Rozendal Partners Investor Letter 30 June 2024

Rozendal Global Fund ('Global Fund'): performance vs. benchmark

Period	Fund*	Benchmark**
Since inception***	8.7%	9.6%
Six months to 30 June 2024	5.5%	10.5%

*US dollar returns shown for the B unit class, which is the earliest unit class in existence that is open for investors. Return numbers for other unit classes may differ slightly. Returns shown net of fees assuming income is reinvested gross of tax.

**FTSE Global All Cap Total Return Index in US dollars.

***Compounded annual total rate of return since 22 January 2020. Annualised performance shows longer term performance rescaled to a one-year period. Annualised performance is the average return per year over the period. Actual annual figures are available on request. Fund highest rolling one-year return: 37.4%. Fund lowest rolling one-year return: -18.8%. These represent the highest and lowest returns for any one year over the period since inception.

Rozendal Worldwide Flexible Prescient Qualified Investor Hedge Fund ('Hedge Fund'): performance vs. benchmark

Period	Fund*	Benchmark**
Since inception***	10.3%	8.6%
Six months to 30 June 2024	-4.4%	5.8%

*Returns shown for the B unit class, which is the earliest unit class in existence. Return numbers for other unit classes may differ slightly. Returns shown net of fees assuming income is reinvested gross of tax.

**FTSE/JSE All Share Total Return Index

***Compounded annual total rate of return since 1 February 2018. Annualised performance shows longer term performance rescaled to a one-year period. Annualised performance is the average return per year over the period. Actual annual figures are available on request. Fund highest rolling one-year return: 50.6%. Fund lowest rolling one-year return: -14.3%. These represent the highest and lowest returns for any one year over the period since inception.

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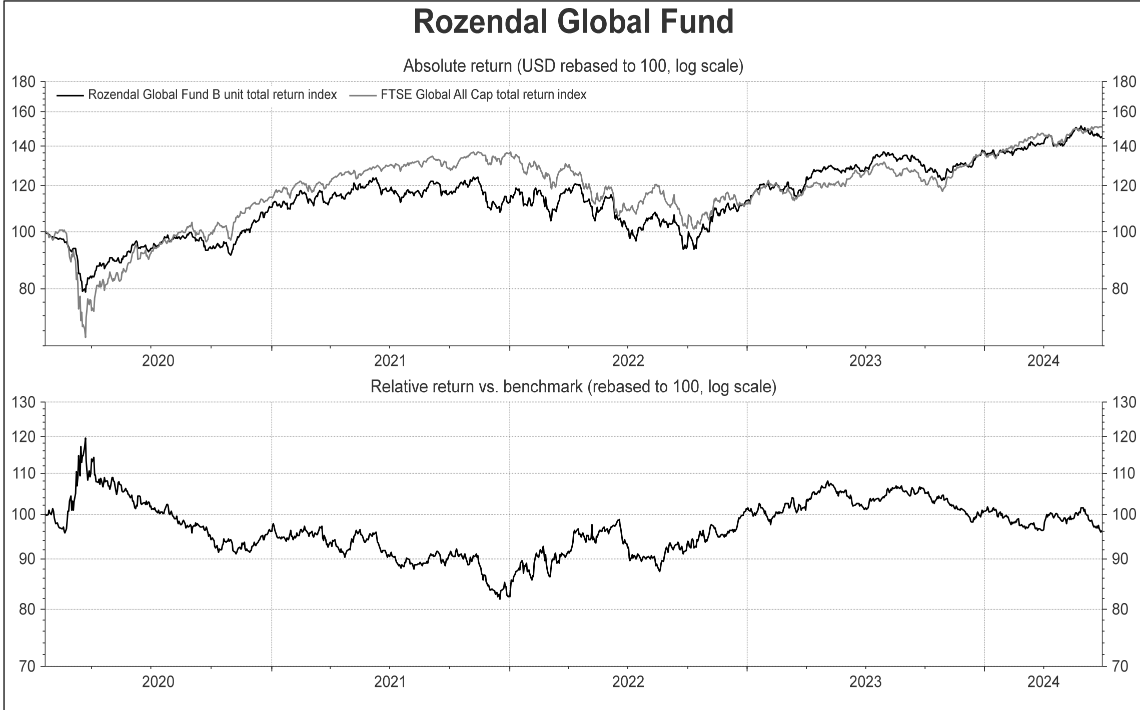
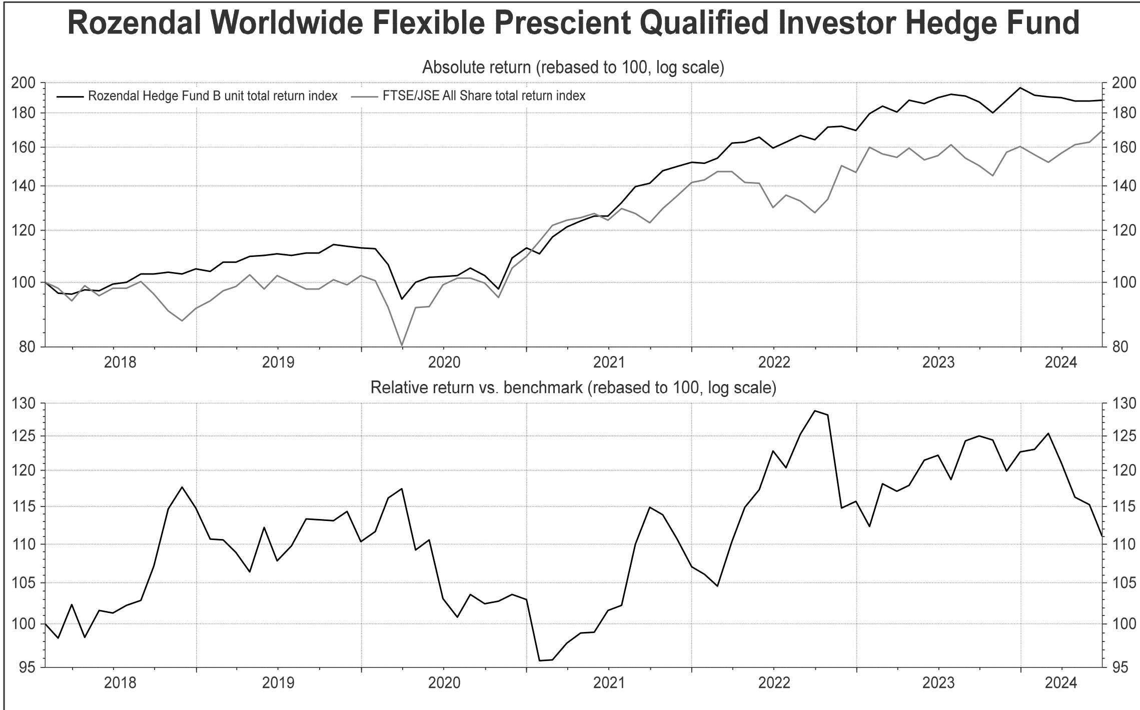


Source: Rozendal Partners, LSEG Datastream 9 July 2024



Source: Rozendal Partners, LSEG Datastream, 10 July 2024

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Dear friends and fellow investors,

A. Introduction

The first half of 2024 saw numerous interesting developments on the global political stage. Elections were (or are soon to be) held in several notable countries. Outcomes so far have often upset the status quo. Some may feel that this portends greater risk for markets. We feel that this is business as usual: markets always find something to fret about, the focus of the fretting merely shifts over time. Our job remains that of keeping an eye on the long term and doing our utmost to apply sound investment judgement in a more level-headed fashion than most. This is one status quo which we trust will never be upset!

As usual, the tables below show investment returns delivered by the world market and the various industry, factor and geographical sectors for the past six months, as well as the preceding five- and ten-year periods.

Table 1: Historical industry sector returns in USD

MSCI Industry Sector	Compounded annual total return: 10 years to December 2023	Compounded annual total return: 5 years to December 2023	Six months return to June 2024
MSCI All Country World	8.5%	12.3%	11.6%
Energy	2.9%	10.0%	9.0%
Materials	6.1%	11.1%	-1.1%
Industrials	7.8%	12.1%	7.4%
Consumer Discretionary	8.2%	11.2%	4.5%
Consumer Staples	5.9%	7.6%	2.8%
Health Care	9.2%	10.5%	7.7%
Financials	6.5%	9.7%	9.8%
Information Technology	18.0%	23.6%	24.9%
Communication Services	4.5%	9.0%	20.6%
Utilities	6.2%	6.7%	5.6%

Source: LSEG Datastream, 9 July 2024

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Table 2: Historical factor returns

MSCI All Country World Factor Index	Compounded annual total return: 10 years to December 2023	Compounded annual total return: 5 years to December 2023	Six months return to June 2024
MSCI All Country World	8.5%	12.3%	11.6%
Value	6.2%	9.0%	6.6%
Momentum	9.3%	10.8%	28.7%
Size	4.7%	6.5%	1.1%
Quality	11.6%	16.2%	18.6%
Volatility	7.5%	7.1%	5.4%
Dividend Yield	6.3%	8.8%	4.6%
Growth	10.4%	14.9%	16.4%

Source: LSEG Datastream, 9 July 2024

Table 3: Global geographical equity index returns

Regional equity index	Compounded annual total return: 10 years to December 2023	Compounded annual total return: 5 years to December 2023	Six-months return to June 2024
MSCI All Country World	8.5%	12.3%	11.6%
MSCI World	9.2%	13.4%	12.0%
MSCI Emerging Markets	3.0%	4.1%	7.7%
MSCI Frontier Markets	2.4%	3.7%	6.2%
S&P 500	12.0%	15.7%	15.3%
Stoxx Europe 600	4.9%	9.8%	6.2%
MSCI Asia Pacific Ex-Japan	4.2%	4.9%	8.6%
Tokyo Stock Price Index	5.4%	6.8%	5.3%

Source: LSEG Datastream, 9 July 2024

The past six months has – we are almost tempted to say 'as usual' – seen the US market trounce all. The large cap technology shares which recovered so strongly during 2023 has continued their march onwards and upwards.

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B. Investment Returns

1. Rozendal Global Fund ('Global Fund')

The Rozendal Global Fund delivered modest positive absolute returns, but weak relative returns for the past six months. Eschewing the US market – and almost by implication the large cap technology shares listed there – has been a headwind for the fund. We highlight some of the more notable contributors and detractors from returns for the past six months below.

Contributors

a. Meta Platforms

As sole representative of the FAANG's or MAMAA or Magnificent Seven stocks (we lose track of the acronyms!) Meta Platforms has certainly delivered the goods for the Global Fund over time. Meta was one of the hardest hit casualties of the tech sector sell-off in 2022. The business has delivered very strong results since then, and the stock price has increased more than fivefold from the bottom it reached in that year.

b. Hargreaves Lansdown

Leading UK investment funds platform Hargreaves Lansdown is one of the more recent additions to the Global Fund. It was historically a fast growing, highly profitable business with a stock price to match. A number of operational missteps, questionable capex spend and increased competition from low cost business models in the UK caused a dramatic decline in the share price from 2019 to 2023. Our view was that this decline was overdone. Recently, private equity investors came to share this view: a bid to buy out the company at a healthy premium to the prevailing share price was made. This launched Hargreaves Lansdown to the top of the list of return contributors in the Global Fund for the past six months.

c. Kaspi

In its home market of Kazakhstan, lending, payments and online retail business Kaspi is probably as dominant a consumer business as one can imagine. Kaspi combines in-country scale, profitability and growth in a way we have rarely seen in our investing careers. Kazakhstan and Russia have historically had close relationships. Since the Ukraine invasion of 2022, this has made the political situation for the country challenging, and has heightened investors' risk perception towards the country. However, Kaspi has continued to go from strength to strength, and the share price has followed suit.

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Detractors

a. Bayer

Bayer suffers the ignominy of making a second consecutive appearance as one of the key detractors from Global Fund returns. At the company's results release and capital markets day during March, management made it clear that there would be no breakup of the company happening in the short term. This disappointed the market: some investors had been calling for a separation and/or sale of parts of the business to unlock value. Combining this news with no near-term expectation of material growth in profitability has caused the company's share price to continue to languish.

b. Metro

Another repeat offender: like Bayer, Metro was also a notable detractor from returns in both 2023 and the first six months of 2024. Profitability which has failed to recover with the rest of the company's industry after the Covid pandemic, combined with a still heavy debt burden and no clarity on the future of the group's Russian business has made life uncomfortable for both management and shareholders.

c. M Dias Branco

M Dias Branco is a leading Brazilian fast moving consumer goods business. The first half of 2024 saw some challenges for the business, with small volume declines, some revenue loss from the implementation of SAP in the quarter and flooding in some areas of the company's production and distribution footprint impacting operations negatively. This held back the share price.

2. Rozendal Worldwide Flexible Prescient Qualified Investor Hedge Fund ('Hedge Fund')

The Hedge Fund's benchmark (the FTSE/JSE All Share index) delivered rather broad-based positive returns for the past six months. The three major sub-indices (Resources, Financials and Industrials) all showed positive returns. In the face of this, the Hedge Fund had a poor six months. There were one or two bright spots in the portfolio, but these were overwhelmed by the larger investments and exposures of the Fund that detracted from returns.

Contributors

a. Nampak

Like some other leading South African businesses, Nampak is a former industrial giant that was brought to its knees by an overly optimistic acquisitive growth strategy in Africa. From early 2023, the

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involvement of activist investors A² Investment Partners precipitated dramatic change in the company though. Equity capital was raised via a rights issue, a highly respected new CEO was appointed, and the company has sold (or is about to sell) some non-core assets. It has recently become clear that these actions have delivered very good results quickly. As this dawned on the market, the share price increased by more than 70% in June alone. This helped the Hedge Fund along smartly.

b. Calgro M3

Property developer Calgro is one of the more recent entrants in the Hedge Fund. It is also a fairly small position. But this has not prevented it from contributing pleasingly to Hedge Fund returns for the past six months. Property development is notoriously capital intensive, but the Calgro team is going about their business in a more capital aware way than most in the industry. Buying back 25% of their shares in issue at a very deep discount to net asset value and paying their first ever dividend recently contributed to raising the market's awareness of the value the management team of Calgro (who are also meaningfully invested in Calgro shares) is creating.

Detractors

a. MTN

Like Bayer and Metro for the Global Fund, MTN makes a second consecutive appearance as a notable detractor from returns for the Hedge Fund. Investors' disillusionment with the economic turmoil in Nigeria and the difficult operating environment in South Africa again weighed heavily on MTN's share price.

b. PPC

PPC has been a volatile investment. It has featured as both a top contributor and a top detractor from Hedge Fund returns on several occasions in the past. During 2023, it was a top contributor. Recently, it has been a leading detractor. The South African cement industry remains a challenging environment to navigate. In its recent results the company announced further asset impairments due to an expectation of continued muted sales volumes. The share price has mirrored this challenging outlook.

c. HCI

HCI has been a strong contributor to the Hedge Fund in recent years. However, the past six months was a weak period for the HCI share price. Via its investment in Impact Oil and Gas, HCI has been a major beneficiary of the oil and gas discoveries off the coast of Namibia. In January, Impact announced a so-called 'farm-out' transaction with Total Energies, whereby Total will be funding the capital costs

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required to develop the Venus oilfield, in exchange for Impact diluting its ownership interest in the field from c.20% to c.10%. We consider this to be a good transaction for HCI. But the market was hoping for a greater extent of immediate monetisation of the asset, and the HCI share price suffered as a result.

d. Naspers stub

The Hedge Fund has held a material long position in Naspers, and an offsetting and equally material short position in Tencent, almost throughout its life. In periods when Tencent underperforms Naspers (in Rands), the Fund benefits. Conversely, when Tencent outperforms Naspers, it is to the Fund's detriment. The past six months proved to be such a period. After a very weak few years, Tencent's share price had a resurgence in 2024. Naspers benefits from this (as it should, given that Tencent is by far its largest investment), but not fully. This cost the Hedge Fund.

C. Investment Cycles Completed

Two Rozendal fund holdings were exited in full during the past six months: Superdry Plc in the Global Fund, and Ibex (formerly Steinhoff) Investment Holdings preference shares in the Hedge Fund. The Ibex preference share investment was part of a c.3% investment (at inception) of the Hedge Fund in various non-equity instruments issued by the Steinhoff group. This investment was made during 2018, after the major fraud in the group had come to light. The Hedge Fund still owns other Ibex/Steinhoff instruments, and we will conduct a full post-mortem of all these instruments (including the preference shares) when we have concluded the fund's investment cycle in these remaining instruments.

A quick caveat: we attempt to distil some lessons from our experiences in the investments we cover in this section in our letters. We are acutely aware of the fact that drawing general conclusions from isolated experiences verges on self-deception. Given the nature of markets and investing, virtually identical situations ex ante can give rise to widely varying outcomes ex post. Without rigorous study and statistically significant sample sizes, it is arrogant (even foolish) to read too much into the outcome of any one investment cycle. Our takeaways from each investment cycle are certainly conveyed with that reality firmly etched into our thinking. But we do find value in the exercise nonetheless, and trust readers may find it of interest too.

1. Superdry

Julian Dunkerton and James Holder founded UK clothing retailer Cult Clothing in 1985. The business initially merely sold third-party brands. But in 2003, the in-house brand Superdry was launched. Superdry was well received, and on the back of this success the company went public as SuperGroup

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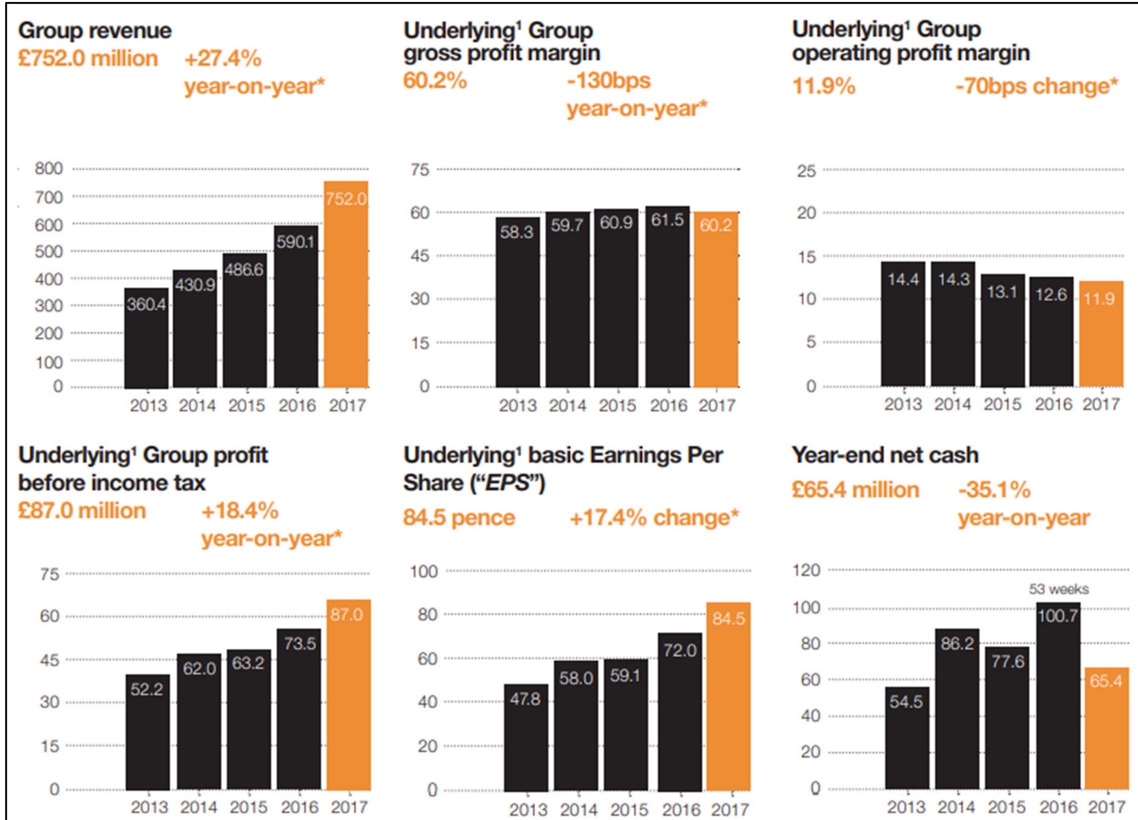
Plc in 2010 (it later changed its name to Superdry Plc). The business grew strongly in the years after listing and the share price increased fivefold to the end of 2017. During this time Dunkerton had stepped down as CEO to focus on product and brand, but he remained the largest shareholder and a board member of the company.

Chart 1: Superdry Plc financial results 2013 - 2017



Source: Superdry Plc Annual Report 2017

2017 would, however, prove to be peak Superdry. The company (whose offering always skewed towards winter wear) was wrong-footed by enduring warm weather in 2018, resulting in two profit warnings and a share price decline of almost 80%. Dunkerton resigned from the board in March of that year and sold a part of his shareholding in the business on account of differences over strategy with the board.

But as befits a founder passionate about his business (and who still owned almost 20% of it), Dunkerton managed to wrest back control of the board in 2019. He assumed the role of CEO again. Dunkerton set out to return the business to its 'design-led roots', away from the 'buyer-led' approach that had taken hold in the company (his words). However, despite suggesting that he had 'saved Christmas' for Superdry (again, his words), 2019's Christmas trading (critically important for clothing retailers) turned out to be weak. And then the Covid pandemic hit the world.

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As a predominantly store-based retailer, Covid lockdown regulations were devastating for Superdry. On top of the kitchen-sinking typical of a new management team taking the helm, in the April 2020 annual results, a sales decline of almost 20% resulted in large operating and net losses being reported. Results for the six months to October 2020 (reported in January 2021) were equally negative.

But by the last quarter of the 2021 financial year (i.e. early months of calendar year 2021), it appeared that prospects were starting to improve. The company released a full year trading statement early in May, with the following commentary:

> *"Our strengthened Ecommerce presence has helped mitigate the impact from enforced closures of our stores. We returned to revenue growth in Q4, and our commitment to a full price stance over the period has seen significant online margin improvement. Our liquidity remains strong, with closing net cash ahead of last year and our facilities remain undrawn.*
>
> *…*
>
> *The early signs following the reopening of our UK stores are encouraging, as lockdown restrictions start to lift, and we can clearly see the light at the end of the tunnel. In short, we are on track with our reset of the brand and there's a lot to look forward to."*

Source: https://corporate.superdry.com/media/yramp2tg/fy21-pre-close-trading-update-v60-clean.pdf

Whilst the share price had recovered sharply from the Covid lows by this stage, it was still 80% lower than the heights reached in 2018. A still depressed share price combined with early signs of a business turnaround appeared interesting to us. After doing further in-depth research on the opportunity, the following aspects of Superdry as a potential investment appealed to us:

a) The turnaround effort was being led by a founder-CEO. Historical evidence[1] suggested that this increased the odds of success notably.

b) The balance sheet was in good shape.

c) Julian Dunkerton had bought a further 2% of the company's shares in the preceding six months.

d) On modest assumptions of normal profitability (compared to what reported profits had been in earlier years) and valuation multiples, the share price appeared attractively priced.

[1] https://onlinelibrary.wiley.com/doi/abs/10.1111/corg.12216

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But of course, there were also risks and uncertainties:

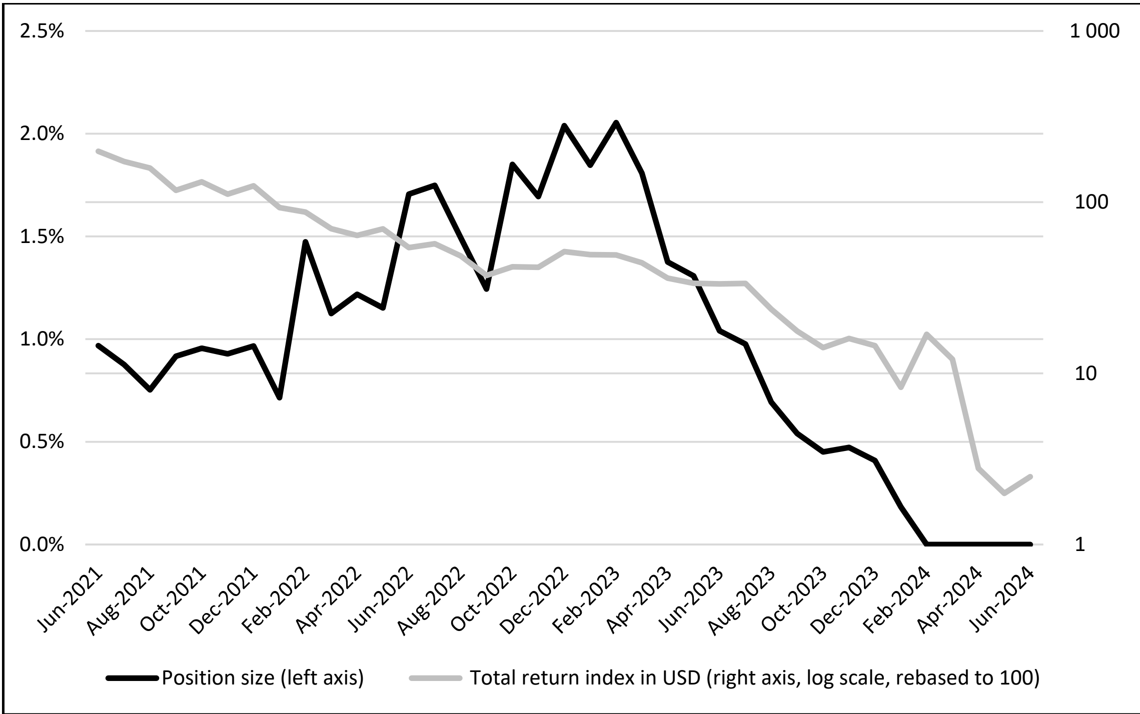
a) History is littered with fashion brands that catch the consumer zeitgeist for some time, grow spectacularly, but then fade away into permanent oblivion. Business turnarounds are a challenging proposition at the best of times - in the fashion industry probably doubly so.

b) Despite the net cash on the balance sheet at year end, the company was incurring a net interest bill for the year – indicative of a balance sheet that is perhaps a bit less robust than what first meets the eye. We took this into account in our valuation.

c) The company had been reporting financial results rather late. This was not entirely uncommon during Covid (as lockdown restrictions allegedly hampered audit procedures), but it was still a warning sign.

Our assessment of the situation was that, on balance, Superdry presented a worthwhile investment opportunity. We proceeded to invest in Superdry shares. In recognition of the substantial risk attached to the investment, the size of the investment was never substantial though – 2% of the fund at most. Limiting the position size would prove to be a prescient decision.

Chart 2: Superdry position size and total return index



Source: LSEG Datastream, Rozendal Partners, 11 July 2024

The company's results post our initial investments (in mid-2021) were mixed. Not unexpectedly, financial year ('FY') 2021 still showed a loss for the group, despite the uptick in trading in the fourth quarter. Cash generation was strong, but we considered the sales performance of channels other than online to be disappointing – these were still 30% below 2019 levels. Substantial costs had been taken out of the business, but capital expenditure was about to increase as the deferral thereof during the Covid period had to be addressed.

FY2022 showed a pleasing uptick in gross margin, and the group returned to operating profitability after two years of losses. However, substantial investment in their online channel and flagship stores had drained the balance sheet of cash. In the results release management noted that trading post year-end had been good. But the results were released exceptionally late – more than five months after the year-end. And shortly afterwards, the company's auditors resigned, citing deficiencies in internal controls as the reason for their resignation. Amidst all of this, Julian Dunkerton had kept buying Superdry shares: more than £3 million worth during 2022.

Late in 2022, the company announced the refinancing of a key asset-backed lending facility. Uncertainty around this was the cause of a going concern comment in the FY2022 audit report. The new facility was provided not by banks, but by Bantry Bay Capital – a 'specialist lender which provides supportive debt capital solutions to corporates in periods of growth and other change'[2]. This new debt came with few covenants, but a steep price.

By early 2023 the share price had again declined sharply. High inflation levels, a so-called cost of living crisis in the UK and unseasonably warm weather (again) had contributed to challenging trading for Superdry. From the levels where we first invested, the share price had halved. Media speculation surfaced that the founder may be considering taking the company private. This was formally denied – but Dunkerton kept buying millions of pounds of shares in the early months of 2023. These purchases were made partly by way of him underwriting a modest equity raise by the company in May of that year – indicative of the tough times the company were facing.

The FY2023 results were (yet again) released very late – to the extent that the share's listing was temporarily suspended on account of missing stock exchange deadlines. And the results – as late results invariably are – were terrible. It became clear that without substantial cost cuts and inventory reductions, the business would soon be in financial trouble. The woes continued in the first half of FY2024: revenue was down 24%. Management attributed this to the ongoing difficult UK retail environment and (yet again!) an unusually warm winter. But results were far weaker than that of competitors. It was evident that the turnaround of the brand envisaged by Dunkerton upon his return to the company in 2019 had not materialised.

We had been revising our fair value for Superdry downwards over time as the company failed to make operational progress since the date of our first investments. By early 2024, our fair value estimate was a fraction of our initial estimates. Up to that point, the share price had persistently been lower than

[2] https://corporate.superdry.com/investors/regulatory-news/rns-announcement/?rid=4221047

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our fair value estimate. By the time of the first half FY2024 results release, our conclusion was that fair value had been impaired so materially that even the dramatically lower share price no longer offered any margin of safety. We commenced selling out of Superdry in full.

Agonisingly though, partway through our sales process, the company announced that Julian Dunkerton had indicated to the board that he – with funding partners - was considering making an offer to acquire 100% of the company. The share price more than doubled on this news.

Despite the prospect of a buy-out offer being presented to shareholders, we forged ahead with the selling of the Global Fund's entire Superdry investment. Our assessment of fair value was now well below the share price. There was a very real prospect that Dunkerton's attempt to bring financing partners on board could fail, and no offer would be forthcoming. We concluded that using the share price spike as a selling opportunity was more prudent than waiting for a greater fool to pay us an even higher price - even if that greater fool was the founder of the business. This again proved a prescient decision.

At the end of March, the company announced that there would in fact be no bid forthcoming from Julian Dunkerton et al. The share price collapsed on this news. But a few weeks later, a further announcement was made by the company. A restructuring plan (essentially of debt, by way of a creditor compromise), heavily dilutive rights issue (underwritten by Dunkerton), and proposed delisting from the London Stock Exchange was announced. The announcement made it clear that in the absence of these proposals being approved by shareholders, the company would face insolvency. With that gun against their heads, shareholders approved the proposals at a general meeting on 14 June. Superdry is now a private company again, with Julian Dunkerton owning c.90% of the business. The story of Superdry has seemingly gone full circle.

Superdry has been a painful investment for us. It delivered a negative internal rate of return of 62.7% over our holding period, compared to the benchmarks slightly positive 3.1% internal rate of return. What lessons do we take away from the experience? Probably the following:

- The emotional appeal of an iconic brand can be a strong competitive advantage for a business. But not all brands are created equal. Some industries have a propensity for more enduring brands than others: luxury goods and fast-moving consumer goods come to mind. There have been some enduring clothing and apparel brands – Nike is perhaps an example[3]. There have also been some iconic brands which disappeared from popular consciousness for decades, only to resurface with a new lease on life – Vans and Doc Martens recently accomplished this feat. Abercrombie & Fitch is a very recent example of a major reinvention and resurgence of a brand which had seemingly withered away. But by and large, clothing and apparel brands are of the more ephemeral kind. Superdry appears to be a case in point.

[3] Though recent troubles at the company suggests that even a brand as etched into consumer minds as Nike is perhaps not as enduring as one may think.

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- Business turnarounds are difficult. When founders with well-aligned interests drive the turnaround attempt, the odds of success are better. But those odds are still not overwhelmingly favourable.

- Circumstances in a business may change to such an extent that what is a positive attribute of an investment initially may turn into a negative attribute subsequently. Julian Dunkerton's substantial shareholding in Superdry was undoubtedly a positive for minority investors for much of the history of Superdry. However, when the prospect of taking the business private arose, Dunkerton effectively pitted himself against minority shareholders. Capital markets regulations strive to protect minority shareholders from abuse in these situations. But we have little doubt that Dunkerton's overbearing influence in the business has played some part in driving events to a conclusion that suits him rather than minority shareholders.

- Value investors tend to abide by the mantra that 'if you liked it at 100, you should love it at 50'. Typically, a lower stock price is viewed as a more attractive opportunity. But this assumes that not much has changed in the underlying business. Where this assumption is not true, a stock price a fraction of what it was even in the very recent past may well represent a wholly unappealing prospect. Weighing up this equation of lower share price relative to diminished business prospects will always be a matter of judgement. And exercising this judgement will never be a simple matter.

- During our investment in Superdry, a number of red flags appeared. We mentioned them above, but to summarise:

    - Results were published late.
    - The company required financing from non-traditional financiers.
    - Auditors resigned for reasons of substance, not merely due to routine rotation.

  We were not blind to these. But equally, there were indications that the opportunity remained attractive.

    - A clearly passionate founder was leading the business.
    - This founder owned a large stake in the business and was persistently buying shares in the company.
    - When we first invested, there were indications that business prospects were improving. This suggested that Superdry was not merely another 'falling knife' in the value universe.
    - And of course, the share price was persistently cheap on metrics like enterprise value to sales.

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Again, weighing up these positive and negative attributes requires judgement. In the case of Superdry, we should have ascribed greater importance to the negative attributes. But hardly any investment will ever present an unequivocally positive or negative picture.

- Where the range of potential outcomes of an investment are widely distributed around a base case expectation, it pays to keep position sizes modest.

Active managers like us must earn our keep by applying better judgement than the market to the ever-ambiguous sets of facts presented to us. In Superdry, our judgement fell short.

D. Investment Observations

1. 'Market structures are broken, and value investing is dead'.

The headline above is taken from an interview with renowned hedge fund manager and value investor David Einhorn. Einhorn was interviewed by Barry Ritholtz in February of this year[4]. In essence, Einhorn makes the point that the astonishing growth of market capitalisation weighted passive index investing over the past decades has resulted in a situation where large stocks attract ever increasing percentages of the global savings pool that is allocated to equities. Smaller stocks attract an ever-diminishing share of the global savings pool. This happens in entirely mechanical fashion. Ever fewer market participants apply their minds to assessing the underlying fundamentals of companies. Capital allocation has become divorced from the economics of the assets to which capital is being allocated.

Einhorn's take on the implication of this is that the traditional way in which value investors generated excess returns no longer work. Traditionally, value investors buy the shares of a company trading on a depressed multiple of earnings, with the view that the prospects of the business are less dire than what the market is pricing in. When the market realises that prospects are in fact not as dim as feared, the share attracts more buyers, which drives the share price up and restores the earnings multiple to more respectable levels. The initially low valuation multiple mean-reverts to more respectable levels.

However, in the absence of sufficient capital being allocated on a fundamental basis, this process fails. There is nobody to come to the realisation that underlying business prospects has improved. The stock will be stuck in low-multiple purgatory forever, and the value investor's source of alpha – mean reversion – has evaporated. The track record of classic or quantitative value investing for the past decade and more certainly makes this assertion plausible.

[4] A transcript of the interview is published here: https://ritholtz.com/2024/02/transcript-david-einhorn/

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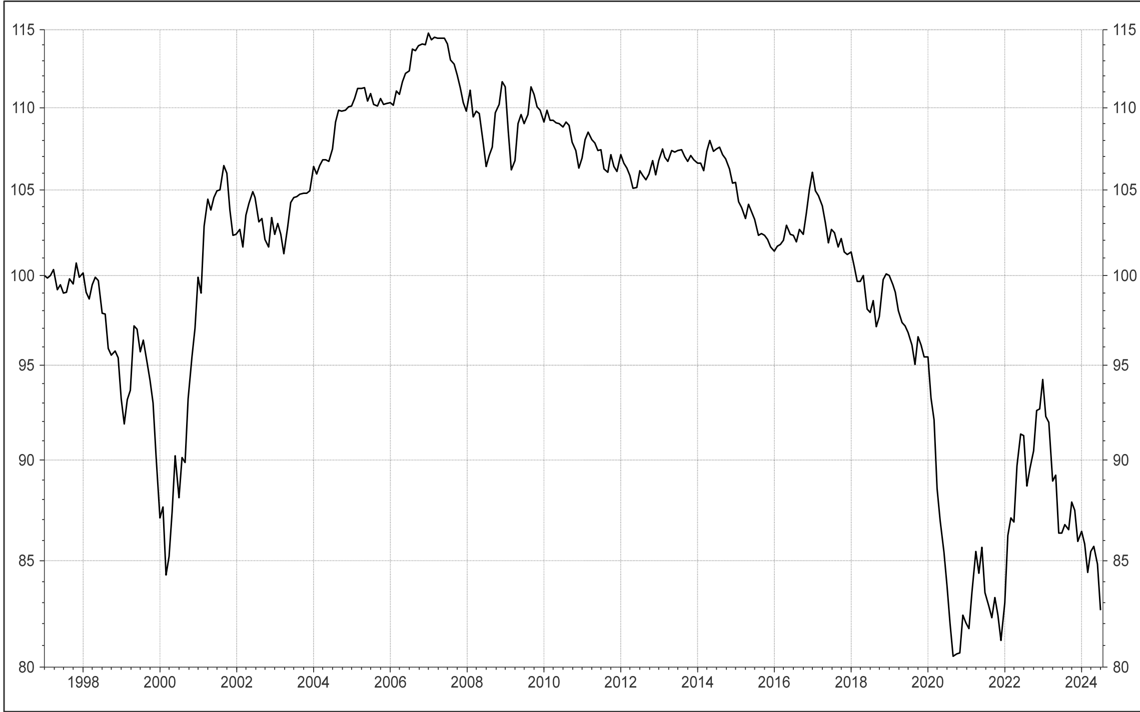
Chart 3: MSCI All Country World Value index vs. MSCI All Country World index: total return relative (USD, rebased to 100, log scale)



Source: LSEG Datastream, Rozendal Partners, 24 July 2024

Two questions arise though. Firstly, is Einhorn's assessment that passive investing has fundamentally broken capital allocation in markets true? And secondly, if it is true, does that indeed mean that value investing as it is traditionally defined is dead?

a. Has passive investing broken equity markets?

It is of course exceptionally difficult to answer this question categorically. Gut feel, anecdotal evidence and those at the receiving end of classic value investing's multi-year underperformance may suggest 'yes'. Those who have studied this topic in a more thoughtful manner come to very mixed conclusions.

U.S. investment firm GMO recently published a well-researched article on this topic[5]. Their conclusion: passive investing is likely to have had some effect on market efficiency, and may have slowed down mean reversion, but the effect is likely overblown by market

[5] https://www.gmo.com/americas/research-library/faq-passive-investing_gmoquarterlyletter/

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commentators. Firms like AQR[6] and Alpha Architect[7] have come to similar conclusions. Asserting that passive investing has broken the equity market makes for a great headline, but not such a great justification for underperformance.

b. If passive investing has broken the market, is value investing dead?

Let us ignore for a moment the inconclusive evidence about passive investing's impact on the equity market. Let us assume that it has in fact fundamentally divorced asset prices from underlying economics. Does that mean that value investing is dead?

Here it is important to clarify what is meant by value investing in this context. Classic value investing is a simple process of buying stocks trading on relatively low multiples of earnings or book value or offering a high dividend yield. The research cited above does suggest that mean reversion in multiples (or stated differently, a re-rating of share prices) appear to be happening at a slower pace in recent years than in the past. To the extent that value investors have relied on this mean reversion to generate excess returns, passive investing has potentially made alpha generation more challenging for classic value investors.

But mean reversion or re-rating of share prices is of course not the only way to profit from buying shares. To quote Einhorn from the same interview:

'… if you pay four- or five-times earnings and the balance sheet is not levered and they're able to return the cash and buy back 10, 15, 20% of the stock in four or five years, they're going to run out of stock, or the stock is going to go up. So, you're literally counting on the companies to make that happen for you.'

In the final reckoning, investing boils down to buying an asset with the expectation that the asset will produce cash flows that equate to a satisfactory return on the purchase price. If a company returns sufficient cash to an investor by way of dividends or share buybacks, an investor will do well from the investment – regardless of whether a share price re-rating occurs. We recently had exactly such an experience in the Hedge Fund: Bowler Metcalf. We covered that investment cycle in our Investor Letter of December 2023.

The absence of share price re-ratings clearly then does not preclude earning excess returns from traditional value investments. The timeframe over which the excess return is earned may extend though. In principle that should not be a problem: a diligent fundamental analyst should be valuing assets based on the cash flows the asset is expected to generate over its entire life. If that valuation is reasonable, and cash flow is generated and returned to investors

[6] https://www.aqr.com/Insights/Research/Journal-Article/Is-Systematic-Value-Investing-Dead and
[7] https://alphaarchitect.com/2022/10/effect-of-indexing/

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as expected, return expectations will be met. No mean reversion or share price re-rating is required.

Here is Cliff Asness from AQR's view on the same topic, expressed in a recent interview with the Financial Times[8]:

'I'm sure you saw David Einhorn's [comment that] the market is so inefficient you can't make money. I agree that maybe things are a little less tethered to reality today. But I do find it odd to say: "My job forever has been identifying errors, and now errors are so big I can't make money." It can change the timeframe and how much pain you have to go through. But if your job is taking the other side, if you can stick with it — obviously a rather large if — it should be more lucrative.'

So what do we make of this debate? Firstly, we can't argue with the evidence that suggests that, despite the enormous amount of capital allocated to passive investing nowadays, market efficiency has not been dramatically impaired.

Secondly, to the extent that passive investing has impacted market efficiency, we expect the impact to play into the hands of patient fundamental investors. Investing based on the cash flows a company is expected to generate, rather than based on the price one expects the market to pay for the shares of the company, makes as much sense today as it always has.

[8] https://www.ft.com/content/50188553-1aa2-4704-ad9e-ef1e5cf0389e

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E. Rozendal Partners Update

It is now seven years since Rozendal Partners was founded. We are happy to report there has been no seven-year itch for us to scratch: we continue to ply our trade in much the same fashion that we always have. We will likely add a team member or two soon, and there are always surprises in store in the world of investments, but by and large we have no major news to share as far as internal developments in Rozendal Partners go.

As always, we welcome engagement with anyone interested in what we do or say. Please don't hesitate to reach out – we are only a phone call or an email away.

Yours sincerely,

Wilhelm

Paul

30 July 2024

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