M.D. Sass Concentrated Value
What Makes Us Different?

MD SASS

A CONCENTRATED APPROACH TO GENERATING BETTER RISK-ADJUSTED RETURNS

- Risk is often defined as volatility, but we think this is wrong. For long-term investors with a long-term investment horizon (like public pension plans, endowments and Taft Hartley), we believe risk is not daily volatility but rather the permanent loss of capital.
- We believe a concentrated portfolio of stocks we know better than most of our peers is LESS risky than owning an over-diversified portfolio of stocks that we don't know well because it mitigates risk of permanent loss of capital. Knowing your names well should reduce the risk of "blow-ups" and likewise reduce the risk of permanent impairment of capital. This runs counter to conventional wisdom that diversification mitigates risk.
- Investing in situations where we have a high degree of conviction enables us to exploit periods of market dislocations even when it feels uncomfortable. *We believe conviction comes with focus and concentration*, not via over-diversification.
- Finally, we believe our job is to generate alpha first and foremost. Diversification is usually the responsibility of our clients.
- We believe many of our peers are overly-diversified which leads to lack of conviction, higher risk of unexpected events and a more difficult environment to generate superior risk-adjusted returns.

WE PLACE A GREATER EMPHASIS ON FUNDAMENTALS OVER VALUATION

- Many of our "value investor" peers form a thesis on stocks based on valuations. *We believe that valuation is an observation and not a thesis*.
- We believe a thesis should be based on having a materially out-of-consensus view on future earnings. Positive earnings revisions drive outperformance.
- Of course, we also seek to buy these investment opportunities at reasonable prices (or even highly attractive prices!) but the valuation analysis is secondary to the focus on fundamentals.
- A focus on valuation over fundamentals largely explains the underperformance of many value-oriented managers as the unprecedented disruption that has occurred across so many sectors has led to "cheap" valuations which are oftentimes traps.
- Given the fact that our estimates are well out of consensus, our portfolio generally has the characteristics of better multi-year growth vs the index but at a cheaper P/E.

OUR TEAM CULTURE IS A CRITICAL INGREDIENT

- Many managers talk about process and performance, but they rarely address culture. We believe a strong culture is critical to the success of any business, including asset management.
- *Our culture emphasizes intellectual honesty, transparency and communication*. We foster an environment where it is accepted to be "wrong" and encourage proactive discussions about mistakes and how new information may invalidate prior beliefs.

- We recognize that we will frequently be wrong but the key to long-term outperformance is to identify errors and mistakes early to avoid significant losses. Likewise, a team culture that encourages these types of discussions from all team members is a crucial element to our process.

THE ROLE OF A PM IS TO "OWN" HIS/HER CONVICTION AND NOT "RENT" IT

- At many investment firms, analysts pitch PMs ideas in a meeting and a decision is usually made whether to transact based on that discussion. We believe that PMs that invest this way are "renting" their analysts' conviction rather than owning it themselves. This can prove detrimental when volatility, crisis or under-performance ensues as the conviction will quickly dissipate.
- Furthermore, this can create a bad dynamic between PM and analysts as trust and faith in analysts will evaporate if the PM rents' his/her analysts' conviction and the portfolio has a period of under-performance.
- We believe a PM needs to own his/her own conviction in every stock in the portfolio. A PM can gain conviction by working alongside the analysts on investment ideas – talking to management, customers, suppliers, competitors, etc. By working in conjunction with the analysts, a PM will own conviction. This is the model we employ as part of our process. Ultimately, this conviction enables a PM to exploit opportunities with confidence and use periods of weakness/under-performance to his/her benefit even when it is emotionally difficult to do so.

POST-MORTEMS AND SELF-ASSESSMENTS

- Most managers spend a lot of time researching a stock prior to owning it and while it is in the portfolio, but oftentimes the analysis ends when the stock is sold.
- We believe it is important to reflect back on investments AFTER they are sold to understand: 1) what role luck played in the outcome, 2) did we express our thesis in the best way possible or did we have opportunity costs with the investment?, 3) what did we do right/what did we do wrong and are their any learnings that we can apply to our process moving forward?
- We believe that our process should be iterative and evolve with our learnings.