David Barr - From Venture Capital to The Venture Exchange
The Business Brew

David Barr (@PenderDave on Twitter) is the President and Portfolio Manager at Pender Fund Capital Management. He focuses primarily on Canadian small cap equities, but is not limited to that subset of investments. Bill met Dave at an MOI Global event in 2019 and was very excited for Dave to join The Business Brew because Dave truly loves stock picking.

Dave is extremely well respected, high integrity, and looks at the world through a unique lens. While some people see small cap investing as riskier, Dave sees it as an opportunity. Perhaps it's because of his background in venture capital ("VC"). Perhaps it's because he does better "work" than others.

Whatever the reason, The Business Brew is grateful for his time and hope we introduce an investor that warrants respect.

Topics discussed include:

~2:50 - Bill and Dave discuss MOI Global as a community

~4:30 - Dave discusses small cap investing

~7:40 - "Microcap draws people who are business analysts"

~8:35 - How venture capital influenced Dave

~10:00 - Why redemptions disproportionately influenced small caps in 2018

~13:00 - How Dave thinks about marrying VC thinking with equity investing

~15:50 - How journaling helped Dave remember what COVID was really like

~20:00 - Avoiding envy in a social media world

~22:00 - Dave's experience getting "active" (read: constructive) with his holdings

~28:00 - What the Canadian Venture Exchange is and why companies are going public now

~35:00 - How Canada can lead in the financial trends and a discussion on how bubbles form

~45:00 - Dave's thoughts on balancing a portfolio of "compounders" and rerating investments

~49:00 - Are public markets really "long term?"

~53:00 - Is it possible to fully appreciate the right tail of outcomes?

~1:00:00 - Companies are people organizations now; reflexivity matters

~1:04:00 - Follow @PenderFelix!

~1:09:00 - Why Dave is respected by colleagues and how he's been able to achieve success

~1:15:00 - What to learn from Buffett

~1:20:00 - Founder/CEO turnover in smaller cap companies as a risk factor

~1:34:00 - Some SPAC talk

[The Business Brew theme]

Bill: Ladies and gentlemen, welcome to The Business Brew. I'm your host, Bill Brewster. Thrilled to be joined by David Barr today. David is the President and Portfolio Manager at Pender Fund Capital Management. As a reminder, nothing in this podcast is investment advice. Nothing's an invitation or solicitation to buy or sell any of the securities mentioned. This is for entertainment purposes only. Please remember to do your own due diligence and consider everything that we say is opinion based. So, with all that out of the way, David, how you doing, man?

David: I'm doing well. How about you, Bill?

Bill: I'm good. I have not featured a Canadian small cap quasi-activist manager, and I couldn't think of a better one than you.

David: [laughs] Thanks, Bill. I'm kind of surprised this is for entertainment purposes. My wife definitely would not agree that this is entertainment, but I'm glad some people might enjoy this.

Bill: Well, there's a subset of nerds out there like yourself and myself that I'm just trying to deliver some entertainment to.

David: [laughs] Yeah. It's great to be able to do this.

Bill: It's wild that the world that we're living in, not only could COVID occur, but with the advent of technology and different mediums and whatnot, I've been able to connect with more people than I would otherwise. Obviously, it's because of this podcast, but it's just what an incredible time to be alive. Buffett talks about he was just born at the right time. If I'm born at any other time, I don't have a podcast. It's just the right confluence of events.

David: Yeah, well, Buffett, if we were born in the 1500s, we would be, fodder for everything else out there right now, right?

Bill: [laughs] Yes. There would be no way that I would have survived in a true survival, go-out-and-hunt-your-own-food world. I'm built to carry things. I'm not so much the kind that can chase him down.

David: Yeah, I'm five foot nothing and hundred nothing, so I don't know what you'd say I would have had 500 years ago, but I'm sure I would have figured it out. That's what I do now.

Bill: Perhaps, we could have both been fishermen or something like that, standing at the side of the-- I don't know. Anyway, I digress. So, Dave, you want to give people a little bit of background on yourself? We met at Manual of Ideas. Shoutout to John. I always like to give credit to John. He's brought me in touch with a lot of good people. But we met the first time was across the pond in Europe, right, in Switzerland.

David: Yeah, at the Zurich project. Also, it's John connecting us, and yeah, shoutout to John. He's just such a great community he's built, and getting to meet you, it was great. I love the success you're having now. Because I remember the first time I met you, we start chatting, and you're so passionate, and I'm like, "I just want to talk about stocks with this guy all day. Where can we get a beer and continue this conversation?" I think that's really part of the reason, the podcast is so great, because you're so engaging and charismatic and people love chatting with you. So, it's great to see. I love being an admirer from the West Coast.

Bill: Well, I appreciate it. I do hope that all the listeners understand that I really may not know anything. That's not just false. I mean it when I say I'm just a retail guy that happened to stumble into a pretty damn good network, and I owe a ton of it to Twitter and a ton of it to John. A lot of it to the guys, the greats that came before me, I tweeted out recently that I thought Qurate was either the best thing or the worst thing that happened to me, and I do think that the world that you play in, the smaller stuff, is really intriguing to me, because I do think that, where I might have an edge on other people is the ability to network and get in contact with people and do the stuff that I think a lot of finance actually doesn't really enjoy doing, like a lot of the interpersonal skills, and I think small is probably where I should have been focused for a long time, but whatever. It's worked out.

David: Well, I'm totally biased. I'm a small cap guy. But I'm going to challenge you, you made the statement, "I'm just a retail guy, and who knows if I know anything." Some of the most thoughtful investors I know who do the best work are individual investors looking at the micro-cap and small cap space. I've been in the space for 20 plus years. There's not a lot of information out there, and you've talking about how you love engaging with people and chatting and gathering information. There's not a lot of sell side coverage on these things, and a lot of people talking about it. When you have these skill sets, you can go out and get information on these businesses. The big institutions that are geared up to do it, they can't buy a $50 million stock. If you want to own 5% of a company, it's a $2.5 million investment. You're running a billion-dollar hedge fund, that's someone's annual bonus. They're not putting it in a micro-cap stock.

Bill: [laughs] Yeah.

David: The micro-cap, small cap space, we obviously love it, and to your point, though, it is actually an attractive place for individual investors. I listened to your pod with Ian Cassel, who's just a great proponent of the space, and I can't say anything, because he just says it 10 times better than me, so I'll just stop there. Ian, thank you. Thank you for all your hard work out there.

Bill: [laughs] Yeah, I think something that's cool. I joined MicroCapClub and I peruse. I haven't submitted an idea yet or anything, but the quality of discussion on that particular forum is very high quality from what I can tell, and it's cool to see-- I guess it's like any community of people that are sharing ideas, but the micro-cap space is really interesting, and I do think it's one of those few places where you can actually have an informational edge, and a lot of it seems to be, to me, making sure that you pick up the phone, ask the right questions, go see people, and then don't-- For me, I could see where my pitfall would be motivated reasoning a little bit. I want to find the next thing. So, maybe putting some guardrails up around myself to make sure that I pump the brakes a little bit, and don't get too married in idea, because I do know that they are a whole lot easier to buy than they are to sell.

David: [laughs] They're definitely easier. Yeah, you can always buy them. You can always sell them when you want.

Bill: [laughs] I find the marks interesting on them too. I, sometimes wonder how people are marking their books when I see a couple of shares trade, and something shoots up, it's like, “Is that a real mark?” I don't know. Seems like volume-weighted marks would be the most accurate way to try to figure out what something's really priced at, but I have no idea.

David: Yeah. The accountants still haven't figured out mark to market accounting.

Bill: Yeah.

David: I don't think they're necessarily equipped for the job. It really doesn't matter what these marks are. It's all about drilling into what the business is worth. That's one of the great things about MicroCapClub in the space, it draws people who are business analysts. You get people from all sorts of walks of life, like former engineers, music teachers, all different things. They just get really keen about figuring out how a business is creating economic value. When you start thinking about that, that's what formulates the right questions to ask when you're doing your due diligence. It's the flip side of people who are trained at a big university, and learn all about efficient markets, and then a total Bloomberg wizard can build a spreadsheet you've never seen. Some of those people can develop into awesome business analysts, but when you’re coming from that different background, different perspective, I think it gives people actually an edge over the industry norms, shall we say?

Bill: Yeah, that makes sense to me maybe because I want it to but I think it actually does. You got your training in private equity, right?

David: Yeah, I started in the venture space. If you're buying a company, and you can't sell it for 10 years, you better make darn sure you want to own it.

Bill: [laughs] Yes.

David: [chuckles] Great. Talk about liquidity, right?

Bill: Yeah.

David: “Oh, I don't like this anymore? Oops, oh, I can't sell it.” See, you got to make sure you really want to own this thing for a long term, and you’ve got to make sure you're partnering with a management team you trust and can get along with for a decade. You're basically getting married. It's got to be an industry where you think the tailwinds exist, and the dynamics are there that when you come out the other side of this, this investment’s going to be worth a heck of a lot more. So, it's really that fundamental business analyst which drives the core part of our investment process today. But yeah, we practice it a lot more in the public markets than we do in the private, because Mr. Market, I love that guy. Every day, he's either giving us chances to buy stuff or sell stuff.

Bill: Yeah, I was listening back to, I think, it was 2019 when you presented at Latticework, and you were saying that you found there to be an abnormal amount of-- I shouldn't say an abnormal amount of deals, but you thought that the opportunity set was getting increasingly better, and part of the reason was you were saying managers that were getting redeemed on were very likely not large growth types. It was small cap value in general where the guys were getting liquidated. So, there were marks that were coming out that a stock would report deceleration and revenue growth from 15% to 12%, but it would be off 40%, because there was just no bidder to sell the shares to. How did that that dynamic-- what did 2020 due to that dynamic? Did it accelerate it? Was your thesis proven out? I guess from last time I heard a big speech of yours to now, the only thing that I've really heard since is the podcast you did, which I highly recommend people listen to it, on This Week in Intelligent Investing with Elliot and Phil and John. You appeared on that in February, but just curious to hear how things have evolved since 2019.

David: Yeah, that was an interesting trend. We saw it start to shake out in 2018. That was a really tough year in the micro-cap, small cap space. Then, 2019, just kept on going, and we're sitting there and we're like, “Wow, this is punishing,” just getting punched in the face every day, because there's not a lot of bid out there for the types of things we are looking at in the space. 2020, it was interesting, because beginning of the year, it looked like the reversal had finally come. January was actually the first kind of bit of risk on market where people come down in market cap size, which was immediately followed with a global pandemic, which blew apart any risk appetite whatsoever. So, there was a massive drawdown. If you look at Russell Microcap index, look at small and micro-cap managers, it was really ugly.

If you look at how 2020 ended up playing out, it wasn't until October, where people started to come back to that market. Where I think we're at today is, we've had this extended period of time where large cap has outperformed small cap. We've had a whole bunch of active managers who buy small cap stocks just go out of business. We've had this both relative and absolute value opportunity where small caps have been cheap relative to large cap on a relative basis, but also small caps are still cheap on an absolute basis, because there's way less people doing the work than there used to be.

Bill: And you will also-- just so people know, I've heard you talk about Zillow and Stitch Fix. You're not simply constrained to small and micro. You'll go up market when you see opportunities. Is that a fair statement?

David: Yeah. So, firm wide, we look at the whole spectrum, and my partner, Felix Nahri, did a great presentation last summer on Stitch Fix at MOI. If anyone's interested in that thing, the Stitch Fix or our large cap strategies, what we do, that's a great place to start. My approach to large cap, and I joke about Felix, because he had a more traditional start, starting at a bigger firm following large cap stocks, and now I tease him a bit, I'm like, "Hey, you're turning into a venture capitalist."

Bill: [laughs]

David: Because when we're looking at a lot of these companies today, what's important in venture capital? Well, you need a big TAM, and you need a great team, and you need a great product with strong internal economics so as it scales up you, you get the cash flow. When we looked at Zillow and Stitch Fix, and a lot of these things, we just saw pent-up opportunity. Particularly coming out of the onset of the global pandemic in March, everybody got excited about Facebook and a bunch of these other companies, Microsoft, where **[unintelligible [00:13:40]** came out and was like, "Well, we just had three years of demand pulled forward into a month," something like that.

Bill: Yeah.

David: There was a period of time where the second-tier-type tech companies hadn't come back yet. We've written about it. Because FAANGs was already taken, we needed a cool name. So, we came up with ZIPs. So, we've got the ZIPs.

Bill: Yeah, I like that. I like that.

David: It's kind of zippy.

Bill: It is indeed.

[laughter]

David: You can tell I'm dad, right? My daughter's probably rolling her eyes at me right now.

Bill: [laughs]

David: Such a dad joke. There was a second tier of tech company, which hadn't been discovered yet. Last spring summer, that's where we rotated a lot of our portfolios into opportunities like that, because you could see how the world has changed. When people's behavior changes, I think, for 62 days, that behavior is usually here to stay. People are just going to buy more stuff online, including real estate, which is the biggest industry in the world, which is being disrupted by Zillow. So, if you want to start with a big TAM, you might as well start with real estate.

Bill: Yeah, that one, I had avoided because I didn't like how they were holding some of the risk in the flipping business as I understood it, but I was obviously not correct in that or at least not according to the stock market, I wasn't correct. I think a lot of businesses when the world stopped, I got a little bit scared of what they were doing, and then maybe I should have pivoted back to opening my mind a little bit more in June after some of the things that I had owned had rerated and some other things hadn't. But that's much easier to say in retrospect than it is to do when you're managing through it.

I found a couple things held me back. One was taxes a little bit. I really didn't want to just generate a bunch of short-term taxes, which is maybe a mistake that I consistently am making. The other was, I knew that-- well, I had a strong degree of confidence that the businesses that I owned could get through it, and trading that into risk that I didn't fully understand, didn't feel like a great idea in the middle of a pandemic. So, what a time to manage through man. They don't exactly write a book on that stuff, do they?

David: Oh, absolutely not. I remember, in the middle of it, I was journaling every day, and I was saying to our team, I'm like, “Look, beat journaling right now, and talk about how you're feeling.” It's good to talk about your feelings right now, because in a year, two, or three, when this is all over, you're going to look back and be like, “Oh, yeah, that wasn't so bad.” I went back a couple of weekends ago, and reread my notes from a year ago, and it was like, “Huh, it was way worse than I remember it right now.” Actually, having it all written out will help giving you that context to prepare for the next time, because there will be a next time. It's going to feel different. You're going to look for similarities but controlling your behavior and emotions in those periods of times, that's what separates the great investors from the good ones. It's way easier said than done.

When we look at what we did, though, reflecting, we weren't looking for new opportunities in that period of time. We were going into places where we’d done a lot of work, and we really liked the businesses already. Another issue is that when you get into those periods of time, it's really hard to pick up a new idea, and drill in, and get to the conviction level you need to buy it. Whereas, if you've done the work in advance and revisiting those companies that you do know well, then you can actually move quite quickly and capitalize on the opportunities. Fortunately for us and our investors, we did.

Bill: Yeah. I have complained about missing, Restoration Hardware is one, and Eldorado Resorts was another that I was looking at. I wonder if the playbook gets run again, if it makes sense to allocate to small-- When the businesses get-- Almost these really levered businesses that have a lot of concern, does it make sense to spray a portfolio of option bets? Because equity has a perpetual duration and obviously, unless you get liquidity or bankruptcy truncates it, but that I wonder if-

[laughter]

Bill: - that would be the concern.

David: [laughs]

Bill: But I wonder if I shouldn't have made a couple more options size bets on the really depressed equity valuations relative to what they would have been normalized. Then again, I could just be resulting, I'm really not sure what the answer is.

David: Yeah. It--

Bill: Easier in retrospect.

David: It's always easier in retrospect. Yeah, we missed so much. There's so much just drives me nuts. There's things we should have bought earlier, and things we just didn't buy at all, which just went up crazy. That's just the nature of what we do. It's kind of like envy. Charlie Munger always talks about it's the worst of the seven deadly sins. Seeing the stocks going up, nothing you can do about it anyway. So, don't spend too much time fretting about the stuff you missed. Just focus on the stuff you did well, and-- You had a pretty a big bold call that that worked out great.

Bill: Yeah, well, that's true. I think that focusing on the next thing is always the most important. We were talking about golf, and that sport taught me a lot, because your last shot doesn't matter at all, all you need is one bad one as your next one, and then entire round can get derailed. I definitely agree with what you're saying. I guess that I have realized that-- the wisdom of Buffett and Munger, I realize that every year more and more, but that envy statement is very, very real. Sometimes, when I find myself not even being able to be proud of what I did last year, which I am pretty proud of. But there are times when I'm like, “Man, I could have done so much better,” it is envy that's driving that conversation internally.

David: Totally. It's even harder in the world today. I love Twitter. I have to block myself from using it.

Bill: Me too.

David: [laughs] There's so many people sharing such great ideas and concepts, and there's so much you can learn about on companies, and then you start hearing about the stocks that are going up, and how easy it is and how great it is, and all these wonderful track records out there, and it's-- In a social media world, envy is even more challenging than it was historically, because the ability to compare yourself to others has never been more prevalent than it is today.

Bill: Yeah. The other thing is, you don't know whether or not the comp’s really apples to apples. You don't know whether-- funds have different funds that they market. People can have different anonymous accounts that they market.

David: [laughs]

Bill: You never know. You never know what's reality on the other side of the coin, but I do know there's a lot of good people doing good analysis that are sharing their work. So, I appreciate that. I have found over the last couple of weeks that the key for me is I need to have blocks of time, and then the other thing that really, I think impacted my head for a bit was, I was feeling the need to respond to everybody that wrote, and it's just getting to a point where it's untenable, like it'll just drive me nuts. So, it's tough, because on one hand, I want to grow a fan base and some audience engagement. On the other, I have to sleep. I just found the dopamine really gotten my-- It was impacting my sleeping habits, and I was like, “All right, this isn't good anymore for me.” So, I have to redefine that relationship.

David: Yeah, it's hard when the incoming starts to overwhelm you. For the longest time, if a student ever reached out to me, I would set up a call with them and call them back. I think I mentioned this enough. So, I've got a lot of students reaching out to me now, because I'd always take a call, and it's now hard for me, I can't respond to everybody. I carried a whole bunch of guilt, because I really wanted to pay it forward. If there's something unique that comes in, like a great stock pitch or a concept or chatting with something then, it's harder for them to get it, but I do allocate time. To your point, I allocate time for that now, but I can't do it all. That was hard for me to come over, because I felt an obligation there.

Bill: Yeah, and you build the brand of being the person that people want to come to. I know who you are. You participate in Manual of Ideas. We obviously all sort of market through that. But I also think that there's a common thread of giving to get in that community. But eventually, I just think to your point, it just gets a little bit overwhelming to field all the questions. We'll see going forward. I don't know.

One of the things that got me really interested in how you invest, if you don't mind going through some of your past investments, if that's how you want to do it or not, but you said that you're not afraid to get involved in-- and I wouldn't say be an activist, but an active investor, and just what that looks like from your standpoint, and if you have a favorite outcome that you want to discuss, or even one that went wrong or whatever, I don't have any agenda on it. [laughs] Sure, the good ones are more fun to talk about.

David: Yeah, the ones that go wrong, you end up signing NDAs and you're never allowed to talk about them again.

Bill: There you go. I was under one of those for 10 years with the old franchise, but I'm pretty sure that's over now.

David: Yeah. I think that really just ties back to being in the private equity world originally. I love finding businesses. I love it at a cheap price. I also love watching them grow and doing whatever I can to help them grow. A lot of it is, as large shareholders of a company, just being actively engaged talking to the management team and the board and trying to help them out. We never go into a situation where it's like, “We think this management team’s incompetent. This is a great company. Let's go in here and shake things up.” Life's too short to be getting in fights all the time. What we do look for is where there's a business we really want to be invested in with a management team that we think has what it takes. Obviously, there's the constructive side where we're doing whatever we can, making introductions, being active in the public markets. One of the areas CEOs of our portfolio companies are calling me and asking me a lot about is engaging with the investment community, who are the investors they should be targeting that they want as long-term supporters. Shareholders, we chat a lot about that.

I think in smaller micro-cap companies, when they start looking at mergers, M&A activity and capital allocation, the level of sophistication isn't what it will be at Berkshire Hathaway. So, we can provide some input there. Where everybody always gets excited and likes to talk about is when all of a sudden, we have a divergence of views with either the board or the management team. There's one company I think I could talk about it now. It was an EMR company up here in Canada, and founder was wonderful entrepreneur, just super passionate about customers, and he came into my office a couple times pitching me on investing in the company. First couple of times, I was like, “This thing's going to zero.” Over-levered balance sheet, cash flow, I couldn't quite figure out because of deferred revenue and all that stuff. Then, he made this acquisition, and it was this-- We're chatting in December, and I look at him, I'm like, “You can't pay for it. You're going to be bankrupt in March.” He's like, “No, no, no. I've got this client customer payment coming in on this date,” and this is just an entrepreneur who knew his cash flows, totally memorized, and was just super passionate about his customers. All of a sudden in April, I'm waiting for the bankruptcy announcement, so I was thinking we might be able to pick the asset up out of bankruptcy and sure enough, he skates through that quarter. I'm like, “Okay, this guy knows what he's doing.”

Bill: Yeah.

David: We initiated a position pretty soon after that, when I was like, “Okay, this guy’s got a vision, and he knows where he's going, and we do like the business.” He always had a harder time communicating with investors out there. So, over the years as he evolved, the company grew and stock price went up, we continued to support knowing the stock and seemed like every two years, somebody would come to us and try and fire him. So, they would come-- and I remember, he came into our office one day, he's like, “Dave, the board fired--” He actually got fired, “The board fired me.” I'm like, “Oh, how would the board fire for you?” He's like, “They fired me.” I'm like, “But you own 30% of the company, and we own 15% of the company, and this other guy owns 15% of the company. They can't fire you.” He's like, “Oh.” I'm like, “Yeah. Just go talk to the other guy, and then go to the board, and say-

Bill: [laughs] “I’m not fired.”

David: -60% of shareholders say, I'm not fired.”

Bill: Yeah.

David: It's funny. I reflect on the board at that point in time. It was a whole bunch of really big company people who were used to corporate governance and procedures, and I asked him like, “Well, why did they fire you?” He's like, “Well, because I didn't want to write reports.” I’m like, “Well, why didn't you want to write reports?” He’s like, “I wanted to go sell product. I want to go talk to customers.” I'm like, “Well, I know exactly what you should be doing.” So, that was a situation where we were able to support the CEO and keep the company on track, despite what the board was thinking. Eventually, that turned into a great outcome for us. We originally built our position at 40 to 60 cents, and then it was sold for over three bucks probably six or seven years later.

Bill: Nice.

David: Situations like that, where we're able to work with management team and help support their growth and protect them from people doing silly things.

Bill: [laughs] Are you finding a lot of your ideas are on the Venture Exchange?

David: Yes.

Bill: As a Canadian small cap, just because people here may not know-- my listeners tend to be US focused. So, they may not even know what the Venture Exchange is, and if you don't mind just briefly explaining how Canada works and where you're finding ideas.

David: Yeah. We, our major stock exchange is the TSX. They've got their smaller company board called the Venture Exchange. What it allows is just it's less onerous disclosure requirements and reporting requirements, so, basically, smaller companies can afford to be public. One of the things we've seen in the US with all the regulation coming out of the financial crisis in 2008, 2009, it's really expensive being a public company down there. The amount of disclosure you have to provide, from my perspective, it's wonderful because I get to learn more about companies and industries. But from a company perspective, if you're 50 people in a $10 million company, you're going to spend all your time writing reports for the SEC or the Canadian Securities Exchange.

In Canada, we've got a junior exchange. There are listing requirements. So, there's a lot of quality companies out there. As an active participant in the space, I can confirm that there is a lot of junk out there, stuff that's totally promoted. So, you do have to be careful in what you're doing, but the Venture Exchange, it's a straight laced up-- It's a good exchange.

Bill: Yeah.

David: Whenever you have an exchange, always people will try to take advantage of the opportunities.

Bill: Yeah, and I think too. There's a perception, at least that I had to fight against for a while, is I would say, why is this company so small in public? Why didn't they just stay private? You'd spoken a little bit about that actually, I think, in the February podcast that you did with Elliot and Phil and John, where now there's maybe a little bit more incentive to go public, because the valuations are maybe a little bit higher in the public market than they previously had been relative to private valuations. Is that a fair characterization of how some of the dynamic is flipped? Does that still exist?

David: Oh, yeah. I don't think there's a private company out there not trying to figure out if they can go public via SPAC or IPO right now. All the inside shareholders of these private companies, they're seeing the opportunity right now. If you look at the IPO market, the go public market in Canada, there's a very rich pipeline right now, but we've seen last summer last fall, we were really active in the space, because there was that arbitrage where companies going public, went public at a price that was probably a discount to what their peers were trading at. As a result, these companies would go public and their stock prices would go up right away. Reflexivity kicks in, and private companies see a whole bunch of people making money, and they want some of that. So, it's driven a lot more companies to go public. What we're seeing now though is that companies that are going public are demanding that in a lot of cases, the top tick valuation, there's no meat on the bones left for the public company investors, so, we're not seeing the exciting stock up 20%, 30% right out of the gate, which I think will probably temper the market a little bit. People like doing things when you make money, and they're easy. When it's harder to make money, probably see some capital flow away, but the market is still really strong.

The setup for this, though, is really in Canada, we've got this history of financing junior exploration companies, both minerals, oil, and gas. So, there's the whole ecosystem is set up around financing these companies publicly. I feel kind of anti-Canadian saying this, but we don't do a lot in the resource space. It's just we're not-- Don't like commodity stocks. But what we've seen is, technology companies, healthcare, and just straight-up traditional industrial companies going public at a really small stage, for whatever reason, maybe deal with some legacy shareholders provide liquidity, or maybe just stockbroker at a small shop, bought a really nice bottle of wine and a steak dinner and convinced him was a good idea. We've seen that too.

Bill: Hmm. That doesn't seem like a great reason to go public, but I respect the guy's choice in wine, because it made somebody make a pretty big decision based on that.

[laughter]

Bill: With the Venture Exchange, do companies get into the quarterly reporting as much, or is that a little bit of a darker market?

David: Yeah, quarterly reporting is required-- There's a bit more leeway. I think it’s 120 days after year end for your year-end financials and up to 90, I think, post quarter. There's just a lot more leeway on the length of time it takes, so it just decreases the burden a little bit. But yes, audited financials, and quarterly reports including management discussion and analysis, which is not as robust as what we'd see in a K or a Q in the US, but still provides some pretty good information on the business.

Bill: You know what’s funny, I have a couple friends that are in private companies that are VC backed, and they said that the perception of not having quarterly earnings calls is completely wrong. I've heard from a number of people, they're like, “I have as much short-term pressure on me as I think I'd have if I were public.” I think it's maybe a consequence of just having outside capital in general, as opposed to whether or not you're public or private, but that may be wrong. My sample size is under five. So, it's not as if I have a huge sample size, but it has been a common refrain.

David: Yeah. Well, if you're a private company, that's private equity or venture backed, you've got a whole bunch of people on the board who are really passionate about your success. So yeah, there will be a lot of pressure. A lot of times, the companies you see go public earlier are when you have a CEO who may not want that same level of adult supervision. When you go public at a smaller size in Canada, your board may not necessarily be holding you to the highest level of account, because they're probably the same people who bought you a steak in a bottle of wine.

Certainly, in the micro-cap space, the accountability to the board is probably not as great as in the private space. The reporting obligations are still there, and maybe you're doing a quarterly call, maybe not. A lot of times, you do a quarterly call and nobody shows up.

Bill: Yeah. Well, that's where the opportunity is for somebody like you, right?

David: Absolutely.

Bill: If you cover everything, and you're the one that shows up, that's why the opportunity exists.

David: That's 100% why the opportunity exists. The great part about Canada is companies are always coming public and the small cap space, there's always new opportunities presenting themselves. One of the most interesting spaces we find the opportunities, when we start this, we see speculative bubbles forming. This is always a fun topic for value investors. People are talking about bitcoin right now, and how cryptos, it's a bubble. Well, in Canada, we had a financing window a couple years ago, where a whole bunch of crypto companies and blockchain companies went public. But about the same time, we also had a big cannabis financing window open up, and a bunch of these cannabis companies went public in Canada in advance of legalization, and valuations just got crazy in both the cannabis and crypto spaces, but we are sitting there watching a lot of these companies at that point in time. We ask ourselves, why does a bubble form? It's because people believe there's some game changing coming on, there's a massive market opportunity, and this new industry is being created.

What's interesting for us is, when I hear about these bubbles, the first thing I think of is big TAM, big TAM, big TAM. When we see these companies coming public at a really early stage, they're generally not investable. All the promoters get involved, you’ve got these people who took a whole bunch of mining companies into bankruptcy, all of a sudden, they're cannabis experts, and then all of a sudden, they're crypto experts.

Bill: [laughs]

David: You just follow these people around. But the reality is, there are companies that are going to come public where you've got management teams that are really trying to execute on a vision. What always happens, and we call it the death spiral zone, as soon as people realize that a lot of these things are not real businesses, or how hard it is to actually build a business, and the fundamentals start to kick in, you'll see your stock price come off 90%. So, what we do spend a lot of our time around these bubbles is trying to figure out which companies have, real business models have high integrity management teams that can actually operate. When the death spiral happens, and the stocks are up 90%, usually, the business, the intrinsic value will start to compound pretty quickly, and you can buy these things super cheap, and it's a great entry point to get into these companies.

I love it when these bubbles form in the micro-cap space, and most people generally love them because they get in long and they write it up and then they don't love it, because they write it down. But for us, it gives us that leading indicator that there's an industry or a company with a big market you can go after, which really helps you find optionality in the micro-cap space.

Bill: Yeah, I like the idea of-- I forget who articulated it the first time that I heard it, but when you look at bubbles, they became bubbles usually, because there was a grain of truth that just got taken too far. I think that my framework of how things can go up and come back down really quickly is that grain of truth starts to get proven out, and then people that haven't done the work start to pile in, and then the momentum gets going. Then, on the way down, there's a lot of we-cans, and then people get flushed out, and then funds have to liquidate that position for there's a lot of reasons that people don't want to have internal conversations and whatever.

That's when I think that the grain of truth that started the bubble is unlikely to be as affected nearly as much as the price of the securities that are reflecting the euphoria and depression of the bubble and the subsequent popping. So, I do like the idea of starting to look and then being ready on the downside. I know Canadian cannabis got decimated. Aaron and I had talked about the US cannabis. I think that's kind of a-- I don't know, that's an interesting setup from the opposite standpoint, because I just think that a flood of capital may be unleashed. But there's a lot of hard questions to answer between today and what the end state looks like. But I don't know that you need to have all of them answered in order to have a view on whether or not there's a good investment or not, but that'll be TBD. I think it's an interesting space.

David: Yeah. It’s interesting, I was listening to that, and Aaron and I have two Canada-listed US cannabis companies in common. He made an interesting statement that really resonated with me and he talked about having-- he's buying stocks, it's like you're buying limited downside but uncertainty to the upside. What we talk a lot about is on the uncertainty the upside is, what does the right tail look like? Because when you look at historical stock market returns, it's a really small subset of the public company universe, which drives a ton of the returns. And it's finding those outliers, those right tail type events, whenever you can find these companies with these big TAMs and if they have a decent probability of hitting it, that's when you can really get a ton of really positive skew into your portfolio, where when these things start to kick in. I love the way Aaron articulated that.

Bill: Yeah. Do you think that maybe, when I came into value, or into investing generally, I studied the books of value investing, and I was like, “Okay, focus on the downside, focus on the downside.” But then, I don't think that I put enough emphasis on what does the right tail potentially look like, and then how are the probabilities assigned here? That's how, I think Sean Stannard-Stockton sidestep a lot of the carnage that came in consumer-packaged goods, because I think he was early to notice that the skew had shifted, and I think that at least when I started-- and I think it's a fair comment on values, generally, one of the mistakes is not getting creative enough to see the true skew, because you have to let your mind drift to the upside. I think sometimes in such a downside-focused practice, that skill set is underweighted a little bit, or if not underweighted, underdiscussed, and then maybe underemphasized. Does that make any sense to what you think about the world, or am I off there?

David: No, that makes a ton of sense to me. People, when they get into value investing, obviously, it's reading security analysis, and there's a lot of balance sheet statement analysis, and people are looking for a formula-- Investing is an art, because the future is uncertain. The value of a company today is the value of the future cash flows. Nobody knows what those are. You have to put some thought into what that is.

Bill: Yeah.

David: If you look at the historical data, there were more traditional industry type companies where you could do traditional value analysis 40, 50 years ago than there are today. So much more of the companies today are people-based businesses. If you just look at randomness, 50 years ago, in this universe of companies you're going to look at, if you didn't pay too much, and then a bunch of these companies, you had some right tail events, you're going to generate some good returns. Just call it probability, call it luck, call it whatever you want to.

In the world today, more of these traditional companies, they're being bought out by Danaher or some industrial rollups who want to buy best-of-breed product in a small market, number one or two market share. A lot of these high-quality companies, that would be traditional value investments, just aren't in the public markets anymore. So, the opportunity set that you're dealing with today is different than it was 40 to 50 years ago. I could be totally wrong, but that's the way I look at traditional value investing today. Not to say it's dead. We found a company on the TSX that was trading at 25% of its real estate value, and they bought the real estate in 1970 when it was in the middle of farmland, and today, it's up and coming suburb in Toronto. So, you can still do value investing, particularly in the micro-cap space, but I think the game has changed, and if you don't change how you look at things, you're probably going to get left behind.

Bill: Yeah, I am certain that's right, at least as certain as I am on anything. When I heard you speaking about something you'd said that, as you look at your portfolio, the higher quality names have generated a little bit more alpha, and if I'm not mistaken, you said I don't know if that's a comment on where we are in the market. But one of the things that I've come to appreciate a little bit better is how much easier the higher quality businesses are to underwrite. So, what is perceived as a 70-cent dollar in a quality name may actually truly be a 70-cent dollar as opposed to a 50-cent dollar that's actually not really a dollar. So, the bargain is maybe a little easier to identify in some of the higher quality names, potentially a late cycle comment, but that's what where I've morphed as an investor.

David: Yeah. It's certainly where I continue to morph. To your point, though, with everybody saying, never sell and compounders are the way to go, there's just this mean contrarian streak in me where I'm like, “Okay, this has to be overcooked right now.”

Bill: Yeah.

David: So, let's not give up on the other side of buying 50-cent dollar. Let's make sure we're doing a little bit of that. But yeah, if you do look over the long term, it's the compounders, the businesses where the internal economics are growing at mid-teens. If you buy those at a reasonable price, just sit on them forever. That's way easier than picking up quarters every single day and trying to find the next opportunity, and then tax leakage, and all the other aspects that go into it. So, that's just me totally sitting on the fence and waffling on the topic, Bill.

Bill: I get it. I think that's the right thing to do, actually. The other thing that I've thought about in my own portfolio is I've thought, okay, well, I try to think about what risks I'm taking, and I think that having some quality in some special situations sprinkled in can truly diversify the portfolio risk. It doesn't all have to be one way or the other, but I do think that for a long, long time, the right tail was underappreciated. Maybe it's overappreciated now. But we'll see over the long term-- What did COVID, and the government responses do to your perception of real left tail risk, if anything? I haven't heard you talk about this, but I'd be interested to hear you riff on it. Especially, as somebody that's in small cap land, I got to think that in March, that was terrifying, because access to capital dries up for the smaller guys quicker than the bigger guys, I would assume.

David: Yeah. There was zero access to capital in the small cap space last March. My political commentary is weak on a good day, but I do love studying incentives, and I know that if you are in politics, and you are in power, the only thing you want to do is stay in power. If you stay in power, everybody has jobs and things are okay. So, you're going to use any tool at your disposal to make sure that people have jobs, and they're okay, and they're not hurt financially, so you can get reelected, you can continue that power.

With that underpinning, I just expect government to keep on coming in. They wrote the playbook in 2008, 2009. It was delayed, but effective and man, did they unleash it with a fury in March, April last year.

Bill: Yeah, that was pretty impressive.

David: Listening to some of your recent guests like Preston, their second-order consequences of what's going on, both from a society perspective, and also from an investment perspective.

Bill: Yeah, I don't know at all how to handicap what is actually going on, how I can have a strong macro view. I didn't even know at the time how big of an impact the stimulus and policy response would have. I think I've gotten myself to the point where when I saw the markets reacting the way that they were, I realized that there was probably something I didn't understand as opposed to just saying, “Oh, this is crazy.” But that was-- I do think, and this is famous last words, but I do think they did a good job chopping off the true left tail. Now, that's not to say that there won't be consequences to the actions, nothing is free of consequence. But we were looking at a potentially really devastating event. I'm not saying the things are good right now. I know there's a lot of people that are suffering, but I'd rather be reopening into what we are than some alternative reality where there was no support.

David: Totally agree.

Bill: That would be tough.

David: Yeah.

Bill: Yeah. Just circling back to your past as a private equity investor, do you feel as though the public markets are as long term focused as people like to say they are, or do you think that there's longer term focus in some of the private equity type ownership? I'm curious to hear you riff on that a little bit. Because it seems like everybody's long term until stuff happens in public markets, and as soon as stock prices start going down, the long-term theory really gets thrown out the window. But you're somebody who's done it and lived with companies for a long time. You've seen successful exits. So, I'm just curious how you see it.

David: Yeah, we saw this great study done where you can add about 200 basis points of outperformance over the long term, if you have high active share and your long duration. The top decile of long duration was a holding period of two years. Long-termism in the past public markets is two years. We're looking 5 to 10 years out, so I get amused when people think-- when you think of 98% of the world out there is trading out of positions every two years. It's totally insane.

There's a great book that came out, Lawrence A. Cunningham wrote *Quality Shareholders*. It's so important for companies to attract the right types of shareholders. People that understand their business and are going to be there, both in the good times and the bad times. It creates a way easier operating environment for the CEO, and the board, and the management team. Conversely, in our business, having quality investors, we couldn't have executed on our investment strategy last year, if we didn't have great long-term investors in our funds. One of the things we spend a lot of our time trying to figure out is, how do we continue to nourish these relationships, and build stronger relationships with likeminded long-term investors, so that we can match the asset to the liability, for lack of better words. It's just so important in the world today, because if you have a long-term perspective, you absolutely can outperform. **[unintelligible [00:51:18]** loves it when I use absolutely by the way, sorry about that.

Bill: [laughs]

David: You can outperform-- You potentially can outperform. But the flip side is, you need to be invested in companies that are thinking that way, and you need an investor-partner base that is supporting you throughout that. So, long-termism in the stock markets, it's not prevalent, which is good, because if everybody was doing it, the opportunity would be arbed away.

Bill: Yeah. When you're going through the portfolio management process, so you've already bought a name-- This is such a hard question to ask, because it's situation dependent, but how often are you re-underwriting your original thesis, and what do you do in situations where a stock just really rips on you? I'm looking at March and thinking, “Oh, well, if I can make 15% over five years on a bet, that's amazing.” Then, all of a sudden, it doubles in under a year, and it's like, “Okay, well, there’s my five years’ return basically compressed into under six months.” How have you trained yourself to be an owner, and be a little bit-- I don't know if agnostic to the market is the right word, but hold through periods of over and under valuation? Because from what I know of you, I really respect how you invest and how you own companies that you own. You're not a trader.

David: Yeah. This answer always drives my team nuts, but it depends. When we look at our opportunity set, in the more traditional value world where we're picking up $1 for 50 cents, we call those and a bunch other people do too, close the discount situations. When our primary source of return is being driven by price movement, mean reversion, and a closing the gap to what we think the intrinsic value is, if it gets close to fully valued or fully valued, we're gone. Otherwise, you're just setting yourself up to round trip.

In compounders, to use an overused word, when the internal economics in the business is growing and intrinsic value is increasing, that's when we will-- when it gets to fair value, we will trim the position. One of our larger cap mandates, I run between a 3% and a 6% weighting. If high-quality company we want to own for a long period of time is super cheap, it'll be at 6%. If it's fully valued, we'll carry it in about 3%. Because the error of omission we can make as investors, and I talked about the right tail, I don't think we can actually ever fully appreciate the right tail. Companies that are doing all the right things, you don't know what little skunkworks they have going on, or what added product functionality, which actually may totally expand their TAM, or may just totally decimate one of their customers, you don't know what's going on.

So, these companies that are doing all the right things, and have a history of doing all the right things, and continuing to compound intrinsic value, you have to give them the benefit of the doubt. So, when they do hit the estimate of intrinsic value, don't be high conviction 20% waiting on it, but dial it back and hold on to it, because the odds are they've probably done something right. We've looked at Starbucks, Felix covered it for 20 years and there was a company that all through the 90s, it would have looked expensive if you didn't understand the unit economics of the business, and we're looking at headline numbers. So, was it a good thing to have sold Starbucks in 1998? Absolutely not.

One company we've talked about recently is a company called PAR Technologies, Savneet Singh is CEO, in the restaurant point of sale space. We had our bull case scenario built out, and then they went and bought this company called Punchh, which increases their exposure in the supply chain to restaurants, where now, they're on the customer loyalty side as well. They add that acquisition in, and then we look at our bull case, and our bull case has changed quite dramatically. Even though, where it was, it was fairly valued based on what we thought, we were maintaining a position because for those previous reasons, we didn't know what they were doing that would potentially add value over the longer term, and then we found out, and then we were really happy we own the stock.

Bill: Yeah, that makes sense. I had talked to Sanjay Ayer about the thesis creep a little bit, and he said like, “Of course, your thesis is going to creep.” If you own something for so long, you can't possibly have the same thesis at the end of your ownership period as you did going in, because so much has changed. That's an element that I haven't really had to deal with outside of, I guess, Berkshire, but that's not really thesis creep. That's just like, they're going to figure this out because it's Buffett and Co, and they know how to think through this stuff. It's not that much more complicated there.

David: Yeah, I feel like we need to talk to Rishi about this one, because he turned me on to thinking on systems. When good things are happening to companies, there's positive feedback loops that are happening. If you're revising your thesis upwards with positive events happening, that might be an okay thing to do. I think where I get really nervous is on the downside. Where it's like your stock is trading at $2, news release comes out, they lose a customer that's 10% of revenue, and the stock's down 30%. The most dangerous thing I ever hear is news is baked into the price.

The flip side where it's, "Okay, well, we've had a negative thesis-defining event happen and so your intrinsic value is going down," but you don't know what actually led to that customer loss. Maybe their product sucks, maybe it's end of life cycle, they never invested in the next product. Maybe they got some salesperson that drives everybody in the industry nuts, and nobody wants to do business with them. So, the odds are your next revision of your thesis is probably down. One of the things we really try to focus on is if you have to re-underwrite your thesis on the downside, it's probably time to move on.

Bill: Yeah, I'm almost certain Bill Miller wrote about this, and I think that the way that he framed it, or it was his firm, I think they said, they went back and looked at when their portfolio underperformed, or a position in the portfolio underperformed, and it's almost always, "Company fell short of underwriting projections. We held on, because we thought the stock you said adequately reflected the reduction." Sanjay touched on this too when he talked, he said like, "Nobody ever models the reality of fade," because it always happens quicker, and I think how he said it, I may be putting words in his mouth, but in years three, four and five, that compounding of deceleration, you just don't capture it in the model in the same way that reality occurs.

Another thing that I was thinking about is people say because the books like, "Oh, well, let's go Henry Singleton, and I want a cheap stock." But when I was at the bank, I can tell you morale is not great when the stock is languishing. That's a very real thing among employees. That's maybe under discussed, I think sometimes among investment professionals at least the ones that I talked to, I certainly don't think that you need to be promotional on your stock necessarily, but if I was at a company and I was running it, I would try to do everything that I could to have my stock trading in a fair range. One, I think it's better currency for M&A. Two, I wouldn't want employees thinking that were looking-- What's our company doing? Well, look at our share price. It sucks. So, the market hates us. So, we suck. I know that stuff's very real. I believe in that interplay of feedback a lot more than I used to.

David: I totally agree. It's a great point, Bill. If your employees are coming to work and they're upset because their neighbor's making way more on their stock options than they are, or their ESOP or whatever the stock compensation plan is, they're going to be slightly less motivated.

Bill: Yeah.

David: The flip side is when all of a sudden you make 10 million bucks, and your stock options overnight, you might have a hard time concentrating at work. You might just be looking at a stock screen.

Bill: Yeah, that's true. [laughs]

David: I hope that's happening to a lot of the listeners out there.

Bill: Yeah. Well, the employees at my company, I hope they're all having that problem, because then I'm having good problems, too. But alas, many are not, I apologize.

David: Yeah. Having an active engaged workforce, particularly in the world today, most of these are people-based businesses. Financial services, healthcare, technology, the majority of all companies now are very people based, particularly in the North American markets. It's so critical. We try to get a feel for it through Glassdoor and other tools we use. It's an imperfect science, but very meaningful, I think, to the outcome of our investments.

Bill: How many people are on your investment team? Do you have a lot of junior people? What's your firm look like? What's it like to run a firm is where I'm really going with this and training people up, and what's it been during COVID? Those are really the questions that I was going to ask you. I just led it with all of them.

David: Yeah. There's four of us who are lead PMs, and then eight analysts supporting the PMs. What I would say is our PMs are all analysts. We're all people who are ripping apart companies and understanding businesses. Some of us also just have to have the added stress of making decisions on what goes in the portfolios. Running an investment management firm through COVID, yeah, it was a lot of fun if you like a lot of stress. The most important thing for me as a leader was to make sure that everybody was behaving rationally. What was interesting is because we went work from home on March 12th. Everybody was at home, and there's obviously, there's a lot of fear going on at that point in time, but people were able to hang out their home office, and just read, and tune things out, and stay very rational throughout a very irrational period of time.

But there was a lot of checking in and Felix, our CIO, was talking to everybody on the investment team. We couldn't have in person meetings anymore, so, how do we actually create that water cooler talk about stocks? So, we created some different ad hoc meetings and whatnot, which actually, I think our level of conversation is more focused and higher than it's ever been on the investment team. So, it's been a positive development for our team in a really unfortunate time.

The fun part about running a fund company though is, probably I'm talking fast with a lot of excitement right now, I love investing. What's great for me, I love going to the MOI events. You go there and you talk stocks, and everybody there is way smarter than me. I just sit there, I listen as much as I can, and I'm just like in awe, “Wow. You did that much work on that name.” It's so impressive. I started my career in Vancouver. There's two places you can work out here, and they didn't want anything to do with me. So, I had to figure out how to do it on my own. So, we started in venture, and I led the firm transitioning into the traditional fund management in 2009. For me, I've always loved having conversations like this, Bill, with other investors out there who do deep work, and are really passionate and have a bit of a value bias. For me, as we build the firm out, it's an ability to attract like-minded investors.

If you want to come talk about cheap stocks that are great companies all day long, it's a great place. The problem is 95% of people in our industry are in it to get rich, they're not going to fit into Pender. You've just got to just want to come and look at stocks all day long. That also supports like-- When we talked about long-termism, you need the organizational structure and discipline to achieve that. Luckily for me, I've been able to create an environment where I've brought Felix over, who's probably one of the smartest investors I know and ridiculously underfollowed online. As we build this out, attracting other people to an environment where we just get to talk about stocks and focus on long-term investing all day. So, I think you really hit my passionate hot button there, Bill.

Bill: How did you start it up? You left private equity and you had a theory that you could affect change-- or I refer to you-- I associate you as an activist, and I know you're not, because I know that has a hostile tone to it, and that's not what you do. But I'm just trying to think about, what you were thinking when you were becoming an emerging manager, and how you thought about starting what has clearly been a successful run?

David: Yeah. I was working with a team at-- I've joined Pender in 2003 and we were focused on the venture space. Then, when 2007, 2008 came along--

Bill: Real quick, when you say the venture space, do you mean the Venture Exchange or do you mean the venture capital?

David: Venture capital.

Bill: Okay.

David: So, 2008 came around, and the two guys I was working with at the time were 55 and 65. Where I'd spent a lot of my time from 2003 to 2007 was on Venture Exchange listed technology companies. Because what we saw was coming out of 2000, there was a bunch of companies that went public in 1999, 2000, they went public too early, and then they were just absolutely orphaned. An investor wouldn't even call them every three years. Which meant the prices were dirt cheap. There's one company, Gemcom software**,** and I remember it was doing $20 million in revenue, I think it was a million dollars of free cash flow, had about $4 million in the bank, trading it like a $4 million market cap and growing at 20% year over year. It's an absolute no-brainer.

Bill: Wow.

David: So, I was following a lot of these small public companies, and what I saw-- The people in the venture space in Canada, they always turn their nose up to the public companies. There was a bit of disdain. Meanwhile, they're paying $100 million for some guy's idea, because they thought they're the next Mark Zuckerberg. I'm like, “Well, I'd way rather pay $5, $6 million for these $20 million business that's kicking out a million of free cash flow growing to 20%.”

Bill: Yeah, that's actually working today.

David: Yeah. You guys do you.

Bill: [laughs]

David: So, we've started to build a pretty good track record in that small public tech space, and in 2007, 2008, I went to Kelly, who's our chairman, and I was like, "Hey, I want to start a small cap hedge fund." He's like, "Oh, okay." So, I was thinking of leaving Pender. The next morning, he came back and he's like, "Do you want a partner?" For me, I'm in Vancouver. There's not a lot of infrastructure out here, and to have Kelly and Bill, 55-, 65-year-old guys at the time, who were venture capitalists. What they love doing is they love financing and helping build individuals who are trying to build companies.

Bill: That's cool. So, you were their venture investment.

David: Yeah. They are two great guys, I knew them and trusted them, and they provided capital and help and experience, and Kelly was active in the business till about 2015, and is now our chairman. Yeah, that was really the foundation towards in 2009, when we launched my small cap fund.

Bill: Huh. That's a very cool story. That's nice that you didn't have to go outside of what you already knew in order to accomplish a goal and be able to stay partnered with people that you respect. It's a good way to spring load your starting conditions, as someone that I know said once.

David: Yes. I feel very fortunate to have had that opportunity.

Bill: Yeah, that's cool. Well, then all you had to do was execute.

[laughter]

Bill: Just make sure not to mess it up.

David: Yeah. Great idea. Just don't mess up.

Bill: That's right. What do you think makes you so successful? When I think about you, I like the framework that you look at. The presentations that you have pitched and made even once that I think are maybe a little bit underloved in the deeper value type names, I always think you're thinking through skew, and I always think that you're really passionate about what you're talking about, and I think that you're always willing to go in places that others aren't looking now. Maybe that's hyperbolic, but that's at least what I've seen from the pitches. Do you think that there's a thread or something that you do uniquely well that has enabled you to succeed for so long?

David: It's kind of you say that, Bill. I think--

Bill: Well, I think, John thinks it too, man. You have a high profile on that community, and I don't think he does that lightly, and I think you warrant it.

David: I think it boils down to this woman I met in business school, and her name was Rebecca Langstaff. Here I am in business school, I move out to Toronto, and all these super aggressive, 90% guys, everybody's so smart, and I'm in class, and I'm listening to this Rebecca talk. She was an artist, did a fine arts undergrad degree, and people were like, “What's she doing here? Blah, blah, blah.” She was lights out the smartest person in the class. Probably one of the smartest people I've met in my life. Right away, I'm like, “This artist is getting accounting faster than me.” So, it's just like, “Okay, there's people way smarter out there than me that--" and then the rest of the class, it's all these people who are working 100 hours a week, and just they've been thinking about it every day, since they were like 16 years old, and I'm a failed doctor for crying out loud. It took me a while to figure out what I was going to do.

It’s whenever you're looking at something, always knowing you're probably wrong. I think that just leads into making sure the probabilities are skewed in your favor, because investing is probabilistic, and when you know you're probably wrong, you’ve really got to make sure the probabilities are in your favor. It resonates a bit with what Munger says where it's like, just avoid stupidity. So, if you can avoid doing something really stupid, which hopefully I've avoided so far-- I've done some stupid things, has left too much damage in the portfolios fortunately. That's terrible. I don't like talking about myself, Bill. I'm sorry.

Bill: Okay, well, I apologize for making you do it, but--

David: That was a really uncomfortable ramble.

Bill: I don't know. I don't think so. You know what's funny is-- well, I know that I and I think that some others have-- I approached life from “I’m right” for far too long, and then once I realized that I wasn't right, I started to realize how wrong I actually was. Now, I'm terrified even in the things that I think that I'm correct about. I have been able to be like, “All right, well, I'm probably wrong, and I just hope I'm not the idiot at the table.” I think that a lot of the conversations that I've had with people over the past year, as I've grown into more of my own investor that I'm proud of, has been this struggling with imposter syndrome, and being like, “Man, I don't even know if I belong at the table with the people that I talk to.”

I think that's a common characteristic among the people that I really look up to. I don't think that there's too many people that I really look up to that have been like, “Yeah, I'm the shit, and I've always known it.” Almost all of them have said things like, “I'm not the smartest person in the room when I'm in rooms,” or, “I assume I'm incorrect.” I think that's a very healthy attitude. I think it's probably necessary to longevity in a risk-taking business. Because otherwise, I think it's too easy to bet big on the wrong bet.

David: Yeah. They've written books about that. [laughs]

Bill: Well, Bruce Berkowitz always used to say, “The thing that's terrifying is it's the next bet that's going to kill you.” I don't know. I'll let him talk about his own experience, but I think that's an interesting case study.

David: Yeah.

Bill: Enough said on that.

David: [laughs]

Bill: [laughs] So, what do you want to talk about, man? This is a two-way conversation. I don't want you to feel like you just have to talk about you, but I'm really happy that you're on here. So, I'm down to talk about anything you want.

David: Yeah. That question is always difficult, Bill, on the investment success we've had, and I think for us, the most important thing always is to be principles based in our approach, and I think everybody's always looking for the magic formula, and the world's changing. It's always changed. What worked in 1900 didn't work in 1920, didn't work in 1950. The more you can focus on the principles for success-- and I view value investing as a principle. For us, the principle is, understand the value of a business or a security, and buy it at an appropriate margin of safety. It doesn't mean buy shitty broken-down industrial companies at liquidation value. Nobody ever said that. It's always just assess the quality and what the value of the business, and get it at a reasonable price.

There's a lot of other principles that come into play as well. It's looking for companies with big TAMs. The things that always change though, are how are companies going after like, what are the products, what are the services they're selling, because that's always changing. I remember in the mid-2000s early part of 2010, 2011, 2013, before SaaS companies started getting excited, Buffett came out and said, “I don't invest in technology companies, because I don't understand them.” That's a great statement for him to make. He understands his circle of competence. He's got so many opportunities outside of technology, he doesn't need to go there. But what I always found interesting is there was a whole bunch of value investors out there, and they're like, “Oh, yeah, Buffett said, don't buy technology companies. Because if he can't understand them, then I'm not smart enough to understand them.” That's not what he was saying at all. He was just defining his circle of competence, and he's playing so many levels ahead of us. He probably was saying that to give himself some bias on if he says it publicly, then he won't go out and buy something even though he's tempted to, because he knows he doesn't understand it, or he may not understand it as well as he thought.

But Buffett's always preached principles. I think that gets lost a little bit when people are looking for a formula, or an easy way to make money or what's the system we're going to use right now to capitalize on this market. The wonderful thing about a market is it's almost a biological system. It's always changing. New entrants are coming in, there's new competition, the world's growing, the world's changing, people change. So, it's really focusing on the principles, which is what we always try to do. Bringing our investment process back to first principles and is it applicable to what we're doing today.

Bill: How much of focusing on principles if you had to weight it? I know it's not a science, but is model driven versus qualitative driven, how do you integrate? Obviously, they're interrelated, but I'm just trying to get a sense of how much of what you do is hard model-driven principles versus softer stuff.

David: Yeah. On the closer discount situations, it would be way more valuation price driven. It’s way more quantitative. On compounders, it's about 40% to 50% valuation driven, price driven, quantitative, and then 50% to 60% qualitative factors. So, when we're assessing the weighted IRR of any of our companies in our portfolio, 50% to 60% attributed to qualitative factors. We're spending the majority of our time on that 50% to 60%. I think a lot of the quantitative stuff, if can't get it off Bloomberg now or do it pretty quickly, you probably shouldn't be in this industry. So, it's spending your time on the qualitative stuff. So, even though, it's about 50% to 60% of the compound or input, it's a way larger percentage of our output time.

Bill: No, that makes sense, because I think that's where the real insight comes from, and that's the stuff that actually, the numbers start to mean something. you have to understand that stuff in order to make the numbers mean anything. Otherwise, you're just throwing numbers on a board. I think for a while, I was so concerned with buying something cheap-- Flashing back to your broken-down industrial comment, that I totally underweighted, and Rishi is somebody that has helped me get this out of my head. But the agency costs associated with those kinds of situations, and then the other thing that I totally didn't understand is just how expensive it is to liquidate something.

Thankfully, I've gotten less ignorant over time, but I think some of the books, when I read the words on the paper, I didn't understand what they actually meant. I think as I'm starting to understand them a little better, I'm realizing how much more important the qualitative stuff is than I ever appreciated before. Also, the people behind things. I don't understand the idea of not talking to management or other investors about things. Now, I'm not saying that everyone needs to talk to those people, but for me, I need to talk to other people, because I need to be able to triangulate who to trust, who not to trust. That's just how I have to do things. Obviously, the risk is you get sold a story that you shouldn't have believed, but I don't know any other way to-- That's the risk I have to take.

David: Yeah. Whenever you talk to management, it's always risk you have to take. It's interesting, when you look at larger cap companies though, you're probably going to get a way smoother CEO, who is totally talking on point, and is going to communicate to you exactly what they want you to know, and try to influence you and they're probably very skilled at it. Whereas, in our neck of the woods, when we get in the smaller companies, a lot of CEOs, they're just running flat out trying to build their business, and they're just going to have a really authentic conversation with you about their business which is great, because then they end up getting shareholders that understand their business and want to support them.

The truth is usually somewhere in the middle, when you're talking to a CEO, you've got the person who's fully transparent, the person who's trying influence you to buy their stock or sell you a bag of hammers, and it's having the filters to try and differentiate, which is which can avoid you from the heartaches out there.

Bill: One thing that I would think would be tough about this space, and I see it in other tech companies too is if you have that CEO that's passionate and can talk about the business, what do you do when that CEO turns over, and you're long, and it's like, “Okay, well, now--?" Are you typically involved in some of those discussions? The one that's ringing out to me right now is there's a founder of a tech company that just left and it's like, “What do you do in that scenario?” Because so much is bet on the founder, but then at the same time, he or she isn't everything in the organization. So, managing that turnover has got to be an uncomfortable time or uncertain maybe is the is the best word. I don't know.

David: Yeah, it depends.

Bill: Yeah. This is the art of it all, right?

David: Yeah. We've watched a lot of companies grow over the years, and if you look at a tech company, a lot of the really successful tech companies, the founder is someone who totally nails product-market fit. So, they're the product visionary, the champion. That's what you need to get a company started. You need to get that nailed, and then get some customers, start getting cash flow, and then start scaling up. At what point does that founder either lose the capability or the interest in continuing to scale the company up?

So, that's when you get into, is it voluntary, or is it involuntary? Then, it's the assessment of the how robust the process was it bringing the next person in. So, then you have to look the new person coming in, and then the dynamics come into play of, well, how much has the founder really stepped aside, are they still on the board, do they have a relationship with the incoming person? We kind of mentioned Stitch Fix, founder stepped aside as CEO, but they've been nurturing an incoming CEO for a while now, and they've worked together. So, they clearly feel they have a good fit, and allows founder to focus on product and special projects, which is totally their passion.

I get it. At Pender, we just hired a president, because I’d way rather wake up every day finding a new stock to invest in or talk to you about investing than figuring out how to continue to support the growth of Pender. So, we're doing our own transition as we speak, and what's been very interesting from my perspective with it all is, we've been the outside observer watching other companies through this transition. You know all the pitfalls, you see how things go wrong, and so when I'm going through this process, I'm like, “Am I the founder just saying this, and actually doing this?” There's so much self-reflection that goes on, but we've seen so many companies do it well, and so many companies do it poorly, so hopefully, we've stacked the probabilities in our favor that we've done it very well. But check in in a couple of years, we’ve got a great candidate, so I think we probably did.

Bill: I also think that being able to step aside and to say, “You know what, this is what I actually want to do. I've gotten a company to this point. Now, rather than be the quarterback, maybe I need a good quarterback, because maybe I don't want to be quarterback anymore.” That's a sign of leadership, there aren't that many people that are willing to step aside, and maybe sacrifice some prestige and title for the betterment of an organization, and to better their lives. Some people probably just don't want all of the pressure for their entire life. So, understanding how much of that's reality, how much of that's just a story is real key.

David: Yeah.

Bill: I could see that. That's cool.

David: Yeah. That's fine. I've driven much more by happiness than I am by power and prestige. So, the more I can do to structure my day to do the things I want to do the happier I'm going to be.

Bill: It's probably a pretty good lesson for people to drill into their heads.

David: [chuckles]

Bill: I find this among a lot of-- and I don't mean to say value investors, because I don't think that's fair. I'm sure that there are-- who are at some firms that people really respect, like Polen Capital. I think some of these growthy guys, WCM, those guys, value encompasses them when I'm saying this at least to the extent that I understand. And really, within Manual of Ideas, I've seen an abnormal amount of people that say things similar to what you just said, that they're not-- They're driven by the enjoyment of the game more than what they actually get out of it. I think that's a cool community to find myself in the middle of. I don't quite know how it happened, but a lot of it tracks back to Berkshire, and then a lot of it tracks back to John and Manual of Ideas. It's just been great.

David: Yeah. Well, you're a part of that community, because that's who you are.

Bill: Yeah.

David: I remember-- just go back that first time I met you, and all you wanted to do is talk about stocks. You loved it, and here we are today.

Bill: My wife doesn't like that's all that I want to do.

David: [laughs]

Bill: This is true. [laughs] Sometimes, I think she's like, “You know, we do have anniversaries and stuff that would be nice for you to pay attention to,” which is a fair criticism. But I'm also the person she married, and I have been since she married me.

David: Yeah, it's a lifelong journey. We all know we got into.

Bill: That's right. Well, man, do you want to talk about anything else, or you want to wrap this one up? You can always come back on, and I'm happy to keep chatting. I don't have an agenda with these things, and I like how that last segment ended.

David: Yeah. Well, why don't we just leave people wanting more? This has been so much fun.

Bill: I like it. I like it very much, and I do appreciate it. How can people get in touch with you and find you?

David: On Twitter, I am *@PenderDave*. Easiest way to reach me since I'm totally addicted to Twitter. Disclosure, I'm so addicted, I had to go buy the stock last year.

Bill: I am in the same boat, although I paid more than you did unfortunately. But I hope that we both work out okay on that. I will tell you, man, I had to really adjust how I've been using it. It's been a weird year. We were talking about it a little bit before, but going from really nobody-- I'm still nobody. Don't get it twisted, but 18 months ago or whatever, nobody knew who I was, and then Toby put me on and that was awesome, and then the whole deal with Robinhood really raised my profile in ways that I wish it didn't. But it's one of those things, I'm still not sure that I processed everything that's going on. I think that some of my potential Twitter addiction has crept into my sleep and stuff. I'm going to need to revamp how I interact with the platform so that I can live a long and healthy life, and not just the dopamined crazy ones.

[laughter]

David: Yeah, I-- [crosstalk]

Bill: But I do like it. It's a hell of a place to meet people.

David: Yeah, I could just imagine what your DMs look like. I've taken the extreme step of deleting Twitter from my phone every now and again so I can't actually access it, except for when I'm at my computer, but I generally give in and reinstall it.

Bill: Yeah, I think less on the on the phone is huge. My DMs aren't so bad, unless I do something that-- I interviewed Preston Pysh, and I knew that would tick off some of the listeners. I apologize if you still listening and I ticked you off, I'm sorry. But part of the reason that I did that was, I really respect the call-- that took a lot of courage for him to make the call that he made. I don't really have a view on bitcoin. It's cool to me. I like that other people like it. It's interesting, because it's interesting to me, but that's as far as it goes. I don't need to be the bitcoin arbiter of truth. I guess that what I need to be better about what this podcast is saying, I understand that you wish that I had asked different questions, but that's not my podcast. I'm not interested in the intrinsic value of bitcoin. That's not even the conversation I wanted to have, and I had the one I wanted to have, and I hope that you'll stay with it. I guess that what I need to be more healthy about is, realizing that some of the feedback is people trying to help, and not necessarily people coming at me necessarily. I think that's been the one thing that I probably need to improve on. I don't know that you asked that question. That's just something that I've noticed.

David: Yeah. Well, the reality is you're having some fantastic authentic conversations. I love listening to the pod, and they're going to take the direction they are, and I think you're going to have some upset listeners as a result, because people--

Bill: [laughs]

David: There are some opinions expressed on this podcast, and-

Bill: That's true.

David: -I think the great part is, I don't agree with all the opinions on here, but you have to have an open in mind and listen to them, and understand where you may be wrong. The only thing you take away from Preston's podcast is there's 21 million bitcoins, and it could be worth $100 trillion market. I mean, there's a right tail skew that is worth thinking about for more than 10 seconds. Don't just dismiss that, think about that, because if it does play out, there are some tremendous opportunities, and we were talking about envy earlier. Be forewarned there may be some envy kicking in if what Preston says is potentially true. So, just do some-- Sorry.

Bill: The thing that's crazy to me too is there are some people that still write me, and they're like, “Well, he's not right.” It's like, “Okay, look. I understand that you say his version of where the world may not be right today.” He was buying in 2015, over six years. That's up 200x. We're still going to argue over whether or not that, even if it's wrong, there's something to learn from that. There's something to learn from identifying hugely asymmetric upside opportunities where maybe you don't have to be right for the precise reason. But you can still make a lot of money. I'd rather be wrong and rich than right and begging for a rerating somewhere, that sounds horrible. So, that's why I wanted to do that interview. I don't know. I just need to be better about saying, “It's my show. I'm sorry if it upsets you.”

David: [laughs]

Bill: Because I'm not trying to upset anybody. You know what I mean? I'm trying to have good conversations. It's coming from a good place.

David: Absolutely. Yeah. There will be opinions. There will be upset people. I think if you could just-- when you get all that negative feedback, can you please let me know, because that's probably I'd like to take the other side of that trade. When people are just that passionate about stuff, and all that can't possibly be right, that means there's probably something to it.

Bill: Yeah, well, that's the Adam Robinson thing. Things that make no sense, and things that are blatantly obvious are the places to play. I really liked that thought. That was one of the core thoughts that I wanted to explore with him. There's some questions that when I listen to these, I wish that I could follow up on and have a different question path. But part of what makes it good, I think, is that it's not scripted, and the cost of being unscripted is, there not going to be perfect in retrospect. But I like how the conversations weave. So, I'm not going to change it.

David: Yeah, please don't.

Bill: Okay, I won't.

David: Well, I feel like we're at a con-- when I'm listening to your podcast, I feel I'm at a conference and getting to know these people alongside. I think that's a great takeaway, because it helps and in a world where it's hard to build relationships, you can get to know people.

Bill: Yeah, that's right. A lot of the times, it's about the people behind it. Whatever we talked about today, go back and listen to the whole thing, but what I know that I can tell people is, I think you are a high integrity individual that is doing something different than the other guests in a different geography than I'm used to, and I think that you're somebody people should at least listen to and get to know. That's the only promise. That's it, and hopefully it's enjoyable for people to listen to. But I think sometimes managing what I'm going to have to manage going forward is, if somebody is on the podcast, that doesn't mean it's an endorsement of what they're saying. I don't necessarily agree with everything, but I'm also not going to be a huge dick to somebody if I don't agree. I'll try to push back a little bit, but I'm okay with just leaving something out there that I don't have to fact check. On the other hand, I'm not trying to just like sow disinformation or whatever.

David: [laughs]

Bill: So, I don't know. It's going to be an interesting needle to thread going forward.

David: Yeah. Well, I'm sure you do a great job handling it, as I'm sure you'll do a great job handling the growth of the Brewster media empire. I'm looking forward to that, continuing to follow along.

Bill: Well, I appreciate it. We may need to SPAC this thing, so I can have a liquidity of it.

[laughter]

David: I love SPACs.

Bill: Yeah, they're pretty interesting. I've gotten-- That's another thing that came out of this pod. There's a lot of things that I used to look at and be like-- a SPAC is a great example of something I used to look at and say the founders are out here looking to rake people over the coals. I don't disagree that the founder shares are very, very cheap in SPACs. I have started to understand why SPACs exist, and why companies are going public via them. Like everything in finance, there's going to be bad outcomes and good outcomes, but just I used to dismiss them all. Now, I'm looking for SPACs that are trading close to trust value where the warrants are going to separate. It's like, “Okay, well. If they can do an interesting deal, maybe that's asymmetric upside for me.” If we're close to trust value, I don't have much downside. Famous last words.

David: Nope. I totally agree. SPACs, there's a lot of fundamental investors out there that just they can't get their head over the fact that there's those founder shares there. They find it so egregious that they won't touch it, and they'll get all-- I bet if you had a bunch of SPAC guests on here, you’ll get a whole bunch of your listeners upset that you're promoting SPACs.

Bill: All right. [laughs]

David: Oh, yeah, all hot and bothered. But if I could buy a SPAC at five bucks, I'm going to do it all day long.

Bill: Yeah.

David: Because I'd just wait for a transaction, and then I'd vote against, I double my money. That's a great investment. Similarly, I think what's changed in the SPAC universe to your point, Bill, is the quality of companies that used to go public via SPAC were somewhere between garbage and [beep] Now, there's a higher, way higher quality of company going out there with some of the promoters and founders who are putting these SPACs together. So, there's some high-quality businesses coming public via SPAC, so what we know from the SPAC experience the previous 10 years, it's actually different. Then, from a probabilistic standpoint, if you're buying it at 10 bucks, and sell the stock, get the warrant, **[unintelligible [01:36:35]** a good deal, you got very limited downside and a whole bunch of optionality. That's a good bet.

Bill: Yeah, that's how I'm trying to think through it. Especially for some of the excess cash that I have in the portfolio, because I almost look at valuations generally, and I hate to be one of these guys, but I don't know that there's a huge amount of opportunity cost to tying up some capital if you're somewhat near trust value and have limited downside. I'm just not sure that that's not a good bet right now, so I'm placing a couple of them, or I guess I should say it more affirmatively, I think it is a good bet, so I'm placing a couple of them. We'll see how it all turns out. Until then, thank you very much for stopping by Dave, I appreciate it.

David: Thank you, Bill. Looking forward to doing this in person soon, when we can travel again.

Bill: As am I. Indeed, indeed. Take care of yourself, and until next time, thank you.

David: Take care, Bill.