ANANDA
ASSET MANAGEMENT

LETTER TO ANANDA INVESTORS
OCTOBER 2019

#1

"HUMANS"

Dear Fellow Investor,

It was one of those peaceful summer nights in the beautiful Vendée countryside. On the terrace, chatting with our 13-year-old daughter, we watched Arthur carefully mow the lawn. I think it was this vision of Arthur – a Husqvarna electric robot – moving effortlessly across the garden, working 24/7, rain or shine, which drove Chloe to ask whether robots would one day replace humans. She did not expect to hear that as far as her Dad's industry was concerned, this had already happened!

In this very first letter, we will discuss the fantastic growth experienced by passive and quantitative strategies over the last 20 years. Review some possible implications for financial markets. Discuss Melrose Industries plc, a stock which quantitative strategies are heavily short, and which we really like. And share with you our conviction that despite our human flaws, robots are not necessarily bad for us … in fact, we view them as some of Ananda's very best friends.

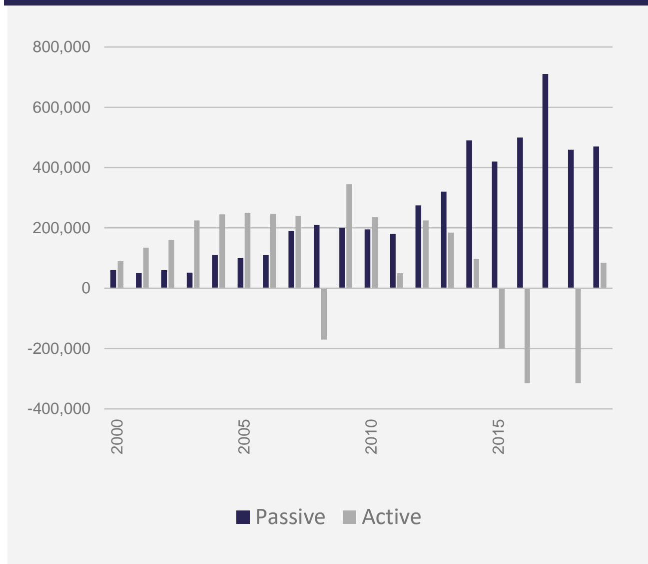
Looking back over the last twenty years. Financial markets have experienced two dramatic changes. The largest has to be the unprecedented level of market intervention conducted by central banks around the world and the enormous impact it continues to have on capital allocation decisions, the structure of societies, and even on our daily lives. We hope to delve into this subject in a future letter. But today we will focus on the second big change (at least for us market participants): the adoption of passive and quantitative trading strategies by an ever-increasing number of investors.

The long-term implications and the degree to which these changes will be permanent is a fascinating and uncertain subject.

The current situation at times feels unsustainable – Michael Burry (of Big Short fame) is even on record describing passive investing as the next bubble. Yet it is impossible to imagine a future without these technologies which have considerably reduced holding costs (passive) and proven their ability to generate attractive returns (quantitative). One thing we do know: the rise of passive and quant trading strategies, a mixed bag we will affectionately nickname "robots" in this letter, offers patient investors some of the best and most unusual investment opportunities in recent years.

Putting numbers around the phenomenon is more art than science: definitions vary and markets are fluid. It is generally considered that in developed markets, passive assets (those following a predetermined rule, say for example an ETF mirroring the S&P 500) have grown from 5 per cent of global assets under management ("AUM") in 2000, to close to 50 per cent today, enjoying significant net inflows in each of the last five years, whereas active funds have seen net outflows in three of those (see Figure 1). This explosion in AUM has been embraced with all the ingenuity the financial industry is capable of: ETFs now come in all shapes and sizes. So much so that someone wanting to invest in the US markets today has more ETFs (circa 5,000) to choose from than the actual number of listed equities (circa 3,700). That is a lot of choices. And because most of those AUM are concentrated in ETFs replicating indices of which the most popular are weighted by market capitalisation, these robots tend to structurally follow consensus. They buy more of the large and popular companies, ignore the small, and sell the unpopular companies as they exit the indices. The contribution to momentum by passive AUM is significant given their scale, and probably a contributor to certain observed excesses. But at least it is not magnified by leverage.

Fig. 1:
NET AUM FLOWS ($m)



Source: Morningstar.

Which takes us to the other members of the robot family: quantitative strategies. "Quants" employ rule-based trading models as well as automated trade signals to manage assets, with clever computers responsible for the investment decisions rather than miserable, fallible humans. Quant hedge funds today represent a third of total hedge fund AUM (or roughly one trillion US dollars) and allocations have been growing 15 per cent per annum over the last decade. This trillion number, as impressive as it sounds, understates the impact these strategies have on trading flows. Quant equity funds typically employ sophisticated hedging structures and run with leverage ranging from 4x to 10x their investors' capital, trading their holdings anywhere between once a month and several times a day. Compare that to traditional long-only equity funds, typically unlevered and trading their holdings with much less frequency. The result of this huge divergence in velocity is that a single dollar of AUM run by a quant fund has the equivalent market impact of hundreds of dollars of AUM in a traditional long-only. A lot of those flows will end up netting each other out in a zero-sum game (less fees!). Still, hundreds of trillions of dollars here, hundreds of trillions of dollars there, pretty soon you are talking serious money. This is an awful lot of trading.

On a combined basis, the volume traded by robots – both passive and quants – probably exceeds 90 per cent of daily trading volumes. And this number still understates their true impact. The inherent reliance on momentum by many of these strategies in turn influences humans running highly levered portfolios (and who are therefore vulnerable to short-term changes in momentum and volatility), enticing them to mimic these flows. These robots are a persuasive bunch. No wonder *The Economist* calls them the "masters of the universe" (see Figure 2).

Fig. 2:
A GOOD TIME TO BE A ROBOT

Source: The Economist, October 5th-11th 2019 issue.

Let that number sink in for a moment: for every 10 shares traded of a stock, less than one is the result of a conscious decision by fellow humans. The other nine buyers/sellers don't suffer from our well identified biases. And boy do we have biases. One of the most interesting fields in the study of finance over recent decades has been behavioural economics. It turns out humans are not perfectly rational beings. Biases cloud our judgement. Chief among them the consistency bias – the unwillingness to alter previously held opinions. Which by the way is a reason we tend not to mention specific stocks in our monthly updates, despite demand: it is hard for humans to change their minds, and doing it publicly makes it harder still. That can be detrimental to decision making.

It is not all gloom and doom though, as robots have their own limitations. Quants have no qualms when it comes to trading, they have an uncanny ability to cut their losses and run their profits in a way we humans can only dream of. But when it comes to investing, and as the investment horizon lengthens, most of them are more emotional than a teenager. When they fall in love with something that is going well, no price is too high, no move is too big. And vice versa. Which makes perfect sense if you are not a human and won’t suffer psychologically from acting inconsistently, if you are never going to experience regret or remorse.

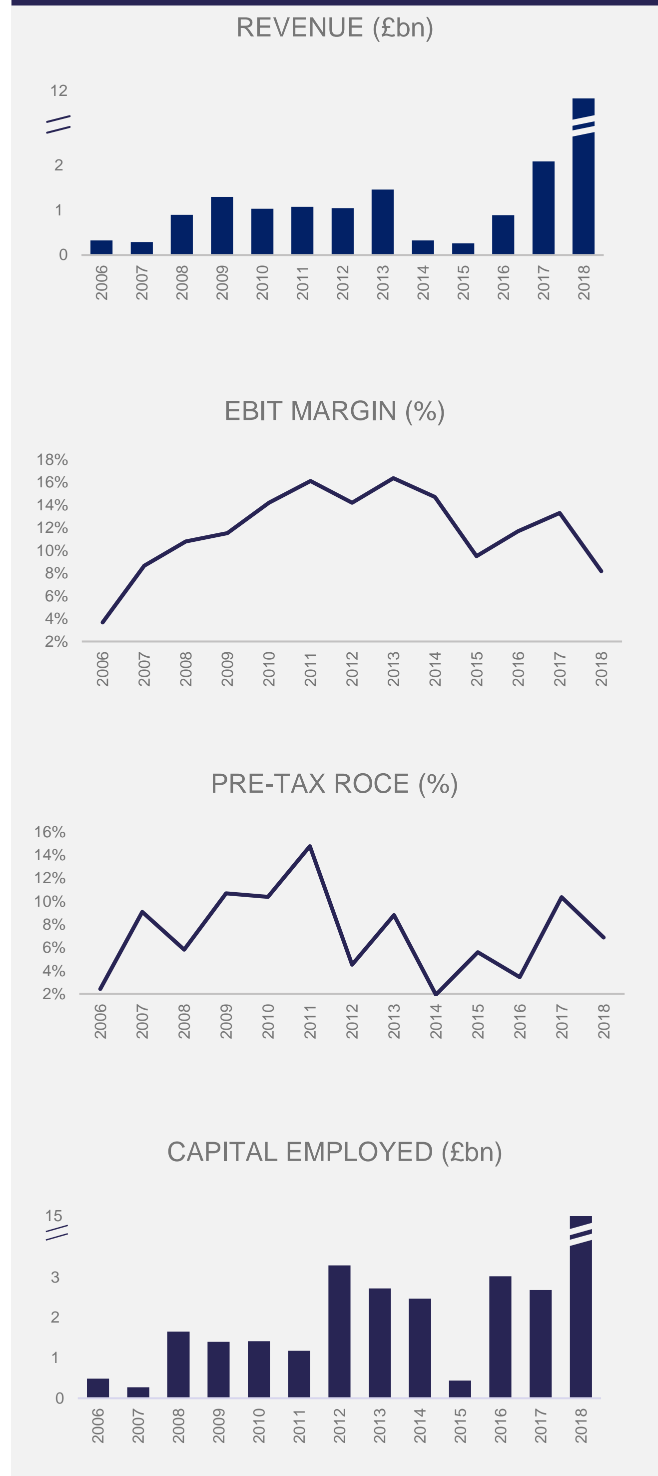
These dynamics create highly attractive opportunities for patient capital and have been a core driver of the way we have structured Ananda Asset Management, and how we design and manage the portfolio.

The last few years have produced abundant examples of trends pushed too far. Companies with positive momentum trading well above their fair value, whilst brilliant companies encountering short-term issues have been severely overlooked. We have observed a curious dislocation whereby the average volatility of indices has trended down, whilst at the underlying securities level, things have never been more shambolic. This creates an environment, theoretically full of opportunities to invest in attractive assets at attractive prices, and to exit or short positions at potentially irrational valuations. Simple. If only it was that easy.

And then there are some assets and situations which are difficult for robots to analyse. Take London-listed Melrose Industries plc (“Melrose”) for example. We currently have a long position and we are very excited about its prospects. Yet, Melrose has no fewer than five prominent quant funds on its short register. Put simply, quant funds have sold short the shares of Melrose, betting it is going to severely underperform the market, and that they will be able to buy back those positions at lower relative prices. Doing so they have created additional selling pressure, which has weighed on the stock price, potentially offering us a bargain. What are they seeing that we don’t?

The graphs (see Figure 3) show Melrose’s revenues, EBIT margin and pre-tax ROCE over time. They are all over the place. Revenues have sudden increases and crashes, rendering the historic growth trajectory meaningless.

Fig. 3:
MELROSE – FINANCIAL METRICS



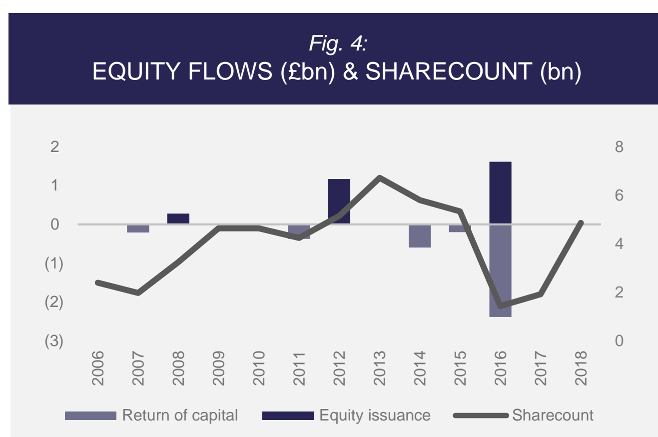
Source: Company filings and Ananda estimates. 2018 is a pro-forma number for the large acquisition of GKN completed in that year.

Even leaving aside 2018 as an outlier, the EBIT margin has been highly volatile and appears to have declined worryingly in recent years.

A high and stable ROCE is often an indicator of a high-quality business with a dominant position – in the case of Melrose it is even more volatile than the EBIT margin, and would appear to suggest that the company has been unable to scale down its capital base in the face of declining EBIT margins.

Looking at the balance sheet, things get even stranger. A company which goes through waves of debt issuance every few years, only to quickly repay it. A management team which returns large chunks of capital to shareholders, only to raise more equity a few years later. In 2016 they repaid and issued equity in the very same year (see Figure 4) – proper maniacs!

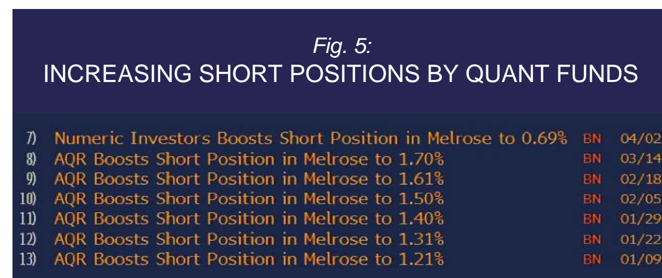
Fig. 4:
EQUITY FLOWS (£bn) & SHARECOUNT (bn)



Source: Company filings and Ananda estimates. 2018 is a pro-forma number for the large acquisition of GKN completed in that year.

Even ignoring the historical analysis (never a good idea!), Melrose today does not appear to be a very attractive business. It has bad margins, low returns and an increasingly indebted balance sheet at a time when the economy appears to be slowing. It is trading at a valuation which cannot be considered cheap at a trailing EV/EBIT multiple of circa 14x for a low margin cyclical business. No wonder the robots hate this company, and that one of their very best (AQR – the largest publicly disclosed short and a preeminent quant investor) is short 1.6 per cent of the outstanding capital (see Figure 5), or more than 50 days of trading, assuming 10 per cent of daily volume. Seen through the eyes of the robots, it is difficult to argue that investing in Melrose is anything but a very bad idea!

Fig. 5:
INCREASING SHORT POSITIONS BY QUANT FUNDS



Source: Bloomberg.

But what if the robots have it all wrong on Melrose? They say it takes two to make a market, and we love the company. We would even go as far as saying that we believe there has never been a better moment to own it than today, and that says quite a lot given the stock has compounded more than 22 per cent per annum since its listing (yes, compounding interest being the 8th wonder of the world, that is a respectable 23x return over 16 years).

Our history with Melrose goes back a long way. We have been fortunate shareholders in previous lives through several of its various incarnations. Founded as a London AIM-listed SPAC by four talented industrialists in 2003, Melrose is a turnaround specialist. To use their own words, they "Buy, Improve, Sell" industrial assets. Having implemented this strategy repeatedly, and with great success, they have established an enviable track record in transforming underperforming assets with a history of mismanagement, underinvestment and poor capital allocation. Melrose has bought and restructured six major businesses and exited four. Each business acquired has thrived under them. They follow principles we hold dear at Ananda: a mindset of ownership, a relentless focus on capital allocation, alignment of interest and accountability.

Under their management the exited businesses have seen their margins increase between 500 and 900 basis points, a relative increase of 30 to 70 per cent (see Figure 6). Needless costs are brought under control, loss-making and low margin divisions are closed. Interestingly R&D is usually increased but it is focused on projects with the highest return. At the end of the journey, Melrose sells a vastly improved business, typically at a significantly higher multiple than for which it was acquired, and returns the money to shareholders.

Fig. 6:
MELROSE – TRACK RECORD

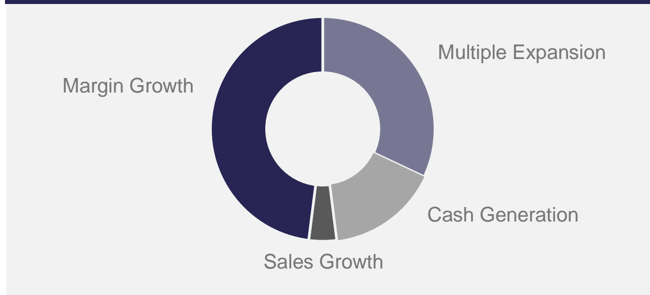
MARGIN IMPROVEMENTS

Company	Entry Margin	Exit / Current Margin	Delta	Increase
McKechnie	18%	24%	600bps	>30%
Elster	13%	22%	900bps	>70%
Dynacast	11%	16%	500bps	>40%
FKI	10%	15%	500bps	>50%
Nortek	9%	15%	600bps	>60%

Source: Company filings and Ananda estimates.

Remember those graphs which showed the highly volatile margins and returns, as well as the strange capital ebb-and-flow? These are not the hallmarks of a bad asset run by a hopeless management team, but rather the progress of successive acquisitions and successful restructurings done by all-star industrialists. What algorithms can't see is that the peaks and troughs in Melrose's margins are the very sources of the company's value, and the engine which drives value creation (see Figure 7). Melrose's average cash-on-cash return for the exited investments has been 2.6x. No wonder the stock itself has been such a strong performer. Those returns, which match the very best private equity funds, have been achieved without the benefit of leverage, by implementing simple (but again, not easy!) operating principles of transparency, accountability and calm, disciplined capital allocation.

Fig. 7:
SOURCES OF VALUE CREATION



Source: Company filings and Ananda estimates. Value creation in respect of exited businesses: McKechnie, Elster, Dynacast and FKI.

And wait, it gets even better! *(spoiler alert: for the humans)*

In 2018 Melrose completed their biggest investment to date (remember that big spike in the revenue and capital employed charts?) with the acquisition of GKN. Another company we have followed for years, but this time on the short side, given it was arguably one of the worst run listed industrial business in the United Kingdom.

* * *

A brief summary of GKN
– a defensible business, badly run:

GKN comprises three main business lines: Aerospace (35 per cent of revenues), Automotive (50 per cent) and Powder Metallurgy (15 per cent). Most of these activities are fundamentally good businesses, or at least have the potential to be so, and combined they now represent circa 80 per cent of Melrose's total group revenues. GKN occupies specialist positions in niche markets and provides real value to its customers. Margins today lag far behind all major peers. The company had lost its way, suffering under a string of short-term CEOs who pursued value-destructive M&A and chased revenues at any cost (so much so that the company spent c.£3.2bn, half its market capitalisation, on capex and acquisitions over the five years prior to Melrose's approach, and yet margins in 2017 were around the same level as they were back in 2011, below the low end of management's stated targets). Crazy as it sounds, more than 10 per cent of profits in some divisions were being squandered in loss making contracts. Factories directly competing against each other for external business were not rare. Their approach to cash management and investment could best be described as "spend and hope". Classic hallmarks of a culture without internal discipline or accountability, targeting increased sales rather than increased profitability and returns on capital.

Such a backdrop of disarray should provide Melrose fertile opportunities for margin improvement via internal changes without the need to rely on future sales growth. And these improvements will free up cash which can be invested rationally in high return projects.

Our internal research suggests the underlying GKN businesses have real potential. The Aerospace division supplies components to all the leading aircraft manufacturers. In an industry which supports high returns on capital and has significant switching costs – GKN's orderbook gives good visibility over future cashflows. In Automotive, GKN is the leading engineer of driveline products globally, supplying over 90 per cent of the world's car manufacturers with a circa 50 per cent market share. Secular shifts toward fuel efficiency, hybrid and electric vehicles rely upon ever more sophisticated drivelines. The Powder Metallurgy division is the global market leader and develops highly customised products as part of long-term relationships with customers. Historically, a disparate production footprint has been spread across continents and a disorganised approach to procurement and customer acquisition has resulted in SG&A expenses far higher than peers. A long list of issues, but all eminently fixable.

Melrose management are keen to fix things, and it is amazing what an able and properly incentivised team can achieve. A big factor in Melrose's success, and a core value at Ananda, is that generally you get what you incentivise for. GKN has been tangled up with ill-matched businesses, bureaucracy, and the simple fact that individual business managers were neither empowered nor incentivised to do the right thing for shareholders. Melrose is unusual in that it has a very entrepreneurial incentive structure, which explicitly benchmarks the return they deliver to shareholders over five years periods. If they do well, they get paid, and so will we.

At our entry point, in the 170s, Melrose had a market capitalisation around £8bn. Our estimates of the improvement potential indicate Melrose generating circa £1.3bn of EBIT in the early 2020s. Conservative multiples, and allowing for gentle deleveraging, result in an almost doubled share price. A very healthy annualised return. Ultimately the real test will be in the exit values that the management team of Melrose are able to achieve. This illustration would equate to a roughly 2x return on equity for the GKN investment, below Melrose's historic track record of 2.6x. A best case could see even higher returns being achieved as some assets have a strategic value, particularly if the business cycle is more favourable at the time of exit.

* * *

Of course, plenty could hit us at Melrose, and plenty probably will. Its current collection of cyclical assets does not make it a stock for orphans or widows. The coming economic slowdown will be a big headwind, even if it helps the management team execute their savings plans. Also, given the company was acquired via an hostile takeover with limited visibility, there could be skeletons in the closet. Although interviews we have conducted with management have been very reassuring on this point, especially considering they have now owned the asset for a full year. Finally, management could fail to deliver as strongly as they have in the past, it is after all their biggest ever acquisition.

But all things considered, we think quants – through their shorting of the stock – have offered us an opportunity to invest alongside a great management team, with interests closely aligned, in a business we know and like and which has tremendous potential, at a valuation offering a large margin of safety.

To come back to the unmatched ability of robots to change their minds. If our Melrose investment thesis plays out, the shorts will need to be covered, providing a first step in outperformance. This could have already started (see Figure 8).

Fig. 8:
DECREASING SHORT POSITIONS BY QUANT FUNDS

Source: Bloomberg.

Then, as the business fundamentals improve and the restructuring bears fruit, we expect the robots to join us on the long side. In fact, this could even push the stock price above its fair value if the momentum-driven robots get greedy. Imagine that: they would have sold Melrose to us too low, and bought it back from us too high. Whilst not quite a free lunch, that would not be a bad result for a team of imperfect humans – see what good friends we have in robots!

"We'll see what happens", as Donald says. It all sounds quite simple, but we remain cautious and vigilant: we have done this long enough to know it is never easy. We spend a lot of time thinking about this. How to create an environment which makes it easier to best do our job. It is a work in progress, one we hope to continuously improve over the years. But if we execute our overarching ambition at Ananda to build a stable team, to foster a culture of simplicity, radical transparency and accountability, whilst staying focused long-term on the process rather than the outcome… things will work out, eventually.

They certainly did work out for the talented management team at Melrose. And though this team may sound like one in a million, or this opportunity very specific, in this new era we are seeing a lot of crazy things.

Robots have created an environment rich with tremendous opportunities for patient capital. Patient will never be able to call the bottom, nor sell the peak. Patient will often be early, as frankly we probably are at Melrose. But it does not really matter. What does matter is an ability to think independently, in a structure which allows one to seize opportunities to buy assets when they are cheap for bad reasons and hold them as they rightfully rerate.

Technology has deeply impacted the way financial markets function; it is a very different world from the one which existed even 10 years ago. But one thing technology has not done is make markets rational. Quite the opposite, it has created new kinds of irrationalities. That is why we tap dance to work, why we find our job exciting and fun: and as long as there is irrationality in markets, in life, and opportunities like Melrose, you can expect us to be out there hunting, trying to take full advantage of it for you!

Thank you for your partnership,

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