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Great Investing Requires Reinvention and Adaptation to Change

While investing requires one to learn from your mistakes and successes, avoiding the former and repeating the latter, I think this oversimplifies feedback loops and can lead to complacency and different mistakes. Businesses and the investment backdrop are always changing. The capital investment cycle has a huge influence on improvement and deterioration in returns in various businesses, and technology and new backdrops can cause yesterday's bad business to be a great business or vice versa. It is important not to over extrapolate one's success because there are always different circumstances in different timeframes and yesterday's failures can turn into today's successes as well.

One of my investing heroes was Peter Lynch, whose book inspired me to get into the investing business at a fairly young age. When one references Lynch, many think of the set ups he was well known for, namely finding off the beaten path smaller cap growth companies. He would go to the mall and find retailers and restaurants that he thought could replicate economics that had proven strong in part of the country by rolling them out throughout the rest of the U.S. This simple strategy of finding "undiscovered companies" – small caps that had low multiples yet significant probabilistic growth ahead of them - was a great source of return in the 1980s and 1990s. However, this belies a much more sophisticated strategy where he pursued special situations, depressed cyclicals, and even invested in treasuries near their all-time lows. He invested in auto stocks when the cumulative sell through of autos was significantly depressed by very high interest rates; he owned Fannie Mae when it was a cheap monopoly compounding at a high rate; and when I was at Raymond James during the TMT bust he called into our tower analyst at the time and seemed to be making a bet on the tower companies when they were depressed and subsequent 100-baggers. He invested in government privatizations in the U.K. and bought as many S&L de-mutualization he could get his hands on.

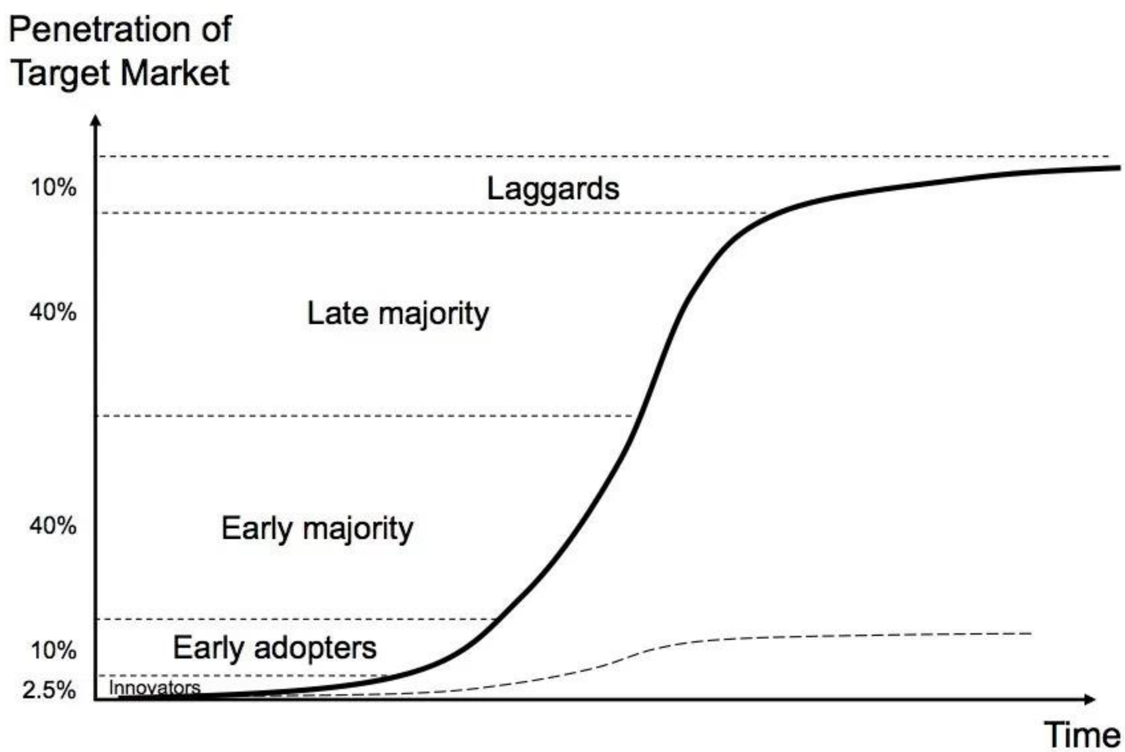
My point here is that Lynch adapted to the environment and found interesting ideas depending on what the market was offering at the time. He continuously adapted and changed depending on the business environment, finding bargains based on circumstances and not based on a predetermined formula that resulted from what worked for him before. I have been talking about how I like certain kind of set ups in longs and shorts and it is very important to align with strong management teams, invest in companies with moats, line up asymmetry by having tailwinds from cycles or headwinds on the short side, and to have valuation on your side. However, it is also important not to be overly reliant on experience or finding analogous situations and to be focused on current business conditions and market psychology.

For instance, in interviewing a number of analysts for the two analyst positions at Blue Grotto, some of the younger candidates that didn't resonate with me were focused on investing in seemingly high-quality businesses that were trading at very high multiples (on any metric). Their recent experience is that valuation hasn't mattered as growth stocks have continued to experience multiple expansion of late but their limited frame of reference having only worked in the business for 3-8 years seems myopic to me. This is why my first analyst hire at Blue Grotto is a very experienced person, who has seen multiple cycles and invested in a variety of businesses.

My Early Career: Riding the Emerging Market Wave

In 2005, when I first came to GMT Capital, it seemed to me that the stars were aligning for wireless businesses in emerging markets. I had observed how wireless adoption in developed markets followed an S-curve of adoption and once they reached ~20% penetration, they headed up the steep part of that curve (an idea put in my head by Ric Prentiss, Raymond James' Wireless Services analyst). GMT Capital at the time was extremely bullish on the commodity complex and was heavily invested in energy, mining, and agricultural companies. From a macro perspective, assuming we were right, this meant a positive backdrop in places like Africa, Latin America, and some countries in Asia. Meanwhile I was following Nokia and a number of the handset and network equipment companies, who were experiencing significant pricing pressure for both network equipment and handsets, spurred on by Chinese companies like Huawei and intense competitive pressures globally. This meant lower cost of entry for the consumer in these relatively poor countries and improved economics for build out of base stations and infrastructure for the wireless operators.

Meanwhile, when I looked at the stocks, although they were up from extremely depressed levels following the collapse of the Internet bubble, they still were statistically cheap. Companies like Telkomunikasi Indonesia, MTN Group in South Africa, Millicom (Latin America and Africa), and NII Holdings and America Movil in Latin America were all trading at 5-6x EV/EBITDA and 10-14x P/E. If I was right that the cost of equipment coming down would result in higher returns and that the cost of handsets coming down would mean greater adoption and improved economic environments in emerging markets would mean more consumption on the part of consumers, these companies were likely to grow fast (which was validated by their numbers). Yet the stocks were priced at relatively low multiples, which was partially the result of a hangover from the TMT bust plus relatively low valuations in these markets at the time. Diffusion theory suggests that as adoption reaches 20%, typically the market accelerates to a steeper level of growth until the market is more penetrated (we noted in a previous piece that this is true of cloud computing today).



We dug in and did a comprehensive study, eventually deciding to invest in some of the companies mentioned above and others based on their operating countries' penetration rates, valuation, market structure (the fewer carriers the better and the higher the market share of the operator the better), and other factors like corporate governance. We really liked the carriers with number one positions in countries, because they could leverage that position by offering cheaper on-network calling rates, perpetuating their position as the scale carrier. They also could market more effectively by offering better availability across a country, with Millicom's management at the time thinking of their business as a fast-moving consumer good and painting their brand (Tigo in most cases) on shops and restaurants across the country.

As a result, the stocks we owned experienced both substantial growth in earnings as our thesis played out plus multiple expansion as the stocks' EBITDA multiples in some cases doubled as we headed into 2008. While we sold some prior to 2008/2009 on valuation (and should have sold more in hindsight), the macro was the main reason these stocks sold off. For instance, Millicom grew EBIT over 27% in 2008 and over 15% in 2009 despite substantial currency headwinds. The stocks were killed due to a combination of currency depreciation and an overall market liquidation, but we largely stuck with the bet and even increased our ownership of these companies because this fundamental call was still playing out.

All good things must come to an end, and as penetration rates increased in these markets, the wireless market became more saturated. After that we started to see the writing on the wall as penetration ramped up to 60%, 70%, and in some cases 90%+. Everyone in Russia and Africa had a cell phone with multiple SIM cards and that meant it was time to move on. However, if you think about this situationally, I had only been a PM for a few years and the emerging market wireless theme helped get me promoted and made a lot of money for GMT and me personally. Psychologically, it was tempting to stick with this bet (and also our significant bet against newspapers and old media, which is another story). Through a combination of reacting to data points, finding more compelling ideas, and reacting to negative reinforcement in a few of these names, I did manage to totally get out of this highly successful investment. While it was nice to have a theme work for several years, I adapted and moved into a number of more idiosyncratic investments based on individual company dynamics.

Where I am going with this is most people who make significant money in a type of business or situation have trouble getting away from that situation even when it's no longer the great bet it was when they first made money in it. The circumstances that made the bet a great bet at one point won't always apply in the future, or have already played out, making it a way worse bet today than it was in the past. This is a much more nuanced version of confirmation bias and one most investors are very susceptible to. It is confirmation bias wrapped in the cloak of a feedback loop. When I talk about situations that have made significant money for me in the past, I realize it is important not to over rely on what has worked for me in the past and to make sure I understand how circumstances might be different now vs. when a certain kind of investment worked for me before.

Finding Inefficiencies in International Small Caps

I have found that my best investments have normally been when there is some negative macro or thematic headwind, real or perceived by the market, that really is not applicable when digging into the underlying overall actual fundamentals of an individual company. The majority of market participants look at the company with disdain because of the geography it is in, or the sector is generally out of favor for secular or idiosyncratic reasons. However, if you dig into the actual fundamentals of the company, they are showing significant growth, suggesting the macro or secular reason people aren't investing isn't applicable.

In early 2013, I was doing screens on "PIGS" countries, because they screened cheap on long-term regressions and seemed to be emerging from significant recessions. I came across a little IT services company in Italy called Reply S.p.A. Reply had partnerships to do system integration and deployment work for Oracle, Microsoft, SAP, IBM, Google, Amazon Web Services, and a number of other software companies. The company also has a number of different internally developed solutions for various applications and services. The company is organized via different areas of expertise and industry verticals, with a structure analogous to the ad agency holding company business model where different boutiques are run autonomously.

I understood both the ad agency and the IT consulting/BPO business through previous investments. What caught my eye on Reply in the screen was the stock was trading at 5x EV/EBITDA and under 10x P/E at the time, which was much lower than other IT services companies despite a superior track record of growth and profitability. A cursory look at the company's financial track record suggested the company was managed superbly as it grew double digits through the European financial crisis.

I reached out to management who walked me through in detail how the company was organized, how the company sought to be at the leading edge of new technologies by providing a large number of specific examples, and how the individual groups at the company were incentivized on profitability. The company had a great track record of executing on acquisitions and so had the capability to grow both organically and inorganically if the past was at all indicative of the future. At the time, the market cap of the company was quite small so I thought there was plenty of room for growth if the company continued to execute. With IT services businesses, the most important variable is usually management as execution is the key to their success and people are the most important assets in the business.

I also managed to reach out to several former and current employees and customers. The management team's story seemed consistent with what customers and former employees were telling me. The Chairman of the company and largest shareholder, Mario Rizzante, was described to me as a fanatic with great business acumen. One former employee whose business was acquired by Reply told me the company had the best back-office systems and financial controls he had ever seen.

We invested in the company at around 35 Euros at the time and continually scaled into a position on the way up. Despite being a small company, GMT was able to buy a substantial position, although it took a while. Currently the stock is around 242 Euros (split adjusted) and as I write this and continues to execute well. The company has strong positioning in IoT, cloud computing, and e-commerce related businesses and seems to continually find a way to grow its top line double digits.

While there are not many places in the world with economies that are depressed and recovering right now, we are finding more idiosyncratic cycles driven by businesses that have undergone crises that have run their course and are now recovering. A recent idea we discovered is Village Roadshow (VRL AU/A$2.25). Village Roadshow is a major theme park operator in Australia and also the largest independent movie exhibitor in the country. The company also has film distribution and marketing arms that are smaller portions of the business. Pretty much everything went wrong for the company last year, which we think has compressed the valuation to a point where the risk/reward is compelling.

In late 2016, four people died at a theme park called Dreamworld in Australia on a ride called Thunder River Rapids. The horrible tragedy caused theme park attendance to drop significantly in Australia as consumers reacted to the incident (we note Dreamworld is not owned by Village Roadshow). This exacerbated already poor pricing discipline by the two major theme park operators in Australia and was a major headwind for attendance. To add insult to injury, the movie exhibition business in Australia suffered from the lack of compelling films in 2017 (which hurt the box office in Australia and globally). The company poorly executed in its film distribution business and faced secular headwinds in that business. The company opened a TopGolf on the GoldCoast, which had start up costs associated with it last year. As a result of all of these issues, EBITDA dropped by 1/3 for the year. The stock de-rated and the company was forced to sell some assets and do an equity offering to de-leverage. We doubt there are many happy Village Roadshow shareholders at the moment.

However, this year the positives are adding up. Village Roadshow changed its pricing strategy and its competitor in the theme park business followed, which resulted in July ticket sales rising 56% y/y. We've followed the theme park business in the U.S. for some time and have never seen a number that strong (of course this is only one month, but YTD pricing is up 16% and ticket sales are up 8%). The Australian box office is up 10% YTD. The start up costs associated with opening a Top Golf are now behind the company and that business should generate A$5 million cash flow this year. The company has cut $8 million in costs. The company has a new CEO running the theme park business that seems to be doing a better job of innovating on dynamic pricing and following the lead of more sophisticated U.S. peers.

The stock is currently trading at 5x forward EBITDA. Six Flags trades around 14x EV/EBITDA and movie exhibitors tend to trade at 8x-12x EV/EBITDA globally. The regional theme park business is fairly differentiated and can be a reliable cash flow generator. Yesterday's disaster can become next year's gem of an investment, and we model the stock tripling in 3 years. Note we're just getting involved in this one after evidence business momentum is improving is fairly clear (we'll scale in and continue to do monitoring work; new investments are where there is the highest likelihood that we could be wrong). As we do continuous monitoring work on the company and focus on pricing and attendance trends in the theme park and exhibition businesses (the key issues), we'll scale into a position if the thesis continues to check out and if not, we'll exit and will have not taken a lot of risk since we hadn't established a full position yet.

Cyclical Businesses and the Capital Cycle

We prefer to invest in secular growth businesses, but we also occasionally invest in cyclical businesses that we think have a beneficial backdrop from a cycle standpoint and have something extraordinary from a business differentiation or management standpoint. In cyclical businesses, the key forecastable driver of pricing power, and therefore returns on capital, is supply. Edward Chancellor and the team at Marathon Asset Management wrote an excellent book called *Capital Returns: Investing Through the Capital Cycle: A Money Manager's Reports 2002-15*. In it, they provide compelling evidence that mean reversion (in both directions) in companies and industries largely occurs due to under and over investment in capacity.

One of the stocks we invested in heavily in 2011 and 2012 was Smurfit-Kappa Group. While not the best business in the world, the company is the largest integrated producer and supplier of corrugated boxes in Europe, with smaller businesses in Latin America and the U.S. We originally started looking at the stock at 8 Euros and the stock eventually fell to around 4 Euros during the crisis.

Our thesis on Smurfit-Kappa, which some of my coworkers took to calling Smurfshit Crappa as time went on (because the stock got cut in half after we established a position), was that corrugated capacity had come out of the market in Europe the prior few years, which would eventually lead to positive pricing power for the existing players. Smurfit was well managed and was paying down debt from a pretty leveraged position after being taken public following private equity ownership. Their integrated model would result in stability in the business ultimately. We thought the leverage of the company was reasonably high but not so high that it would cause major problems for the company.

Investing inspiration can come from anywhere. In this case, the tipping point for me was when I read a downgrade of the stock by Bank of America Merrill Lynch in late 2011. The stock had been roughly cut in half by then, which any investor will tell you will wear you out and make you feel a certain amount of hatred for the company/stock (note: if I had waited for the turn like I advocate now, I would have saved myself and investors a fair amount of personal anguish and the 50% drop in our initial position). I hated the stock at this point (when you own a stock that's been cut in half you usually don't like it very much). When BAML's downgrade note hit my inbox, I probably just held my breath before reading it. However, when I started to read it I woke up to how absurd the situation had become. In the note, the analyst highlighted that on an extreme bear case around the pricing cycle for corrugated boxes, the stock was now at around 7x bear case earnings. He accentuated the potential for a continuation of negative pricing trends and then just as an afterthought mentioned the valuation if his bear case played out.

I don't want to sound callous here. The downgrade of the stock and my contrarian viewpoint toward it was not the only reason we invested substantial amounts of capital for our investors. We were continually interviewing the management team, monitoring data from industry publications (in this case RISI), talking to competitors like DS Smith and private companies, and talking to analysts about the company. The key issue we thought was most important was overall industry capacity – in somewhat cyclical businesses like this, lower supply is bullish. But when you are investing, sometimes you become inspired by that last data point, and in this case, I thought based on experiences of seeing stocks trade at cheap valuations on trough earnings that it was likely the stock was near bottom.

As a general rule, if a stock looks extremely cheap on the worst-case scenario, you should back up the truck and buy as much stock as you can. This was the case on Smurfit at the time as highlighted by this ridiculous (and probably emotionally driven) downgrade. We more than doubled our position in Smurfit at around 4 Euros per share. It hung out there for a while as the European crisis slowly dissipated, driven by a bottoming of bond prices on the periphery, eventually rising as our thesis around pricing played out and the European economy started to improve, driving volumes as well.

When I was in London talking to the analyst I worked with on the name, I joked with him that if things got much worse, at least Europeans would probably buy more boxes for housing. However, the bear case earnings never played out, the company de-leveraged its balance sheet and drove earnings to closer to 2 Euros, meaning we were buying the stock at 2x forward earnings at the time. The stock took several years for earnings to improve, debt to get paid down, and the stock to re-rate based on changing perceptions about how risky the situation was. Eventually the stock went to the low 30s and we cut our position dramatically, but even today Smurfit is a well-run industrial business at a cheap price of around 29.76, giving it a multiple of around 11x P/E.

A current name, familiar to me from following it through GMT Capital's European office, that may have an interesting supply backdrop for the next few years is Israel Chemical (ICL-IL). Israel Chemical operates some of the lowest cost potash operations in the world. Approximately 80% of production is sourced from the Dead Sea at $150/tonne, the third lowest cost globally. To maintain its competitiveness, ICL has recently embarked on an operational improvement plan across its potash operations with the intent of driving down costs by 10%-15% per tonne over the next five years. This plan extends from ICL's Dead Sea operations, to combining its two mines in Spain, and lastly restructuring its UK potash operations to a specialty product, polysulphate. ICL's geographic location in Israel and Spain provides them with strong footholds in the higher growth Chinese, Indian, and Brazilian markets. With the improving potash environment and low-cost market position, ICL should see meaningful financial upside. All else equal, every $10/tonne increase in potash prices equates to $45-$50mm in additional EBITDA (~4%-6% uplift). There should be additional upside as the cost rationalization programs materialize over the next several years.

However, a more interesting angle to Israel Chemical is ICL's bromine dominance (they control 50% of the market), which should be supported in the intermediate term by this element's concentrated supply (3 players have about 80% of the market). ICL continues to increase prices prudently to take advantage of the demand for flame retardants for large screens, electronics, and electric vehicles without attracting pricing response. Similarly, ICL's largest competitor, Albemarle Corporation (ticker ALB; #2 with estimated 150-175k tons production), is maintaining stable/higher pricing in bromine partly because it is investing in its other businesses. ALB provided a positive outlook on its call: "Overall market pricing continues to be supported by constrained construction and higher than normal local elemental bromine pricing in China." Interestingly, the other source of supply that was less predictable historically, namely Chinese production, has fallen significantly in the past year due to new Chinese environmental regulations. I think the Chinese increasingly are focused on improving very difficult environmental issues, and this has wide ranging implications across a number of industries.

From a timing perspective, Israel Chemical grew earnings 83% in the most recent quarter despite dilution it experienced from selling off a significant division to de-lever its balance sheet. A new CEO with a better track record than the prior one is focused on moving upstream in three major product categories to create more differentiated products closer to the end market. Since the bromine business has grown in importance for the company, we think the multiple could re-rate higher to be more in-line with other high-quality specialty chemicals companies. Regardless, the asset is a unique one, with long-term reserves and a low-cost position associated with this unique asset that is a quasi-monopoly with long-term rights to mine in the Dead Sea. With bromine and potash pricing data points suggesting a significant earnings improvement, we think Israel Chemical at 23 NIS vs. a peak of 60 NIS, and trading at its historic average multiple has a favorable risk/reward backdrop.

Deterioration in Interest Rate Sensitive Areas

In our research over the past 3-4 months, one theme that has stuck out is the auto and housing sectors have been getting progressively worse at the margin. In housing, Redfin recently made comments on their Q2 conference call around the overall housing market starting to show weakness in the last month of the quarter. We have also heard Zillow has been making negative comments about "macro headwinds" in its business and note Zillow has taken numbers down twice this year (although we think this is more related to business model issues). A window and door manufacturer, JELD-WEN Holding, preannounced weaker numbers just yesterday. In the auto market, things are significantly worse, with profit warnings from most major auto OEMs and suppliers in Q2 and renewed guidance cuts in recent weeks. A combination of higher raw material prices and a weakening SAAR in China, North America, and Europe have all had a significant impact on production and margins.

In the auto market, we have been short Visteon (ticker VC), which took its numbers down for FY2018 in its most recent quarter. Last year, the global auto market grew 2% in terms of units, while Visteon's sales grew less than 1% on an organic apples-to-apples basis. In the most recent quarter, the company's sales declined, and the company guided to further deterioration in Q3'18. The company counters this by touting its new business wins, although it's not entirely clear that the business wins aren't predominantly replacing business on platforms that are expiring or moving to new auto programs. In the company's slides at a recent conference, it shows business wins being completely offset by contract roll offs in 2018, largely being offset in 2019, and then growing substantially in 2020. We think this can easily be fudged, while the evidence is actual sales were flat the last two years and down this year.

The infotainment and audio system market in autos is highly competitive, with at least 10 credible competitors in the market. Since Samsung bought Harman, we think Visteon's share of the market has actually shrunk (as evidenced by sales growing slower than global auto production). The company does appear to have gained share in China, especially among the local Chinese OEMs like Geely. The company claims its order backlog has grown 22% in the last year to $21.1 billion from $17.3 billion, so it is possible that it will gain share in 2020/2021, since there is a roughly 3-year lag between orders and fulfillment. However, in the near-term the backdrop continues to weaken for autos and Visteon trades at a premium that doesn't appear to be warranted based on sales or earnings vis-a-vis other suppliers. When we entered Visteon short, the stock traded at 17x P/E (it is down to 12x today) while high quality suppliers like Continental in Germany traded at under 10x P/E.

Our purpose here is not to point out we made a great call on shorting an auto supplier here, simply that cycles can work in both ways and it is important to know where you are in a cycle regardless of the multiple of the stock. While many times it is hard to predict cycles, I have found many times one can react to early data points and get positioned prior to other market participants.

The weakening housing and auto markets were somewhat predictable as a reaction to higher interest rates and a multi-year boom in sales in these categories. We think the more interesting housing cycles going forward are in Canada and Australia, markets that didn't correct like the U.S. did and where affordability and sanity have yet to prevail. There have been significant signs these markets are starting to roll over and we have several shorts that could work really well if this continues (but we think we have minimal risk if housing in these markets just muddles along).

Portfolio Construction and Diversified Sets of Risks

One great benefit of being able to invest in an Israeli Potash company, a U.S. junk yard and replacement auto parts manufacturer, a European frozen food roll up, a natural gas heavy MLP, and an Australian theme park asset at the same time is you get exposed to a diversified set of risk factors that help smooth overall portfolio level volatility. Each bet is focused on earning a high return, but macro and other factors result in the payoff coming at different times. I mention an industrial short above because layering on shorts in weakening areas creates an added level of portfolio diversification. It is easy to miscalculate on one, or more than one, of these names in any shorter-term period. For instance, we owned a domestic oriented U.K. name during BREXIT. However, if you are assessing each name and entering at asymmetric valuation levels, getting quality right so the long-term is on your side, and cutting back names incrementally as valuation becomes fuller, a portfolio full of diverse assets like this is a wonderful thing. The benefit of diversification by asset class, sector, and factors is important, as illustrated by the following "asset return quilt."

Table 3: The Asset Class Quilt of Total Returns

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017*
Commodities 31.8%	US Fixed Inc. 8.3%	Commodities 25.9%	MSCI EM 56.3%	REITS 32.0%	MSCI EM 34.5%	REITS 37.5%	MSCI EM 39.8%	US Treasuries 14.0%	MSCI EM 79.0%	Gold 29.2%	US Treasuries 9.8%	REITS 23.8%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	S&P 500 12.0%	MSCI EM 44.8%
US Treasuries 13.4%	US Treasuries 6.7%	Gold 25.6%	MSCI EAFE 39.2%	MSCI EM 26.0%	Commodities 21.4%	MSCI EM 32.6%	Gold 31.9%	US Fixed Inc. 4.5%	MSCI EAFE 32.5%	MSCI EM 19.2%	Gold 8.9%	MSCI EM 18.6%	MSCI World 27.4%	REITS 11.7%	US Treasuries 0.8%	Commodities 11.8%	MSCI EAFE 27.4%
US Fixed Inc. 11.7%	Cash 4.4%	US Treasuries 11.6%	MSCI World 33.8%	MSCI EAFE 20.7%	Gold 17.8%	MSCI EAFE 26.9%	Commodities 16.2%	Gold 4.3%	REITS 31.7%	Commodities 16.8%	US Fixed Inc. 7.8%	MSCI EAFE 17.9%	MSCI EAFE 23.3%	US Fixed Inc. 6.3%	US Fixed Inc. 0.6%	MSCI EM 11.2%	MSCI World 20.6%
REITS 8.5%	Gold -0.7%	US Fixed Inc. 10.3%	REITS 33.5%	MSCI World 15.2%	MSCI EAFE 14.0%	Gold 23.2%	MSCI EAFE 11.6%	Cash 2.1%	MSCI World 30.8%	REITS 15.9%	S&P 500 2.1%	MSCI World 16.5%	REITS 0.7%	US Treasuries 6.0%	Cash 0.1%	Gold 8.6%	Gold 18.9%
Cash 6.2%	MSCI EM -2.4%	Cash 1.8%	S&P 500 28.7%	S&P 500 10.9%	REITS 10.7%	MSCI World 20.7%	MSCI World 9.6%	Commodities -35.6%	S&P 500 26.5%	S&P 500 15.1%	Cash 0.1%	S&P 500 16.0%	Cash 0.1%	MSCI World 5.5%	MSCI EAFE -0.8%	MSCI World 7.5%	S&P 500 16.8%
Gold -5.4%	REITS -7.8%	REITS -2.4%	Commodities 23.9%	Commodities 9.1%	MSCI World 10.0%	S&P 500 15.8%	US Treasuries 9.1%	S&P 500 -37.0%	Gold 25.0%	MSCI World 12.3%	MSCI World -5.0%	Gold 8.3%	US Fixed Inc. -2.2%	Gold 0.1%	MSCI World -0.9%	US Fixed Inc. 2.6%	REITS 12.5%
S&P 500 -9.1%	S&P 500 -11.9%	MSCI EM -6.0%	Gold 19.9%	Gold 4.6%	S&P 500 4.9%	Cash 4.9%	US Fixed Inc. 7.0%	MSCI World -40.3%	Commodities 18.9%	MSCI EAFE 8.2%	REITS -9.4%	US Fixed Inc. 4.5%	MSCI EM -2.3%	Cash 0.0%	REITS -3.4%	REITS 1.3%	US Fixed Inc. 6.0%
MSCI World -12.9%	MSCI World -16.5%	MSCI EAFE -15.7%	US Fixed Inc. 4.1%	US Fixed Inc. 4.7%	Cash 3.1%	US Fixed Inc. 4.4%	S&P 500 5.5%	MSCI EAFE -43.1%	US Fixed Inc. 6.1%	US Fixed Inc. 6.8%	MSCI EAFE -11.7%	US Treasuries 2.2%	US Treasuries -3.3%	MSCI EM -1.8%	Gold -10.4%	US Treasuries 1.1%	US Treasuries 4.6%
MSCI EAFE -14.0%	Commodities -19.5%	MSCI World -19.5%	US Treasuries 2.3%	US Treasuries 3.5%	US Treasuries 2.8%	US Treasuries 3.1%	Cash 5.0%	REITS -50.2%	Cash 0.2%	US Treasuries 5.9%	Commodities -13.3%	Cash 0.1%	Commodities -9.5%	MSCI EAFE -4.5%	MSCI EM -14.9%	MSCI EAFE 1.0%	Cash 0.7%
MSCI EM -30.6%	MSCI EAFE -21.2%	S&P 500 -22.1%	Cash 1.1%	Cash 1.3%	US Fixed Inc. 2.6%	Commodities 2.1%	REITS -10.0%	MSCI EM -53.2%	US Treasuries -3.7%	Cash 0.1%	MSCI EM -18.2%	Commodities -1.1%	Gold -27.3%	Commodities -17.0%	Commodities -24.7%	Cash 0.3%	Commodities -11.1%

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg; * 2017 annualized returns

What most people take away from this chart is simply the returns of different asset classes vary widely by year, so it's better to own a basket of everything. For an average individual investor who is not spending a lot of time on investing, this is true, as returns of various asset classes are relatively unpredictable year to year. The benefit of diversification is when you own different asset classes with a correlation less than 1, it reduces drawdowns over time, which allows your portfolio to compound without having to get back losses. If you suffer a 50% loss in your portfolio, it takes a 100% return to then get back to even. No doubt it is prudent to own assets across different geographies and different asset classes, whether you are managing a pension fund or an individual saving for retirement.

However, investing in sectors or asset classes that have gone down substantially can set up great mean reversion trades at times. It's also important to have a feeling for where you are in terms of longer term, more meaningful cycles. For instance, when gold and commodities suffered a 20-year bear market in the 1980s and 1990s, underinvestment in mining and producing commodities set up a big cycle in this market for the next decade, while stocks basically went nowhere as they shook off the biggest bull market in American history. This also carried over to emerging market stocks, which prospered due to the rising agriculture, mining, and energy markets since emerging market economies are, on balance, exporters of these commodities. As an example, when you combine this macro backdrop with the potential for the adoption of wireless service, which leapfrogged other traditional telecom services, this led to stocks like MTN Group going up 17-fold from its lows in 2002 to 2008 (in Rand and not dollar terms).

Meanwhile, as stocks went nowhere if you owned them from their peaks in 2000, if you picked up Internet stocks after most dropped 90%+, you probably did well, even if you held them through the 2008 financial crisis. All you had to do is recognize that the Internet was a real innovation and that some businesses on the web had promise despite the over hyped and over-valued beginning of the sector. In technology, very hyped sectors in their infancy can be dangerous on the long and short side – they trade on this hype to dangerously overvalued levels usually, then crash down to earth as the hype proves too early or unfounded.

However, this is the time when it's usually a good idea to look through the rubble and see what is still standing. This worked during the TMT bust with towers, data centers, and Internet companies. GMT Capital in late 2015 and early 2016 also made a bet on mining companies that paid off well as these companies traded to the brink of oblivion. As a general rule, if most of the companies in a sector are down 70%+ and most are trading at single digits, you should buy the sector or some companies in the sector. This is a sign that there is full capitulation towards the business, and I have yet to see a whole sector of the economy go bankrupt (of course sub-sectors like airlines can get permanently impaired from time to time).

Diversification occurs as you layer these kinds of bets on over time. How diversified you are depends on how much uncertainty you have about a situation, how much risk you are willing to take, and how many good potential bets you can identify. The more bets you can find that have good risk/reward that are relatively uncorrelated the better. As is the case in most areas of investing, diversification is a balancing act; you want to have an appropriate level of diversification but also make big bets in high conviction areas. We plan on flexing up industry or geography bets to as much as 20% of the portfolio at times; we've found that focusing on business momentum is a better determinant of making these bets than focusing solely on valuation (although it's the business momentum relative to valuation that really matters).

Conclusion

It is important in investing to not get too comfortable with a business or set-up simply because it has been a profitable area of investment for you in the past. Circumstances are always changing and becoming overly complacent or reliant on a lack of change can result in disaster. For instance, most consumer staples businesses were historically reliable growers but that seems to be changing in many cases today. The watch business was historically a very good business but new entrants like the iWatch and people using smartphones to tell time could mean the past is not a reliable proxy for the future in this business. Technology changes can also cause yesterday's bad business or asset to become a much better business in the future.

One of the great areas we have found promising, both intellectually and as a way to make money, is looking for interesting businesses around the world that are off the radar and set up really favorably due to unique management teams or operating assets. I would go as far as saying International small cap equities are one of the best areas of inefficiency currently left in the market. Also, by exploring various cycles around the world, you can usually find different supply driven cycles that set up an industry for higher returns on a multi-year basis. Cycles can be exploited long and short, with more of a focus on timing on the short side. At Blue Grotto, we plan on looking around the world for different interesting businesses with very favorable risk/reward profiles, which can provide great portfolio level benefits in addition to being good sources of higher returns on an individual basis.

Sincerely,

Ben Gordon, CFA

Founder and Portfolio Manager

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