



**THE
MANUAL
OF
IDEAS**

TM

Value-oriented Equity Investment Ideas for Sophisticated Investors

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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Investing In The Tradition of Graham, Buffett, Klarman

Year VIII, Volume VIII
August 2015

When asked how he became so successful, Buffett answered:
"We read hundreds and hundreds of annual reports every year."

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About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.



REPLAY at ValueConferences.com

THE DEEP VALUE ISSUE

- ▶ Screening for Deep Value Bargains
- ▶ 20 Companies Profiled by The Manual of Ideas Research Team
- ▶ Proprietary Selection of Top Three Candidates for Investment
 - ▶ Exclusive Interview with YCG Investments
- ▶ In Depth: Gianluca Ferrari on Exor, Toby Carlisle on Movado
 - ▶ 10 Essential Screens for Value Investors

Deep value candidates analyzed in this issue include Avon (AVP), Barrick Gold (ABX), Benchmark Electronics (BHE), Callaway Golf (ELY), Cliffs Natural Resources (CLF), Cloud Peak (CLD), Encana (ECA), Kelly Services (KELYA), Kuhlmann Sofa (KLIC), Lands' End (LE), LeapFrog (LF), M... (MUSA), Oppenheimer (OPY), POSCO (PKX), ScanSource (SCSC), Tech P...

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Exclusive Interview:
Brian Yacktman and Elliott Savage,
YCG Investments

*With compliments of
The Manual of Ideas*

New Exclusive in the MOI

(log in at www.manualofideas.com
or email support@manualofideas.com)

- ▶ Arik Ahitov on...
- ▶ Three Presentations...
- ▶ Meetup Group, Cur...

Exclusive Interview with YCG Investments

We are pleased to bring you our recent interview with Brian Yacktman and Elliott Savage of Austin, Texas-based YCG Investments.

The Manual of Ideas: Please tell us about the genesis of your firm and the principles that have guided you since then.

“We turn on its head the common, mechanical practice of estimating distant future cash flows, valuing those cash flows at an arbitrary discount rate, and then purchasing those cash flows at some predetermined discount to intrinsic value.”

—BRIAN YACKTMAN

Brian Yacktman, Chief Investment Officer, Portfolio Manager and Principal:

For as long as I can remember, I’ve grown up hearing my father talk about investments, so I think it was natural for me to develop this passion over time. As he mentored me and as I saw the results his strategy produced, I became convinced his methodology had merit and really came to believe in his philosophy. After working with him for several years, and realizing his separate account minimum was so high (it’s over \$50 million), I wanted to offer management to those who desired separate accounts but couldn’t meet the minimum. I also wanted to add upon what my father taught me by offering the “option enhancement” strategy. When I suggested lowering the minimum to my father, he basically said, “Great idea, just don’t do it here!” because their business model was focused on managing very few, large accounts. So, with his blessing, in 2007, I left his firm and created Yacktman Capital Group, the name of which we later changed to the initials YCG to avoid confusion between the two firms. Then, in 2012, with my father’s firm growing assets at \$1 billion a month, it became apparent to us that they would likely need to close their funds. So, once again, I desired to offer an alternative to those who would be closed off, and, thus, the YCG Enhanced Fund (YCGEX) was born. To this day, we desire to offer the YCG strategy of protecting and growing capital in an objective manner to as many people as are interested to help them achieve their financial goals.

MOI: What are your key stock selection criteria, and what types of businesses have you favored historically?

Brian Yacktman: We utilize a time tested philosophy of purchasing above average businesses at below average prices. We view the world more in terms of probability distributions and so our goal is to construct a portfolio that will be robust in various economic scenarios. We are market cap agnostic and use a “bottom-up” approach. With a 10 year+ time horizon in mind, we seek to purchase stocks which possess one or more of the following “three P’s:” Price, Product, and People.

Price: We turn on its head the common, mechanical practice of estimating distant future cash flows, valuing those cash flows at an arbitrary discount rate, and then purchasing those cash flows at some predetermined discount to intrinsic value. Instead, when analyzing individual stocks, we first ask ourselves, “What is the expected rate of return if we make a purchase at this price level?” We calculate this forward expected return by digging through the 10-K’s to analyze the true excess cash flow, seeking to answer four basic questions: How much normalized cash flow (cash flow adjusted for cyclicity in sales and margins) will the investment produce, after adjusting for often-overlooked items such as option issuance, pensions, and capital expenditures that will reabsorb the cash generated (including acquisitions which we often view as CAPX in disguise)? When will that estimated cash flow arrive? How predictable or risky is that estimated cash flow? What is the price to receive that estimated cash flow? Based on these estimates, we compute a normalized shareholder yield (excess cash that is truly free for the shareholders) and add to that yield our estimate of the business’s terminal growth rate. Then, we assess how vulnerable our computed expected return is to a set of economic

scenarios to determine the width of the probability distribution around that expected return, and then compare the yield spread between stocks of varying quality levels. The quality level of the business helps us determine this vulnerability, which leads us to our next two points.

Product: “Product” refers to certain innate characteristics that make up a high quality company. We tend to favor high quality companies because we believe that, counter-intuitively, high quality businesses tend to outperform low quality businesses over the long term with less volatility. Additionally, we believe these types of businesses tend to significantly outperform their lower quality peers during catastrophic periods. Generally, these companies possess one or more of the following attributes: high cash returns on tangible assets, low cyclicality, high returns on incremental invested capital, wide and stable profit margins, high market share, pricing power, conservative use of leverage, and a growing competitive advantage.

People: Since we are long-term investors, we realize the people running the business will make a critical difference. While we do believe employee integrity, company environment, compensation amounts and methods, and management experience are important, we believe the largest impact we can have as analysts is to evaluate a management team’s cash allocation skills by assessing the impact their incremental investment decisions have on growing cash flow.

We find our approach allows us to compare investment opportunities across industries and even across asset classes and thus objectively prioritize and focus in on our best ideas.

“Impatience and avarice bias investors away from high-quality, steady stocks that slowly compound wealth over time and towards riskier stocks with a wider distribution of probabilistic outcomes, and overconfidence causes them to believe they can pick the risky stocks with the higher likelihood of positive outcomes.”

—ELLIOTT SAVAGE

Elliott Savage, Portfolio Manager and Principal: Investing, in our view, requires two skills: 1) understanding and valuing businesses and 2) understanding why and when businesses get mispriced. Brian discussed our method for accomplishing the first objective. We also believe we’ve generated some novel insights for accomplishing the second objective. The reason investing in the stock market, bond market, and a variety of other markets is not perfectly efficient is because humans, on average, possess certain behavioral biases that are non-random and non-independent. It seems to us that, most of the time, the dominant behavioral traits determining market prices are impatience, avarice, and overconfidence. Impatience and avarice bias investors away from high-quality, steady stocks that slowly compound wealth over time and towards riskier stocks with a wider distribution of probabilistic outcomes, and overconfidence causes them to believe they can pick the risky stocks with the higher likelihood of positive outcomes. Taken together, these traits have led to the systematic underpricing of high quality stocks and the systematic overpricing of low quality stocks, borne out by the extensive academic literature showing the historical outperformance of high quality stocks in virtually all observable markets.¹ Thus, most of the time, you’ll find that our portfolio is primarily invested in high quality, steadily-growing, relatively acyclical businesses.

Occasionally, however, rapid or prolonged market or sector collapses cause loss aversion to supersede the normally dominant biases of impatience, avarice, and overconfidence. During these times, such as the broad market collapses of 1929, 1973-74, and 2008-09 and the relatively industry specific tech and telecom bust of 2000, investors actually overestimate risk, particularly in the case of still high quality but more cyclical stocks. This overestimation of risk, when combined with forced selling from the overleveraging that generally occurs when prices are going

¹ See http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2055431 for one of the best papers describing this phenomenon.

up, can yield some amazing investment opportunities. While these opportunities are too rare and possess too much tail risk to be central to what we do, even a few well placed bets can have a meaningful impact on results. Thus, we are always on the lookout for those areas of the market in which investors have experienced a rapid and painful loss. During the Great Financial Crisis of 2008-09, for example, we were able to buy a number of wonderful business franchises, including American Express, Americredit, Time Warner, and Carmax, at extremely low normalized cash flow multiples. As the economic environment improved, these stocks vastly outperformed both the stock market and the stocks we sold to buy them, significantly enhancing our portfolio's long-term returns.

MOI: How do you generate ideas?

Elliott Savage: Our idea generation process is both systematic and idiosyncratic. Most importantly, we maintain a list of 500 or so of the best companies in the world, and we do ongoing research on the three P's listed above. Other very fertile sources of ideas to investigate further are the 13Fs of investors we respect, such as Lou Simpson, Glenn Greenberg, ValueAct, and Tom Russo. Finally, we get ideas from reading everything under the sun.

MOI: What sources of competitive advantage have you found to be most durable?

Elliott Savage: We could talk about the relative merits of network effects versus brands versus switching costs, and so on, but we believe a discussion of this sort doesn't provide a completely satisfying answer. At their core, we believe the best businesses in the world, those with meaningful pricing power and durably superior economics, have three characteristics:

- 1) They provide an essential, non-fashion oriented, short repurchase cycle consumable or service. The non-fashion element makes the business more enduring, and the essential nature and short repurchase cycle makes its return on capital robust to a variety of economic conditions.
- 2) The cost of the good the business sells is a small percentage of a person's or business's total purchases but with much higher value-add. This element is hugely important because the time and energy cost to the purchaser of negotiating the best deal or searching for substitute brands or products will likely be significantly higher than the cost of almost blindly accepting price increases. When this condition is present, it enables businesses to protect against input cost variability and also to expand their margins over time through consistent price increases.
- 3) The good's or service's pricing is resistant to the deflationary impact of innovation because, in addition to whatever absolute advantage it provides to the customer, it also confers a relative advantage. The best way to illustrate this principle is by comparing goods whose primary value is absolute, such as virtually all of the hardware in our computers, with goods whose primary value is relative, such as goods that enhance social status. Because almost all of the value we derive from the hardware in our computers is performance-related, innovation relentlessly decreases the amount of our disposable income we have to spend on this hardware, even as its performance vastly improves. Goods that enhance social status are different. Social status is a fundamentally relative good, and so the more time and money each person spends to enhance his or her social status, the more everyone else needs to spend to keep up. In a world of innovation, in which the percentage of disposable income required for necessities is going down, we all will have more and more money available to spend on social status. Because of the high value ascribed to this good, many will spend more, leading others to spend more. So, goods that

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promote social status will likely not only be able to keep up with inflation but actually exceed it over time. However, not all goods that confer social status have durable pricing power. Some are fashion-oriented, such as popular cars like Tesla and many luxury clothing brands. Others confer social status based on their scarcity, and their value erodes as technology makes them more abundant, such as food or electricity. Many are enduring, such as goods that enhance universal cues of youth, health, and beauty like smooth skin, firm muscle tone, clear eyes, lustrous hair, white teeth, and high energy levels.

MOI: When it comes to equity analysis, how do you assess the quality and incentives of management? Which CEOs do you admire most?

Brian Yacktman: We like, of course, when we see management with high ownership in their company, but to us, track record is most important. We evaluate this by examining past allocation decisions and the impact these incremental investment decisions had on growing the cash flow.

Stockholders may receive a portion of the business's free cash flow in the form of dividends, but in many cases this free cash flow may be reinvested by management. Thus, we look for management teams that allocate cash objectively, much as we would choose to allocate our clients' capital. As we see it, every management team has essentially five options, which we call GARDD (or guard): Grow the existing business profitably, Acquire synergistic businesses without overpaying, Repurchase own stock at value prices, Dividend issuance when no other favorable investments exist or when in low tax environments, Debt pay down or build up cash. Therefore, we analyze managements' ability to "GARDD" our businesses' cash flows. Too often, we see management teams that make annual reports and conference calls solely an exercise in optimism, and therefore these mediums of communication only reflect the skill of the company's public relations department in creating false impressions. Instead, we focus on the cash flow statement and the results that management has produced.

In terms of particular CEOs, we admire the results that have been produced by John Malone, Warren Buffett, 3G, Michael Pearson, Tom Murphy, and Henry Singleton, among others. There are obviously no real surprises there. Like most other investors, we like CEOs who act rationally on behalf of shareholders to maintain or increase their company's competitive advantages while, at the same time, operating the business efficiently, minimizing taxes, buying back their stock when it's cheap, and making acquisitions when they are reasonably priced and have a high likelihood of successful integration into the company's existing systems and culture.

MOI: Would you outline the summary thesis behind one or two of your best ideas at this time?

Brian Yacktman: I would prefer to share a more exciting stock, but usually those are found among lower quality, wider probability distribution stocks, and we aren't finding much in that area these days. Plus, given our focus on downside protection, we generally favor high quality stocks with good expected returns and narrow probability distributions. So, while we wouldn't consider **Colgate** as one of our best ideas in terms of being the highest expected return profile in our portfolio, we do view Colgate as a best idea in terms of fitting our mold as a superior business.

Let's look at Colgate in terms of the three characteristics Elliott highlighted above. Colgate's main product is toothpaste, an essential, non-fashion oriented, short repurchase cycle consumable. Additionally, the cost of toothpaste is a small

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percentage of a person's total yearly purchases (probably less than twenty dollars a year) but with much higher value-add (prevents potentially thousands of dollars of dental work and all of the time and pain associated with fixing tooth decay). Lastly, toothpaste is resistant to the deflationary impact of innovation because, in addition to the absolute benefits already discussed, spending more money than others on teeth whitening and other appearance-enhancing oral products confers a universally-recognized relative attractiveness advantage on the spender. It's no coincidence that Brazil and the U.S. (number one and number two in per capita toothpaste consumption) are also among the highest per capita spenders on plastic surgery. So, to sum up, Colgate sells a product with such favorable characteristics that it's likely to be able to grow revenue, margins, and profits for a long time to come, even in a mature market like the U.S.

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What makes Colgate really exciting, however, is its huge international growth opportunity. There are approximately 1 billion people in the developed world and 6 billion in the developing world and, of those 7 billion people, there are currently over 5 billion people suffering from tooth decay. As wealth spreads to the rest of the developing world, these people will desire to improve the health of their mouths. Furthermore, demographics suggest by 2100 there will be about 11 billion people (with most of that population growth estimated to come out of Africa), which means there are an additional 4 billion people yet to be born who are potential customers. Colgate is incredibly well positioned to capitalize on all of this growth. Currently, revenues and profits are 80% international and over 50% emerging markets, and Colgate is the clear toothpaste market leader with a commanding 45% market share worldwide, three times the share of its next biggest competitor. However, even these numbers understate Colgate's true international dominance. In the U.S., Colgate's market share is roughly equal to Crest's at a little over 35%, meaning Colgate's market share internationally is much higher (over 55% in many markets).

Bottom line, Colgate is one of the best businesses in the world with clear dominance in a market large enough to enable the company to grow to many multiples of its current size, yet, when we run the numbers, it's priced to deliver a very high expected return relative to its predictability (i.e. a narrow bell curve stock that does well in recessions and expansions due to its low risk of competitive disruption stemming from market share dominance, massive scale, and brand loyalty) and relative to the returns expected in the overall stock market. Specifically, Colgate's currently on offer for a 3.8% shareholder yield with 5-6% revenue growth potential for a long, long time. Also, over the last 25 years, operating margins have expanded from 10% to over 20%, and we think they can continue to expand, which means returns on incremental invested capital are likely to be better moving forward than historical ROIC's. In the end, this takes you to about a 10-11% forward rate of return vs. what we estimate is mid to maybe even low single digit expected returns for the whole market. So you get a big return premium despite investing in a much safer stock.

Elliott Savage: Another stock we really like is **Charles Schwab**, one of the largest brokerage, banking, and asset management firms in the United States, with over \$2.5 trillion in client assets. In an industry full of firms focused on extracting as many fees as possible from clients, both through high transaction fees and through advisors' pushing of expensive internally managed products, Schwab stands out from the crowd as a result of its laser-like focus on low-cost, technologically superior, and transparent financial product offerings. This approach has turned

Schwab into an asset gathering machine, enabling it to grow assets since the end of 2006 at 9% per year, made up of 6.7% in new client asset growth and 2.3% in asset appreciation. We believe Schwab's advantages remain firmly entrenched even today, with many traditional brokers (representing tens of trillions of dollars of client assets) still charging hundreds to even thousands of dollars per trade, offering maddeningly buggy and inferior trading and administration platforms (we've tested them), and continuing to be financially incentivized to put clients into their own firms' most expensive and complex offerings. Thus, we believe it's likely Schwab will continue to grow new client assets at comparable rates to the past. If the next five to ten years don't include a global financial crisis and the asset appreciation component grows faster than the 2.3% cited above, then Schwab may even be able to grow assets at 10% or more per year. Since its business model is much more technological in nature with far less leakage to high-priced stockbrokers, Schwab's cost structure is more fixed than most brokerage firms, resulting in total costs as a percentage of assets having fallen from 22 basis points in 2006 to 15 basis points in 2014. This fixed cost structure should enable Schwab to grow earnings at an even faster pace than the 8 to 10% revenue growth rate we expect. Even at today's valuation of 31x our next-twelve-months earnings estimate, in which we strip out Wall Street's assumption of interest rate increases, we believe we'll do well over time given Schwab's compelling business model and potentially rapid future earnings growth.

"...much of Charles Schwab's earnings power remains latent due to artificially low interest rates. Schwab makes most of its money from asset management and administration fees and net interest revenue, both of which are currently under-earning."

—ELLIOTT SAVAGE

However, we believe the investment case for Schwab is far better than the one presented thus far because much of Schwab's earnings power remains latent due to artificially low interest rates. Schwab makes most of its money from asset management and administration fees and net interest revenue, both of which are currently under-earning. First, in the asset management and administration fee category, a substantial portion of this revenue is generated from fees Schwab charges on its proprietary money market funds. Currently, because interest rates are so low, Schwab is rebating a large percentage of these fees back to clients. Second, in the net interest revenue category, Schwab generates income by using the deposits of its banking clients and the residual cash of its brokerage clients to make margin, mortgage, and other types of loans to its clients. In addition, it invests some of this money into corporate, government, and asset-backed debt securities. It then makes a spread on the difference between the rate of return it receives on investments and loans and the rate of interest it must pay out to its depositors and brokerage clients. In short-term risk-free interest rate environments above zero, because many depositors and brokerage clients 1) have nominal amounts of money in their banking and brokerage accounts, 2) value the liquidity of these accounts, 3) don't want to go through the hassle of switching banks, and/or 4) value the safety and security of Schwab or other reputable big institutions, they are willing to accept rates below the short-term risk-free interest rate. Since Schwab can then invest this money at the risk-free rate plus a small risk premium, Schwab can earn a big net interest margin. However, now that the short-term risk-free rate has dropped to basically zero, Schwab has to invest at much lower rates but it can't lower the interest rate it pays its depositors by the same amount since to pay depositors less than the risk free rate would mean paying them less than zero percent. And that only works if you're a government in Northern Europe! So, if interest rates rise, Schwab will be able to earn a much wider net interest margin. Overall, combining both the money market fee waiver and net interest margin effects, we believe Schwab's 2015 "earnings power" in a higher rate environment is approximately three times the current \$1.04 Wall Street consensus earnings estimate. Given this

interest rate impact and Schwab's underlying asset management growth, we think an investment in Schwab could easily earn high teens returns over the next five years in a rising interest rate environment, even in the face of material earnings multiple contraction.

Since we're value investors, we can't talk about the upside without also talking about the downside. The major downside risk would be a big stock market rout. In a repeat of 2008-2009, we estimate Schwab's earnings could fall from the projected amount of \$1.04 to \$0.95, which is a far cry from the impact at that time (earnings went from \$1.06 in 2008 to \$0.38 in 2010 even though client assets rose by 9% and client deposits plus brokerage receivables rose by 139% from the end of 2007 to the end of 2010). The increased robustness on the downside reflects the fact that the largest negative pressure on earnings from 2008 to 2010 was the relentless decrease in interest rates and its enormous impact on net interest revenue and money market fees. Since short-term and long term rates have both been low for so long, we believe an incremental impact from a stock market crash on these two categories would be fairly benign. A Japanese-style deflation could cause significantly more earnings pressure, but we believe the probability of such an occurrence is low given the size, diversity, and innovativeness of the U.S. economy as well as the much more favorable demographics of the U.S. population. We also believe Schwab's earnings multiple may be more robust to the next market downturn because, in the last crash, there was a concern that the money market business would be destroyed by new regulations. Since that time, the Fed has come out with new regulations that leave the money market business intact.

The last potential way to achieve an attractive rate of return on Schwab is through a takeout. Goldman and many other investment banks have been experiencing significant pressure in their trading businesses, and we believe they're also being outcompeted in their wealth management businesses by Schwab. Thus, we give some credence to the intermittent speculation that Goldman or another investment bank may make a buyout offer, and we think founder Charles Schwab's age increases the probability he would accept an offer if it were high enough.

MOI: What role in portfolio construction does your "option enhancement" component play, and how do you typically implement this component of your strategy?

Brian Yacktman: Because the systematic impatience, avarice, and overconfidence of investors is not limited to stock investors, it makes sense to devise more general definitions of securities that investors tend to over and underprice. We think investors generally a) overprice securities that have ostensibly attractive asymmetric payoffs (low quality stocks fit this description with reasonably probable 100% downside but also non-negligibly probable near-term upside of significantly more than 100%) and b) underprice securities that have ostensibly unattractive asymmetric payoffs (high quality stocks fit this description with a low probability of near-term 50-60% downside but possibly even a lower probability of near-term 50-60% upside). As we look around the investment universe, call buying, in which the downside of 100% is reasonably probable but the potential payoff is theoretically infinite, seems to have an attractive asymmetric payoff, and put selling, in which the downside is theoretically but improbably 100% but the upside is limited to the put premium, seems to have an unattractive payoff. Thus, we should expect a strategy of call buying to lag the underlying asset's performance

"...we should expect a strategy of call buying to lag the underlying asset's performance and a strategy of put selling to beat the underlying asset's performance. Empirical data supports this assertion."

—BRIAN YACKTMAN

and a strategy of put selling to beat the underlying asset's performance. Empirical data supports this assertion.²

Thus, once we have selected our favorite risk-adjusted expected returns in stocks, we may utilize options as a strategic way to enter and exit positions by writing puts against positions we want to own, and calls against positions we want to sell. We view this almost as being compensated to put in limit orders. But we don't just write options "willy-nilly," however, and instead take a much more objective approach. For example, suppose we're looking to make a purchase in a stock. We look at the premium we would pull in from the sale of a put a few months out and divide it by the notional value of that option. Then, we annualize that number, adjust for dividends, and tax effect it in order to determine an after-tax expected rate of return on the option. Then we compare the two rates. If the spread between our expected return of the stock and the expected return of the option are wide enough, we'll write options against the cash we would've used to purchase the stock. Essentially, this cash is now indirectly being invested through a cash secured put. This process allows us to be much more objective, both in determining which stocks we are interested in, as well as when it is appropriate to be writers of options.

What we find is, most often, people are willing to pay us a premium to write these options relative to owning the stock outright. In other words, the expected returns of writing options tends to be much higher than the expected return of owning the stock outright! Again, we believe this is due to the casino mentality of most investors looking to make a quick buck. Thus, we almost view ourselves as the house, writing these options in stocks we have already fundamentally determined we want to buy or sell, and then allow others to gamble in the options.

"Another advantage of this ["option enhancement"] strategy is allowing us to convert short-term capital gains into long-term capital gains."

—BRIAN YACKTMAN

Another advantage of this strategy is allowing us to convert short-term capital gains into long-term capital gains. Since we're long-term oriented (as you can see from our low turnover), whenever options are assigned to us, chances are good that the premium from the option will be converted from short-term to long-term capital gains, since both put and call premiums are treated as having an equivalent holding period to the underlying stock. This tax rule really comes in handy when we want to sell a stock that has almost, but not quite, become a long term holding for tax purposes. For example, we wanted to sell some appreciated BCR, but it was still a couple months from going long-term in our portfolio. So, instead of selling the stock immediately and getting taxed at short term rates, we sold a covered call a couple months out. The stock was called away, but, by that time, the holding period of BCR was long-term. Thus, the premium from the option was added to the sales price of the stock, and now what would've been short term capital gains on both the stock and the option are now all treated as long-term. Not to mention it deferred taxes into the following year!

Overall, we believe "option enhancement" is a way to both mitigate a value investor's bias of buying and selling early and generate high after-tax returns with less risk.

MOI: You have stated that "prudence, except in rare market environments, does not mean holding cash." Please elaborate on your views on cash and how you address portfolio-related risks.

Elliott Savage: Our views on cash are informed by two assumptions. 1) Over the long-term, stocks will generate higher returns than cash sitting under a mattress or invested in low risk short-term instruments. There's obviously a huge amount of

² See charts at [http://www.ycginvestments.com/media/19-2012-12-31-Client-Letter-\(Website\).pdf](http://www.ycginvestments.com/media/19-2012-12-31-Client-Letter-(Website).pdf)

historical data showing this outperformance,³ and we think this pattern is almost certainly likely to continue in the future. 2) In the short and medium term, we can't reliably predict the direction or magnitude of the movements of the economy, the stock market, or, even, a single security. Just like our first assumption, there is a large body of real world evidence supporting this claim.⁴ Thus, if we accept that stocks will outperform cash and that we can't reliably predict short term stock price fluctuations, it follows that we should always be fully invested in stocks. The only time we shouldn't is if we get new evidence that should cause us to question one or both of these assumptions.

“...if we accept that stocks will outperform cash and that we can't reliably predict short term stock price fluctuations, it follows that we should always be fully invested in stocks.”

—ELLIOTT SAVAGE

The first assumption could become invalid if we were to encounter an extreme environment in which stocks we can understand become so much more expensive relative to cash sitting in Treasury bills that we believe it's likely we can get similar or better risk-adjusted returns sitting in cash. Although, since we recognize that our investment opportunity set also includes the future, it's possible that even if cash rates were lower than expected returns in stocks, we may consider holding some cash if the forward rate of return on stocks became so low on an absolute basis that the opportunity cost of experiencing a permanent loss of capital in cash from inflation was also low. In this case, we would view cash as purchasing an inexpensive option on the future as we patiently wait for better opportunities to arise. Thus, in these rare cases, we would diversify into cash. The second assumption could become invalid if we discovered new evidence that short-term price movements can be predicted, and we determined that we had the skillset and competitive advantages necessary to exploit this opportunity (a very unlikely chain of events, in our view).

So, instead of holding cash, which we believe is very likely to reduce long-term returns, we choose to manage risk by owning a portfolio that is predominantly comprised of market dominant consumer staple, toll-taker, and/or utility-like businesses. In most cases, these businesses are also global and conservatively leveraged. As a result, we believe they will perform well in most economic environments and do particularly well relative to the market during periods of deflationary, downward shocks or political turmoil. Yet, unlike cash, we also believe we are getting this risk reduction while not sacrificing long-term returns. We also spend a lot of time studying both history and the present, which enables us to make a list of the biggest potential risks to cash flows and to then stress test our portfolio against these risks. In today's market, we believe the biggest risks are profit margins well above historical norms, overleveraged developed economies, unsustainably low volatility, slowing growth and potential construction bubbles in some key emerging markets like China, a likely end to the commodity supercycle, and artificially low interest rates. Having this list gives us an additional framework for prioritizing work on new investments, and it helped to make the benefits of Schwab, a relatively new idea that we mentioned earlier, even more obvious. Since many of our businesses have such consistent cash flows, they, along with almost every other asset class, will experience some pressure on their earnings multiples in rising interest rate environments as the discount rate people use to value them goes up. Schwab, on the other hand, has explosive earnings upside potential in a period of rising interest rates and, along with our large holdings in Aon and Wells Fargo, serves as a great interest rate hedge for the rest of the portfolio.

³ See our favorite chart at <https://www.fairr.de/docs/dimson-marsh-staunton-2011.pdf> (it's figure 2).

⁴ Again, our favorite chart can be found at <http://www.ycginvestments.com/media/28-2015-03-31-Client-Letter---Website.pdf>

“...we generally end up owning about 20 to 30 stocks, but they probably only participate in 15 or so fundamentally different types of businesses, and our percentage weightings are generally skewed towards the most advantaged business categories, such as consumer staples, payment processors, and brokers.”

—ELLIOTT SAVAGE

MOI: How do you strike the right balance between being concentrated in your best ideas while remaining sufficiently diversified to keep downside risks under control?

Elliott Savage: Well, we want to be diversified enough that our investment results are reflective of our skill, not a lucky or unlucky outcome in one or two stocks. But we also obviously don't want to over-diversify and charge fees for performance that's almost guaranteed to mirror the index. Studies show that a portfolio of roughly 20 randomly selected stocks eliminates most of the diversifiable risk of the stock market. Since we're not randomly selecting stocks, we need to be cognizant of the correlations of our cash flows, which means we'd ideally own 20 businesses, all of which would have very different profit drivers and places of business. This outcome is unfortunately not always achievable since great investment opportunities are rare, and they generally cluster around certain advantaged industries. Thus, most of the time we have to make a choice between concentrating our bets in these industries and diversifying among bad or more expensive businesses. We always choose the former, but we get some additional risk reduction by owning different companies in the same industry that we believe have similar return characteristics. On the whole, we generally end up owning about 20 to 30 stocks, but they probably only participate in 15 or so fundamentally different types of businesses, and our percentage weightings are generally skewed towards the most advantaged business categories, such as consumer staples, payment processors, and brokers.

MOI: Can you recommend one or two books that have given you new insights into the art of investing?

Brian Yacktman: We could list the obvious books, but we're sure your readers are already familiar with them. One that you may not associate with investing but that we think helps us to understand biases that are innate in human nature is *Thinking Fast and Slow* by Daniel Kahneman. As we mentioned earlier, studying the systematic, non-independent biases in human decision-making is essential to understanding why and when investment mispricings occur. But if you're looking for a book that covers some basic principles of the bipolar nature of the markets and the margin of safety concept, as well as what to look for in businesses and how to value them, I would recommend reading *The Warren Buffett Way* by Robert Hagstrom. The first few chapters give you a synopsis of the Warren Buffett classics *The Intelligent Investor* by Benjamin Graham and *Common Stocks and Uncommon Profits* by Philip Fisher, and then the rest of the book is made up of individual case studies.

Elliott Savage: Another book that is a little more unusual but that I found incredibly useful is *The Infinite Resource* by Ramez Naam. It's an extremely data-driven book that explains the different types of innovation and then shows how they have made material goods vastly cheaper and more plentiful over time. It also acknowledges some of the energy and other resource constraints humanity is now facing. However, given the vast chasm between the amount of energy we currently extract from the sun and the maximum amount we could theoretically extract, it argues that the biggest risk to our future is not running out of resources but rather neglecting to protect and improve the political, social, and economic systems that have been so successful at unleashing innovation. Overall, it reinforced for me the importance of owning businesses that benefit from innovation and avoiding businesses that are likely to be harmed by it.

MOI: Thank you very much for your time and insights.

The Manual of Ideas research team is gratified to have won high praise for our investment idea generation process and analytical work.

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Definitions:

CAPX – Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings, or equipment. It is often used to undertake new projects or investments by a firm.

Yield Spread – the difference between two forward rates of return when compared with each other.

Returns on Incremental Invested Capital – A measurement used to assess a company’s efficiency at allocating the capital under its control to profitable investments. This is calculated by taking the incremental earnings over a specified time period divided by the amount of earnings retained in the business over that same timeframe.

Return on Invested Capital (ROIC) – A measurement used to assess a company’s efficiency at allocating the capital under its control to profitable investments. This is calculated by taking a company’s net income divided by total capital.

13 Fs - A filing with the Securities and Exchange Commission (SEC), also known as the Information Required of Institutional Investment Managers Form. It is a quarterly filing required of institutional investment managers with over \$100 million in qualifying assets. Companies required to file SEC Form 13-F may include insurance companies, banks, pension funds, investment advisers and broker-dealers. This form, which must be filed within 45 days of the end of each quarter, contains information about the investment manager and potentially a list of their recent investment holdings.

Return on Capital – is a profitability ratio. It measures the return that an investment generates for capital contributors, i.e. bondholders and stockholders. Return on capital indicates how effective a company is at turning capital into profits.

Free Cash Flow - the cash flow from operations that is left over after spending on maintenance capital expenditures and acquisitions that are required to protect the business. In other words, it’s the cash flow from operations that is free and clear to be distributed to shareholders in the form of dividends and share repurchases, and/or to be allocated towards ways to grow the existing business through means such as “growth” acquisitions or new capital expenditures, or simply pay down debt. Typically, we calculate this by looking at a normalized view of net income plus depreciation and amortization minus the maintenance capital expenditures and acquisitions that are required to protect the business, adjusted for often overlooked items such as pensions, stock option expenses, and leases.

Basis Point – is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to $1/100^{\text{th}}$ of 1%, or 0.01% (0.0001), and is used to denote the percentage change in a financial instrument.

Earnings growth – A measure of growth in a company's net income over a specific period, often one year. The term can apply to actual data from previous periods or estimated data for future periods.

Earnings growth is not representative of the fund’s future performance.

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