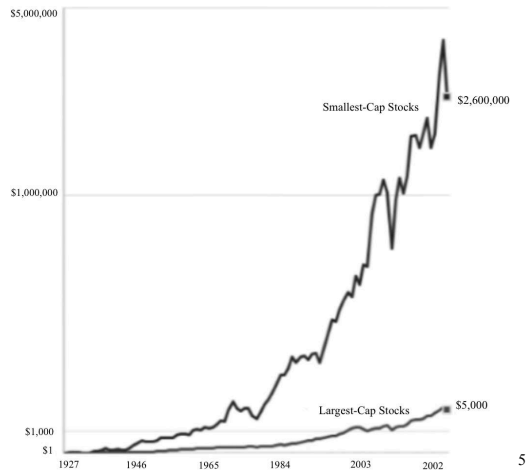


We can determine value stocks outperform because they grow earnings similarly to growth stocks, but with heftier earnings yields which can be returned to shareholders in the form of dividends or buybacks.

Small Cap vs Large Cap.....

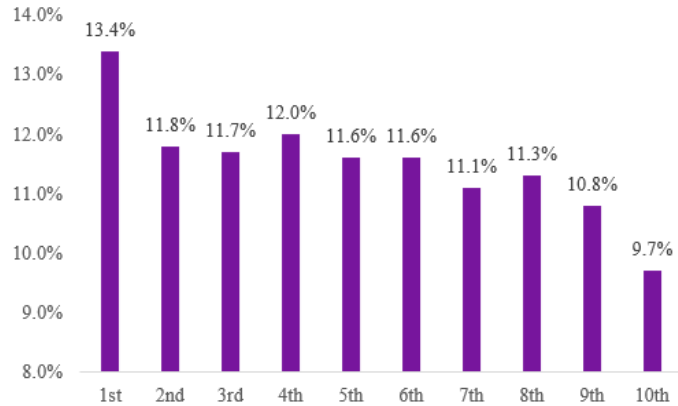
The next base rate we're going to unpack is the outperformance of small cap stocks. Between 1926 and 2014 the smallest decile (<\$300mm market cap) outperformed the top decile (\$25B+) by almost 400bps (4%) annually.

⁴ Factset

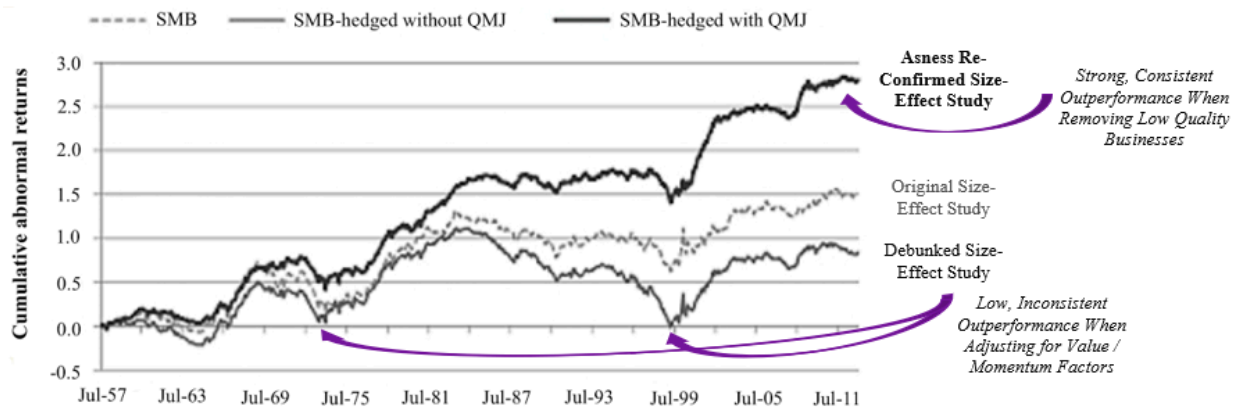


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Annualized Return by Market Cap Decile (1926-2020)



This outperformance is known as the “size effect” and while it appears to be a straightforward premium paid to small-cap shareholders for the inherent risk and illiquidity they endure, it has been questioned time and again due to the inconsistency across regions and time periods. Below we see the size effect across three studies: 1. The original size-effect study without any adjustments (“SMB”, light-gray dotted middle line), 2. The debunked size-effect study adjusting for factors like momentum and value (“SMB-hedged without QMJ”, dark gray bottom line), and 3. A recent study by Cliff Asness of AQR Capital Management reconfirming the small cap outperformance across months, industries, and 20+ international markets when adjusting for one variable: **business quality** (“SMB-hedged with QMJ”, top black line).



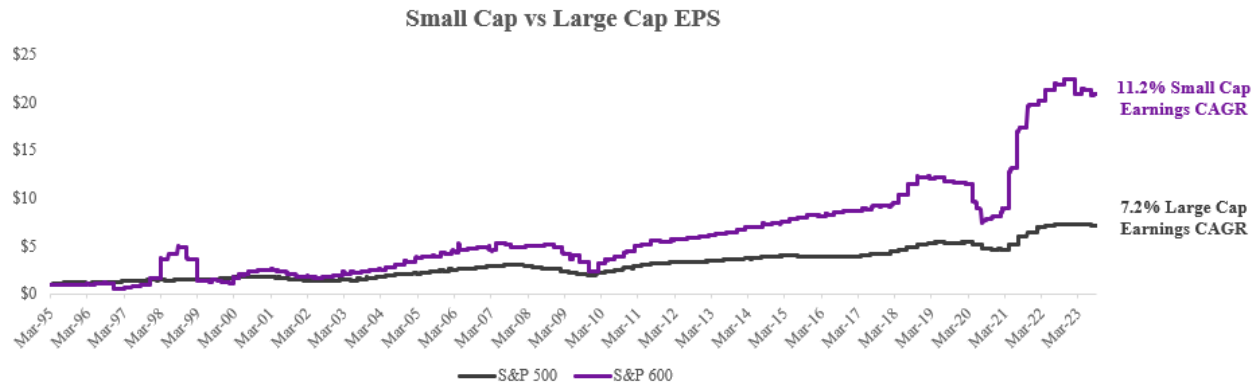
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The takeaway here is that there is indeed a small-cap performance advantage, but it exists only when comparing “high quality” companies, defined as companies with higher profitability (measured by gross profit, margins, earnings, accruals, and cash flows), higher growth, higher safety (measured by low volatility in stock price and financial KPIs) and higher payout - the amount of net capital returned to shareholders. The outperformance is approximately ½ a percent a month, or ~6% per year.

⁵ Fama French Library, Dartmouth College

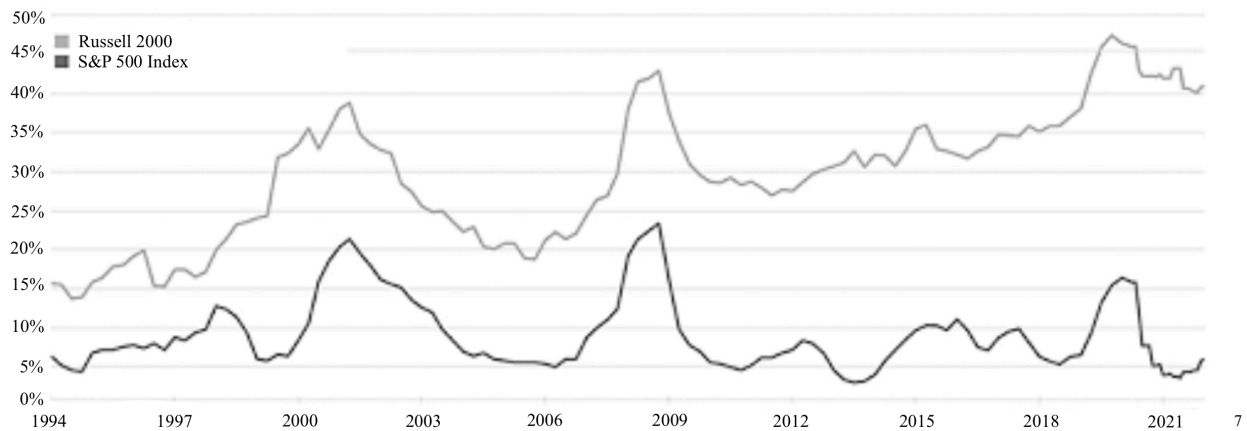
⁶ Asness, et al.: “Size Matters if You Control Your Junk”

While value outperformed due to a cheaper multiple with similar growth, quality small-caps outperform due to faster growth at a similar multiple. As we observe below, the earnings growth of the S&P600 (US small caps) has outpaced that of the S&P500 (US large caps) over the last almost 30 yrs by ~400 bps per year.



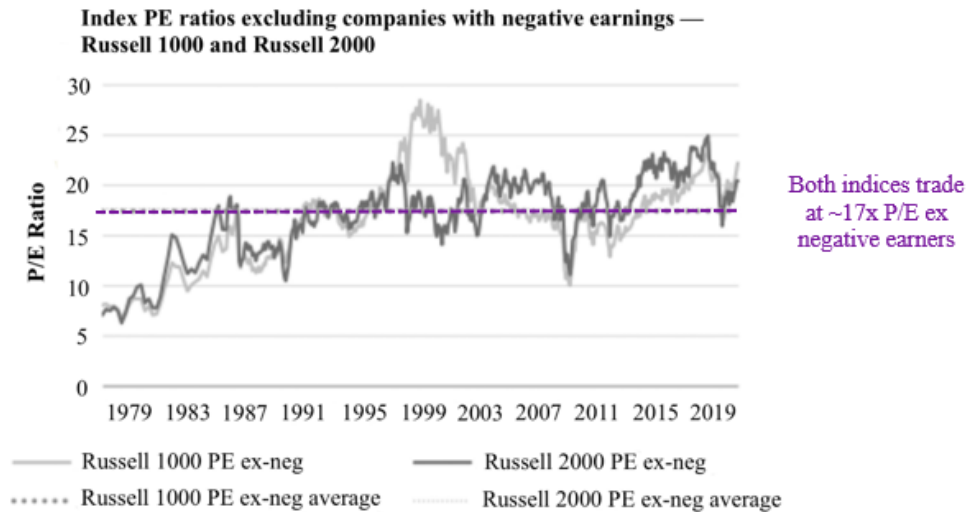
At the same time, the S&P600 has only been slightly more expensive historically at ~23x P/E vs ~19.5x for the S&P500, despite the fact that small cap indices generally have a significantly higher percentage of low and negative earners (as implied by Asness' business quality adjustment).

**Percentage of Companies with Negative Earnings
1994 - 2022**



When the negative earners are removed, small cap indices are usually the same valuation as the large cap indices:

⁷ Pacer ETFs, Factset



What we observe is that the multiple declines 23% for small caps and 11% for large caps when removing negative earners. Thus if we adjust out the negative earners from the index, we essentially get a cash-flow-positive majority of the index which is the same valuation as large caps but growing faster.

Ingredients for Strong Performance.....

At this point, we’ve shown that “value” outperforms “growth” due to similar earnings appreciation but at a more attractive valuation and small caps outperform due to rapid growth with a similar multiple. We conclude that the key determinants to returns are growth and valuation, which is unsurprising since they are the key components of basic equity returns math. When decomposing return on investment, the only ways to generate return are growth in FCF per share, capital returns to shareholders via FCF yield, and an increase in the FCF multiple:

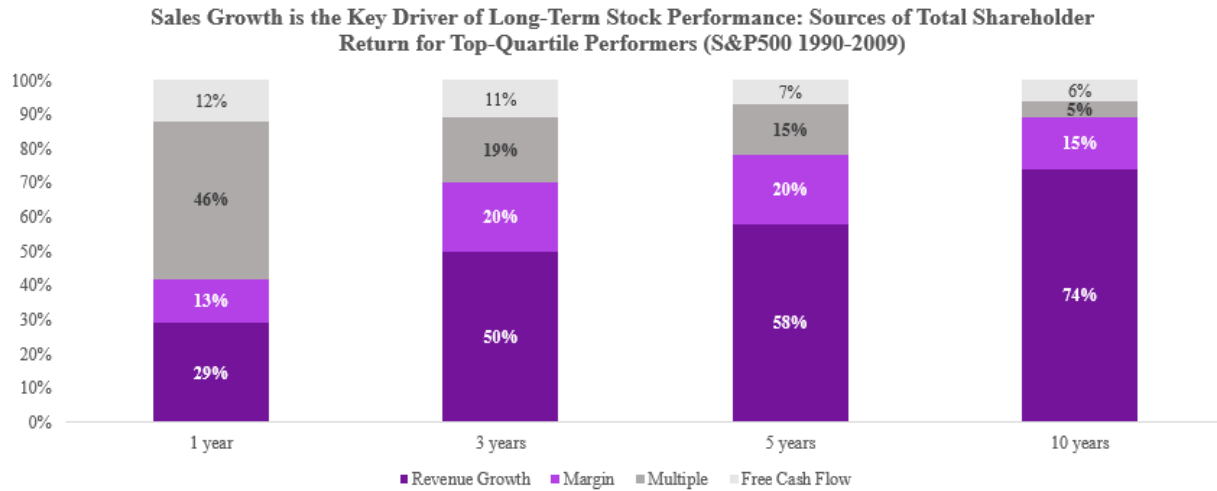
$$\text{Expected Return} = \underbrace{(1 + \text{FCF Growth})}_{\text{Growth}} \times \underbrace{(1 + \text{FCF Yield}) \times (1 + \Delta \text{FCF Multiple})}_{\text{Valuation}} - 1$$

In this section we’ll dive into an analysis of growth and valuation.

Growth

There are many studies showing the importance of growth to excellent long-term investment performance. One such study by Boston Consulting Group illustrates this well, :

⁸ FTSE Russell: “Russell 2000 – 40+ Years of Insights”, March 2020



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Over the short term, multiple expansion drives elite performance, as multiples can swing dramatically more in a given year than revenues. Over time, revenue growth is the primary driver of value creation (for already profitable companies). To verify this data, we decided to run our own analysis of the past three decades' top equity performers. What we found is that 74% of annualized returns are driven by EPS growth (a combination of revenue growth, margin expansion, and change in shares outstanding). We also find that the average top stock performer in a given decade is a 22% revenue grower with modest operating leverage at the gross margin and operating margin levels.

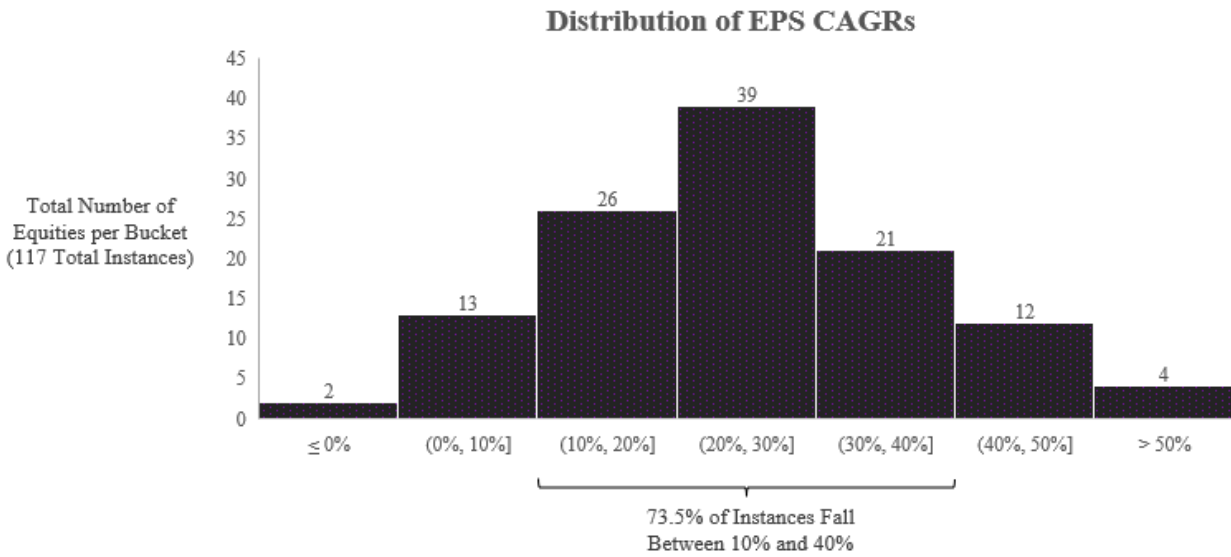
Top 50 Stocks by TSR	1990's	2000's	2010's	Average
Avg TSR CAGR	37%	27%	32%	32%
Avg Revenue CAGR	24%	19%	24%	22%
Avg Gross Profit CAGR	24%	21%	26%	24%
Avg EBITDA CAGR	28%	25%	29%	27%
Avg EPS CAGR	24%	22%	25%	24%
EPS % of TSR	66%	81%	78%	74%
Average Starting P/E	18x	17x	20x	19x
Average Ending P/E	45x	22x	36x	34x

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The average top performer began at a 19x P/E multiple and benefited from an 85% re-rating over each decade. Therefore, we can conclude that these situations are earnings compounders and not statistically-cheap (<10x P/E), deep-value plays solely dependent on multiple-expansion or yield. We also observe that while there is a wide range of earnings growth CAGRs in the dataset, 73.5% of the values fall between 10% and 40% EPS growth.

⁹ Boston Consulting Group, Morgan Stanley

¹⁰ "TSR" = Total Shareholder Return



Below are the executive summaries for each decade:

<u>Company</u>	<u>MoM</u>	<u>TSR CAGR</u>	<u>Rev CAGR</u>	<u>GP CAGR</u>	<u>EBITDA CAGR</u>	<u>EPS CAGR</u>	<u>LTM P/E Start</u>	<u>LTM P/E End</u>
1990's Top Performing Stocks								
1990s Top 10 Avg.	76x	53%	31%	33%	40%	35%	18.6x	61.0x
1990s Top 50 Avg.	30x	37%	24%	24%	28%	24%	18.1x	44.9x
1990s Top 50 Max.	133x	63%	43%	45%	53%	48%	92.1x	116.8x
1990s Top 50 Min.	10x	26%	1%	1%	-2%	-4%	92.1x	116.8x
1 Jack Henry & Associates, Inc. (NASDAQ:JKHY)	133x	63%	33%	34%	38%	33%	5.1x	37.8x
2 Best Buy Co., Inc. (NYSE:BBY)	101x	59%	37%	36%	45%	45%	14.2x	35.7x
3 Microsoft Corporation (NASDAQ:MSFT)	97x	58%	30%	31%	34%	39%	19.7x	70.8x
4 Maxim Integrated Products, Inc. (NASDAQ:MXIM)	92x	57%	36%	39%	41%	35%	15.5x	70.0x
5 The Charles Schwab Corporation (NYSE:SCHW)	84x	56%	28%	28%	25%	44%	22.4x	51.0x
6 Applied Materials, Inc. (NASDAQ:AMAT)	71x	53%	33%	34%	45%	32%	15.5x	70.0x
7 Amgen Inc. (NASDAQ:AMGN)	59x	50%	28%	30%	53%	28%	13.4x	57.2x
8 Oracle Corporation (NYSE:ORCL)	49x	47%	27%	27%	45%	36%	54.4x	116.8x
9 Micron Technology, Inc. (NASDAQ:MU)	40x	45%	34%	45%	45%	27%	10.2x	62.7x
10 Intel Corporation (NASDAQ:INTC)	38x	44%	24%	27%	31%	31%	15.1x	38.3x

Company	MoM	TSR CAGR	Rev CAGR	GP CAGR	EBITDA CAGR	EPS CAGR	LTM P/E Start	LTM P/E End
2000's Top Performing Stocks								
2000s Top 10 Avg.	31x	39%	22%	23%	35%	27%	8.3x	20.2x
2000s Top 50 Avg.	14x	27%	19%	21%	25%	22%	17.2x	22.4x
2000s Top 50 Max.	71x	53%	45%	61%	90%	45%	77.7x	65.4x
2000s Top 50 Min.	6x	20%	3%	3%	4%	1%	3.4x	9.0x
1 Monster Beverage Corporation (NASDAQ:MNST)	71x	53%	32%	34%	45%	45%	10.7x	17.6x
2 Clean Harbors, Inc. (NYSE:CLH)	48x	47%	18%	20%	25%	28%	10.5x	42.0x
3 Amedisys, Inc. (NASDAQ:AMED)	47x	47%	31%	31%	90%	24%	3.4x	9.5x
4 Deckers Outdoor Corporation (NYSE:DECK)	39x	44%	22%	24%	35%	39%	8.2x	11.3x
5 FTI Consulting, Inc. (NYSE:FCN)	21x	36%	40%	39%	41%	22%	5.7x	16.8x
6 CarMax, Inc. (NYSE:KMX)	21x	36%	14%	18%	43%	28%	12.4x	22.1x
7 The Middleby Corporation (NASDAQ:MIDD)	17x	33%	17%	20%	28%	26%	8.5x	14.6x
8 ANSYS, Inc. (NASDAQ:ANSS)	16x	32%	23%	23%	29%	19%	13.0x	36.0x
9 HollyFrontier Corporation (NYSE:HFC)	15x	31%	22%	13%	13%	23%	5.4x	10.2x
10 NVR, Inc. (NYSE:NVR)	15x	31%	3%	4%	4%	13%	5.2x	22.2x

Company	MoM	TSR CAGR	Rev CAGR	GP CAGR	EBITDA CAGR	EPS CAGR	LTM P/E Start	LTM P/E End
2010s Top Performing Stocks								
2010s Top 10 Avg.	30x	40%	39%	40%	34%	27%	13.9x	43.4x
2010s Top 50 Avg.	17x	32%	24%	26%	29%	25%	20.4x	35.8x
2010s Top 50 Max.	41x	45%	75%	74%	92%	46%	42x	87x
2010s Top 50 Min.	11x	27%	7%	7%	6%	9%	2x	8x
1 Netflix, Inc. (NASDAQ:NFLX)	41x	45%	28%	29%	28%	31%	27.3x	77.0x
2 Neurocrine Biosciences, Inc. (NASDAQ:NBIX)	40x	44%	75%	73%	35%	11%	5.4x	75.0x
3 Domino's Pizza, Inc. (NYSE:DPZ)	35x	43%	10%	10%	23%	21%	5.4x	27.8x
4 Nexstar Media Group, Inc. (NASDAQ:NXST)	29x	40%	28%	26%	32%	15%	3.5x	24.4x
5 Exact Sciences Corporation (NasdaqCM:EXAS)	27x	39%	69%	64%	N/A	N/A	N/A	N/A
6 MarketAxess Holdings Inc. (NASDAQ:MKTIX)	27x	39%	16%	20%	22%	20%	13.0x	56.7x
7 DexCom, Inc. (NASDAQ:DXCM)	27x	39%	48%	74%	N/A	N/A	N/A	N/A
8 Texas Pacific Land Corporation (NYSE:TPL)	26x	39%	44%	43%	45%	45%	29.0x	19.0x
9 Cheniere Energy, Inc. (NYSEAM:LNG)	25x	38%	49%	36%	44%	N/A	N/A	24.2x
10 Repligen Corporation (NASDAQ:RGEN)	23x	37%	26%	23%	44%	46%	N/A	N/A ¹¹

Another reason growth should be integral to an investment approach is that if a stock stays flat while it grows its earnings, then the multiple compresses and the stock becomes more attractive to a broader set of investors (eg. “value” investors) waiting for a lower multiple. We generally refer to this concept as growth *becoming* value. From our experience, “value” rarely becomes growth (low growers accelerating to 20%+ revenue growth). Even one of the most impressive business accelerations (Microsoft’s push into cloud applications (Dynamics) and web infrastructure (Azure)), only exceeded 18% top-line growth once in the last 15 years. Albeit this transformation away from Windows drove massive multiple expansion and returns for MSFT shareholders. We use data from UK manager Fundsmith to illustrate growth becoming value and value becoming expensive:

¹¹ “N/A” used for unprofitable companies

Stock	Entry Price (Jan 2015)	Trailing EPS	Multiple	2020 EPS	Entry Multiple of 2020 EPS
Deutsche Bank	€ 22.54	€ 1.17	19x	€ 0.07	322x
Exxon	\$92.83	\$7.60	12x	-\$5.25	-18x
GE	\$24.09	\$1.50	16x	\$0.58	42x
IBM	\$162.06	\$15.59	10x	\$6.13	26x
Shell	£2,168.00	£143.00	15x	-£217.00	-10x
Adobe	\$72.34	\$0.53	136x	\$10.83	7x
Amazon	\$308.52	-\$0.52	-593x	\$41.83	7x
Facebook	\$78.45	\$1.10	71x	\$10.09	8x
Netflix	\$49.85	\$0.09	554x	\$6.08	8x
Paypal	\$40.47	\$0.46	88x	\$3.54	11x

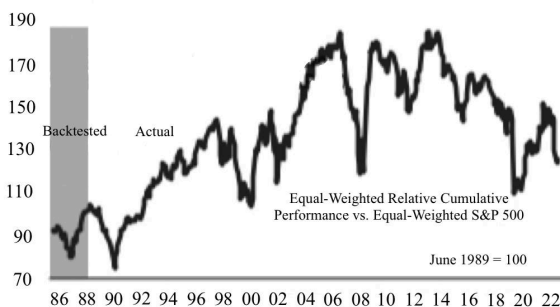
Here we see that high growth businesses can grow into their valuations when earnings become substantial, while cheap stocks can often be “value traps” when the core businesses are in decline.

Valuation

The first step of valuation is deciding which financial KPI to use. Academically, companies are valued based on the present value of their free cash flows because FCF is what is available to be returned to investors via dividends or buybacks. In fact, top decile EV/FCF is the best performing valuation metric, beating even forward P/E by 300%+ over the last 30 years.

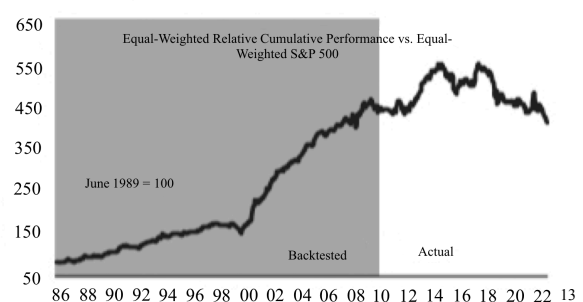
Forward Earnings Yield Top Decile: Relative cumulative performance

The factor outperformed the index in June



FCF/EV Top Decile: Relative cumulative performance

The factor outperformed in September

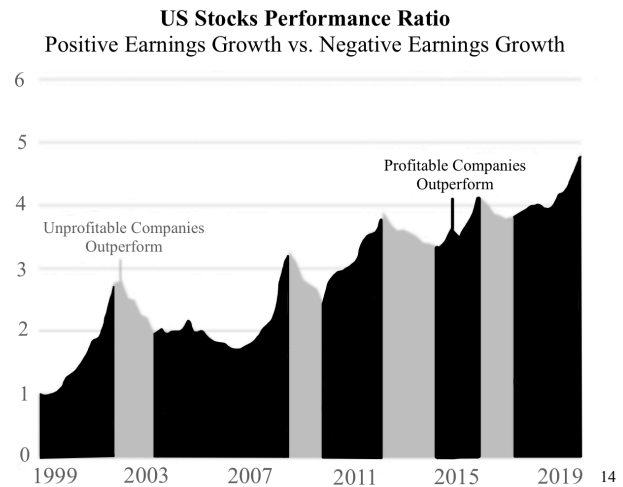
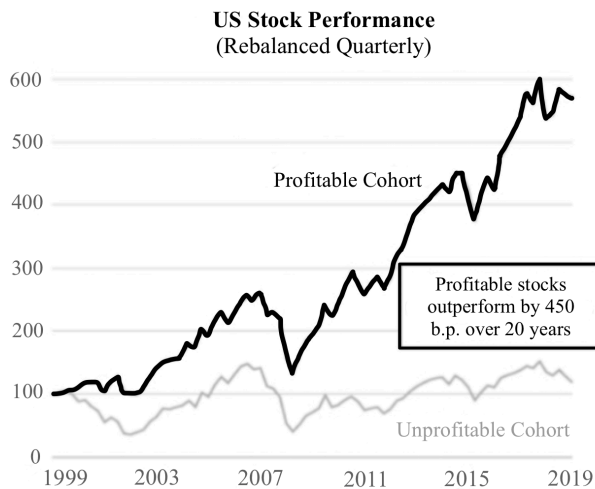


If forced to use other multiples, even the lowest deciles aren't particularly correlated with long-term stock performance. The cheapest deciles of other metrics like Price-to-Book and Price-to-Operating-Cash-Flow underperformed the S&P500 by 1-2% each over the last 30-years. We conclude that such KPIs are not good proxies of LT earnings power, capital returns, business value, or shareholder returns. For example, low P/B or low EV/S does not inherently say anything about the profitability of the company, and profitability is a very important factor

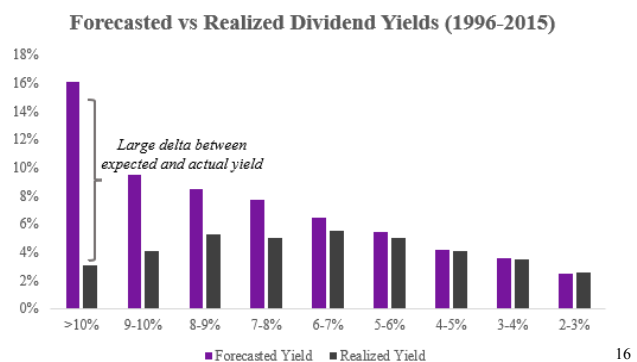
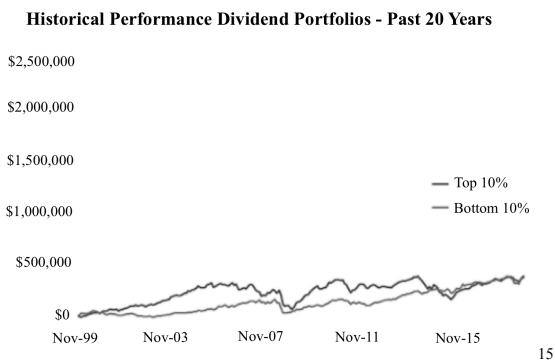
¹² Fundsmith

¹³ Bank of America Merrill Lynch: “Quantitative Profiles Nine Shades of Value”, Subramanian

for long-term equity performance (as implied by the Asness small-cap study, and shown below via Alliance Bernstein):



Even while net income and EBITDA are technically metrics indicating profit, they can be manipulated and can sometimes vary drastically from FCF. Interestingly, while profitability and FCF yield are highly predictive of future returns, dividend yield (a product of FCF) is not, with there essentially being no difference between top and bottom dividend yield cohorts:



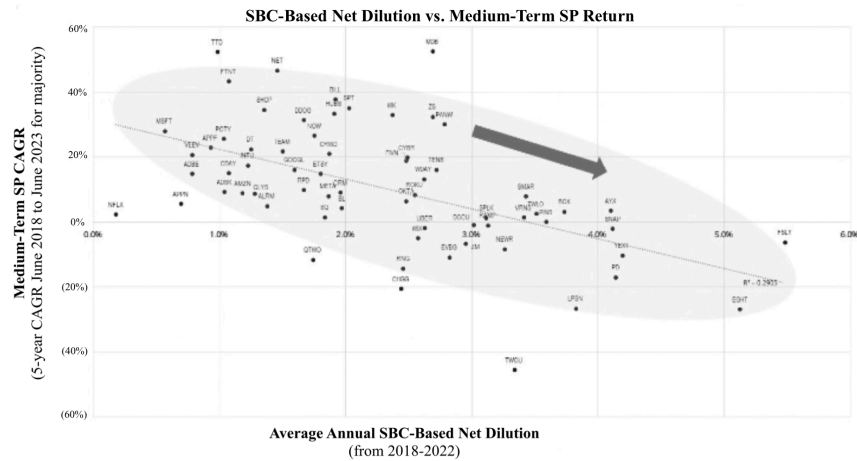
It appears this phenomenon is caused by the high-yield stocks cutting their dividends such that the realized yield is much lower than expected. Companies buying back shares, on the other hand, outperform the S&P500 index by 110bps per year¹⁷ and stocks issuing greater than 3% new shares per year (through stock-based compensation or equity raises) generally underperform (negative relationship between TSR and stock-based-compensation shown top right).

¹⁴ Alliance Bernstein: "For Growth Stocks, Profits are the New Normal"

¹⁵ Accelerate Shares: "Whatever You Do, Don't Invest Based On Dividend Yield", April 2019

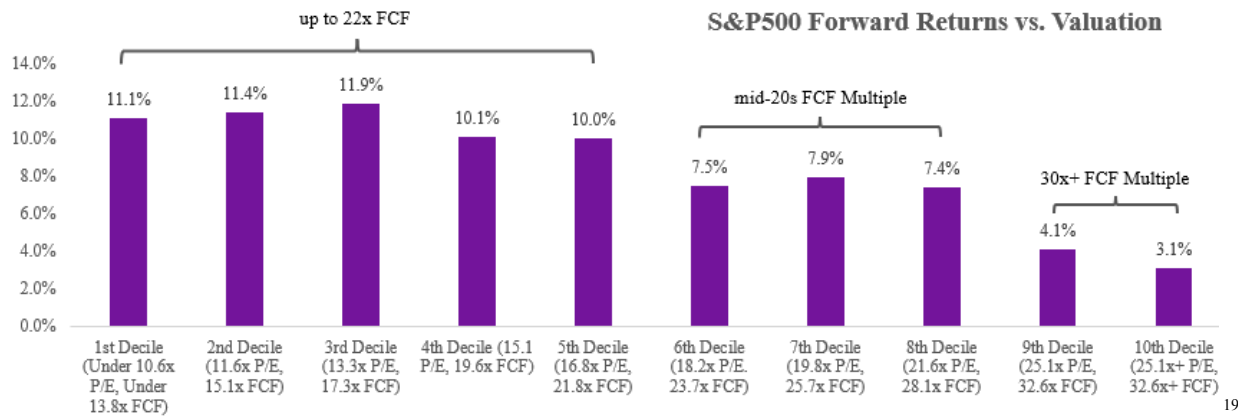
¹⁶ Mellon Capital, CNBC

¹⁷ S&P500 Buyback Index vs S&P500 performance 2009-2019



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The next component of valuation is determining what “cheap” truly is, and or what multiple to assign businesses we’re researching. Based on historical S&P500 data, the cheapest 30% of multiples are 13x P/E and 17x FCF or lower, respectively.



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However, we don’t believe this can necessarily be extended to the entire global equities universe. The S&P500 is consistently growing, profitable, and generally high quality. Smaller stocks or international stocks are more cyclical, less profitable, and lower quality generally. Taking what we can see on small caps, they tend to be similarly priced in the meaty part of the bell curve, but exhibit higher dispersion at the extremes (small cap stocks can be much cheaper and much more expensive).

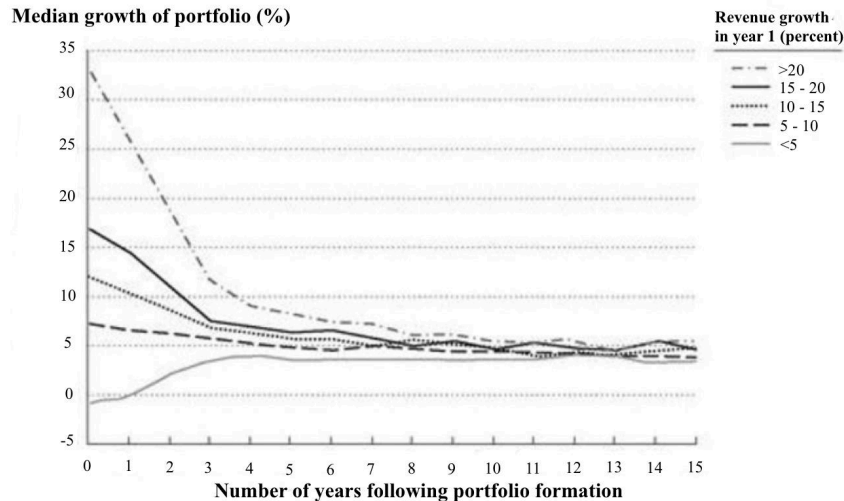
Another study we found (Weigand Irons, 2007) helps us understand the risk of multiple compression in higher multiple stocks, and the optionality of multiple expansion for really cheap stocks. The most expensive stocks rerated down by 10%, while the cheapest stocks rerated upwards by 158%.

¹⁸ TDM Growth Partners: “SBC-Based Dilution Across US-Listed Growth Tech Companies”, Dec 2023

¹⁹ Novel Investors: “How EV Value Metrics Performed This Century”, June 2021

Beginning P/E Range	Midpoint TTM P/E	Nominal Stock CAGR	Nominal EPS CAGR	Assumed Dividend Return	Implied Exit P/E	Implied Rerating
5.30-10.00	7.65x	15.51%	2.99%	76.54%	19.74x	158%
10.01-12.98	11.50x	11.01%	4.05%	54.09%	17.78x	55%
12.99-15.19	14.09x	7.60%	3.22%	42.10%	17.03x	21%
15.20-17.65	16.43x	6.58%	4.38%	38.58%	16.11x	-2%
17.66-26.88	22.27x	7.51%	6.80%	32.90%	20.00x	-10%

As is shown in our value vs growth study earlier, the lower multiple tiers (5.30x-12.98x) generally grew inline with the next two tiers (12.99x-17.65x), which was likely the cause of their re-ratings. These results also coincide with many other studies that demonstrate mean reversion in valuation ratios. We believe the mean reversion in multiple stems from mean reversion in growth exhibited in stocks generally:



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As discussed earlier with the growth indices, investors overestimate, and therefore overprice, earnings growth of growth stocks and underestimate / underprice the earnings of “value” stocks. We believe this is because over about 5-10 years stocks tend to approach the same equilibrium growth rates regardless of whether they started at 30% or 0% growth. A Taiwanese study, “E/P Mean Reversion-Based Strategies for Investment Practice: Evidence from the Taiwan Market²²”, found that the average time to mean reversion in their market was 125 days.

Conclusion.....

We believe there's a great investing analogy from the Moneyball story about Sabermetrics (deep statistical analysis) in professional baseball:

²⁰ Weigand, Irons: “The Market P/E Ratio, Earnings Trends, and Stock Return Forecasts”, 2007

²¹ McKinsey: “Valuation”

²² Yan-Ting Lin, Shang-Chi Gong, Sou-Shan Wu and Tsung-Pei Lee

“People who run ball clubs, they think in terms of buying players. Your goal shouldn't be to buy players, your goal should be to buy wins. And in order to buy wins, you need to buy runs...what I see is... is... an imperfect understanding of where runs come from...Baseball thinking is medieval. They are asking all the wrong questions.” - Moneyball

In investing, fund managers think in terms of buying growth, value, quality, dividends, or other overemphasized styles. But their goal should be to buy expected returns. In order to buy expected returns, investors need to buy yield and growth. Herein lies the imperfect understanding of investing and where returns come from.

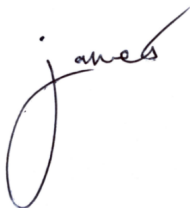
After unpacking controversial topics like value vs growth and small cap vs large cap it becomes clear that the winning approaches are not the extremes of any styles but the intersection of them. Some niches like value outperform because they are cheaper but grow earnings similarly, while some factors like small-cap outperform due to more rapid earnings growth but at similar valuations. Growth vs value doesn't matter. Small cap vs large cap doesn't matter. Spinoffs vs IPOs doesn't matter. An investor does not have to be focused on dedicating to a niche as long as they focus on buying cheap growing cash flows; The investment funds and portfolios with the lowest multiples of future free cash flow will come out on top. This is what we call being a style generalist.

Since launch, under-performers in the Tenebrist Global Fund have primarily been in three areas: rapid growth deceleration (50% growers quickly becoming 20% growers), paying “too high” multiples (40x+), and investing in unprofitable companies reliant on new capital to fund ongoing operations (worse than teens negative FCF margin). While it is possible to generate attractive returns in some of these situations, the likelihood is lower so capital should be reserved for only the best of these opportunities (like our investment in SentinelOne, a leading endpoint software vendor we acquired shares in last year). From the research exhibited in this letter, looking back we can see why some of our investments didn't work out, and that most of the time we should be looking for businesses that are:

1. Consistently growing revenue 20%+ with operating leverage (margin expansion).
2. Profitable and trading at less than 22x FCF & 17x P/E.
3. Diluting shareholders minimally (under 3%), & preferably buying back shares.

We believe the Tenebrist portfolio currently outperforms the benchmarks set above. In 2024, 100% of Fund investments will be operating-cash-flow-positive and 84% will be free-cash-flow positive, with average revenue growth of 36%. The Fund's weighted average forward operating-cash-flow multiple is 9.8x and free-cash-flow multiple is 13.4x.

Thank you a million times over for your time, support, and investment,



James Reynolds, CFA

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