RAVENSTONE
CAPITAL MANAGEMENT

Memo

To: Ravenstone Clients

From: Daymon, Adam and Paul

Date: Monday March 18, 2024

Re: Thinking and Acting Like a Business Owner

"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."

— Benjamin Graham

This memo was inspired by an incoming client call during a period of recent financial market turbulence. The discussion that ensued, centred on why selling equities and waiting for the dust to settle before reinvesting was a bad idea. He feared the market would plunge even more, given warning signals being sent by financial media at the time. With the benefit of knowing this person's stable financial position and long-time horizon, we proceeded to explain why short-term price volatility, while unsettling, does not concern us, nor should it concern him. Our resolve is deeply rooted in our conviction as minority owners in a collection of some of the best businesses in the world. Our client respectfully disagreed with our assertion and proceeded to challenge our "ownership mindset".

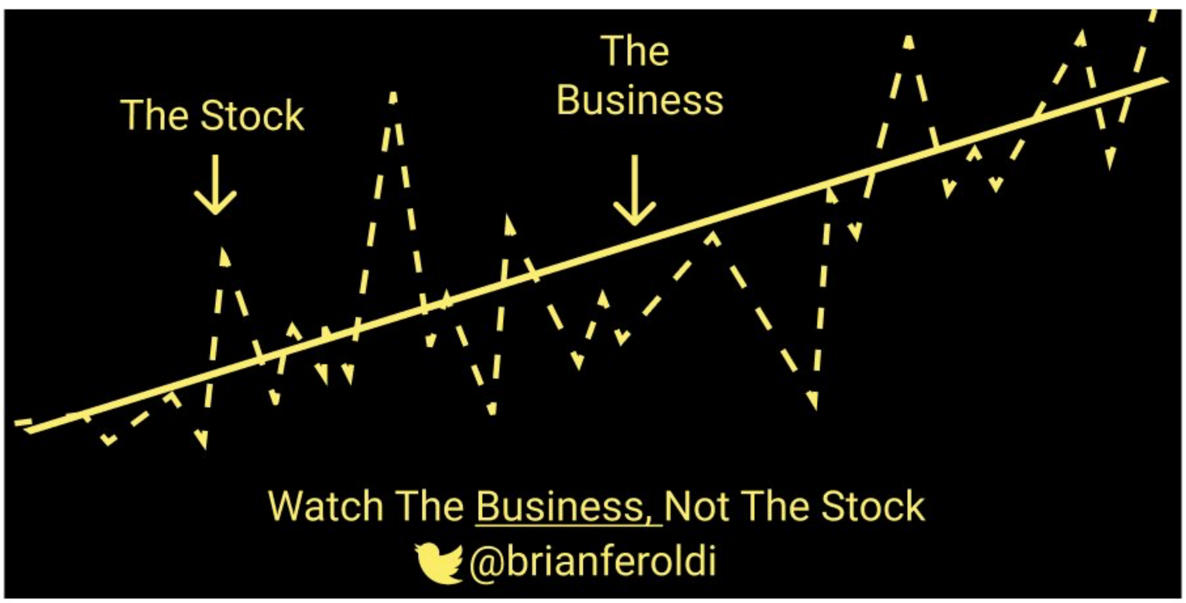
First, we think it's important to define risk. Modern Portfolio Theory defines risk as the volatility of price movement (statistically speaking; the standard deviation of returns). In other words, the more a stock moves up and down, the riskier it is. The opposite is also thought to be true – the less a stock moves in either direction, the less risky it is. It seems reasonable to associate price volatility with principal risk given the statistical explanation supporting Modern Portfolio Theory, however, we believe volatility and risk are not the same. Simply put, <u>our definition of risk is the permanent loss of capital</u>.

Volatility is a normal market phenomenon. In fact, investments that exhibit low to no volatility could be considered abnormal – lets face it, the business cycle is volatile and investment returns are anything but linear over time. It is worth noting, that since 2000, the S&P 500 has gained on average, more than 8% one month after a market bottom, going on to gain more than 24% the following year. Clearly, most market corrections have proven to be short-lived, and have been precursors to significant gains in their aftermath. Stocks are volatile. There is no doubt about it, but over the long-term they become more stable, while steadily producing cash flow and positive, real (inflation adjusted) returns. Accepting volatility as a normal occurrence and a temporary cost of growing your wealth, should help you stick to a plan and realize better outcomes.

Over the years, we have consistently articulated that our investment philosophy was born from Benjamin Graham's famous quote ***"investing is most intelligent when it is most business like."*** Stocks represent part ownership of a business. As a shareholder, you are entitled to participate in the economic returns of that business. At Ravenstone, we embrace an "ownership mentality" rather than the commonly held view that stocks should only be "rented" for the short term. This ethos guides all investing decisions at the firm.

There are several ways to behave like a business owner. First and foremost, business owners focus on the fundamental performance of a business. They favour criteria such as a healthy culture, revenue growth, profit margins, and returns on capital. They pay close attention to the relative stability of the business, the dependability of cash flows, and balance sheet strength. Economic trends, geopolitical news and media noise are secondary inputs to the extent they impact a businesses intrinsic value. Stock prices are never an input into their decision-making process.

Business owners focus on the long-term. They are not preoccupied by random changes from month to month or quarter to quarter. True business owners follow fundamental progress on an annual basis and monitor the development of their strategy over many years.

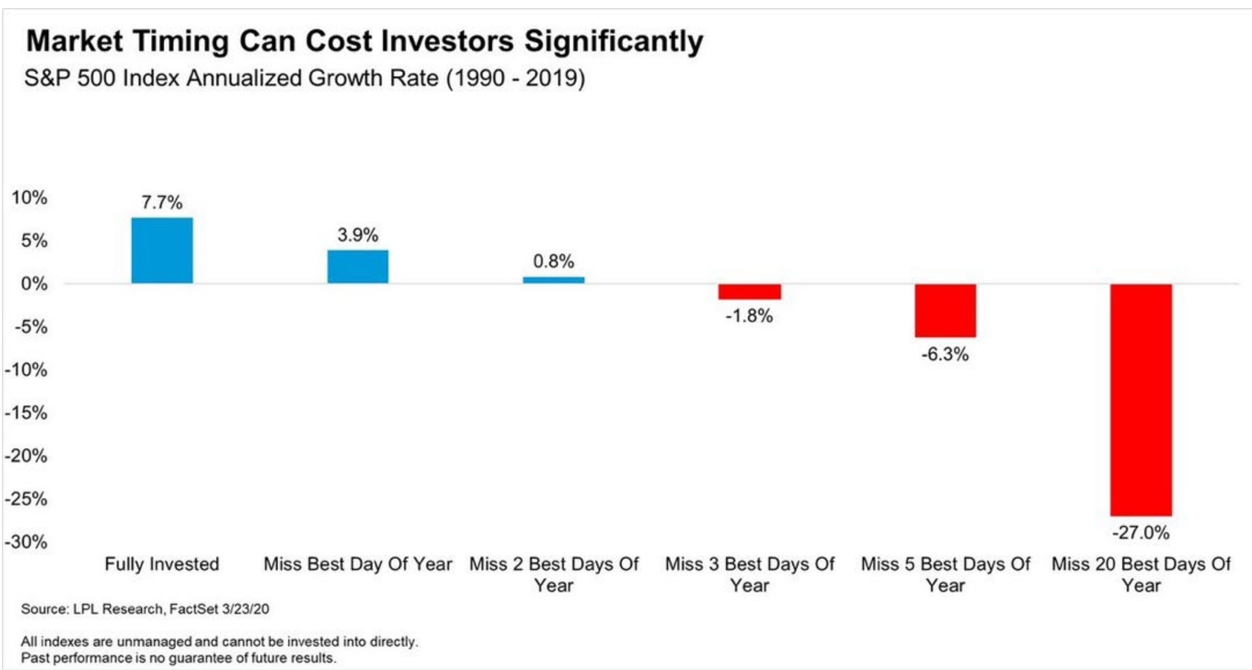


Palo Alto Networks CEO when recently asked about missing billings guidance for the third quarter 2023: *"I would not classify this as a short-term hiccup. I know you guys would love life that was linearly nice in quarters and moved up in a beat-and-raise percentage basis. I'm trying to get this done in the next three to five years."*

Sticking to an investment plan in today's world is a challenging task because of "information overload" we all experience daily. Humans have become increasingly vulnerable to being influenced by social media, online advertising and financial pundits obsessing over every data point and economic indicator. These comments tend to get our attention because they seem credible when seen on television or read about in the news. Having said this, track records of accurately forecasting financial and economic events is horrendous (at best). JP Morgan looked at the investment results of a handful of prominent "Armageddonists" the media flock to for thoughts on the impending disasters facing investors. They computed the missed returns by switching from stocks into bonds and/or cash based on these predictions; the realized underperformance ranged from 30% to 60%.[1]

A large part of our job involves not being swayed by such distractions. While current events of the day may seem consequential, they often have minimal, if any impact on reaching your long-term investment goals. We cannot control the world around us; however, we can control how we behave. People who claim to know why financial markets are moving and where they are headed next, are nothing more than educated guessers. It is likely that Mr. Market's mood swings are just that and nothing more. (Warren Buffet explained the concept of Mr. Market in the 1987 letter to Berkshire Hathaway shareholders - https://www.berkshirehathaway.com/letters/1987.html).

The key to achieving attractive returns is time, not timing. This concept is core to our investment process at Ravenstone. Studies have shown that people usually lose money by attempting to time the market as can be seen in the chart below.



Market timing, as it applies to long-only investing, is the activity of purchasing shares of a company (or "the market") before experiencing a positive inflection point in the business and then selling shares of the same company before a negative inflection point occurs. Doing so successfully requires not one, but two correct decisions; when to buy and when to sell. The challenge lies with being able to identify inflection points that largely occur in an unpredictable manner, making consistent and reliable forecasting practically impossible. When someone becomes increasingly

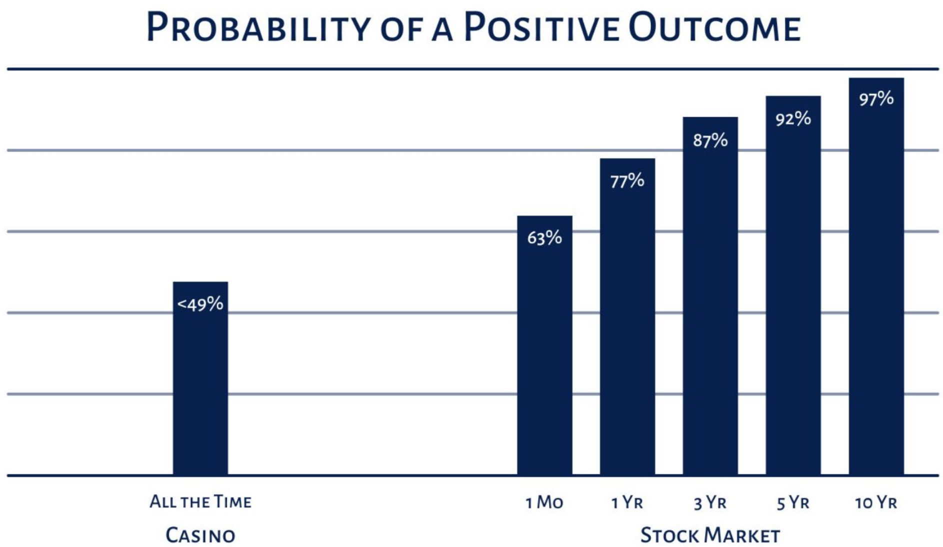
[1] (https://am.jpmorgan.com/ca/en/asset-management/institutional/insights/market-insights/eye-on-the-market/medical-complications/).

concerned about where stocks are headed, they get farther away from thinking and acting like a business owner and get closer to thinking and acting like a speculator.

Since 1984, independent investment research firm Dalbar Inc. publishes its annual Quantitative Analysis of Investor Behavior report. Each year, the study concluded, patient investors (the minority of the sample population) who embrace market volatility experienced more successful outcomes than those making ill-timed, emotional decisions. Interestingly, the average holding period for stocks is now less than a year, as can be seen in the chart below:

As investors, we find it difficult to reconcile this behaviour. The main reason we do not allow short-term thinking to guide our investment decisions, is because we are business owners – not renters. The stock market is the opposite of a casino, the longer you stick around, the higher the odds you win. Ownership is the key to protecting and building wealth. This famous quote best captures this concept: *"The stock market is a device for transferring money from the impatient to the patient."* [2]

[2] Warren Buffet



Having a plan that accounts for your temperament is the key to staying invested through difficult times. The right asset allocation match to your personality, will help you stay the course and minimize making poor decisions that compromise your investment objectives.

Most investors tend to be preoccupied by stock prices and macro indicators instead of business fundamentals. Another famous quote on this subject that comes to mind is *"Nowadays, people tend to know the price of everything and the value of nothing".*[3] Rather than reacting to stock price fluctuations owners prefer to focus on shifts in business fundamentals. Ultimately, it's the underlying economics of a business and its ability to grow that drive returns. As such, our investment research focuses on companies that check the following boxes:

- Leaders in their industry.
- Have a durable, competitive advantage.
- Have a history of growing revenues.
- Have a history of growing profit margin.
- Have a history of increasing cash flows.
- Must be capable of generating high returns on capital.
- Must possess a strong, resilient balance sheet.
- Must be led by a capable, shareholder-friendly management team.

Let's use a real time example to help explain. Behaving like a business owner and focusing on the business fundamentals, has helped us ride Microsoft to huge gains over many years. Microsoft has been a multi-bagger for shareholders who stayed invested, even as the share price experienced multiple bouts of significant volatility.

[3] Oscar Wilde

Microsoft revenues and earnings-per-share from 2013 to 2023

Year	Revenue ($bn)	Revenue Growth	EPS	EPS Growth
2023	211,915	7%	9.68	0%
2022	198,270	18%	9.65	20%
2021	168,088	18%	8.05	40%
2020	143,015	14%	5.76	13%
2019	125,843	14%	5.08	31%
2018	110,360	14%	3.88	19%
2017	96,571	6%	3.25	27%
2016	91,154	-3%	2.56	74%
2015	93,580	8%	1.48	-44%
2014	86,833	12%	2.63	2%
2013	77,849		2.58	
CAGR		11%		14%

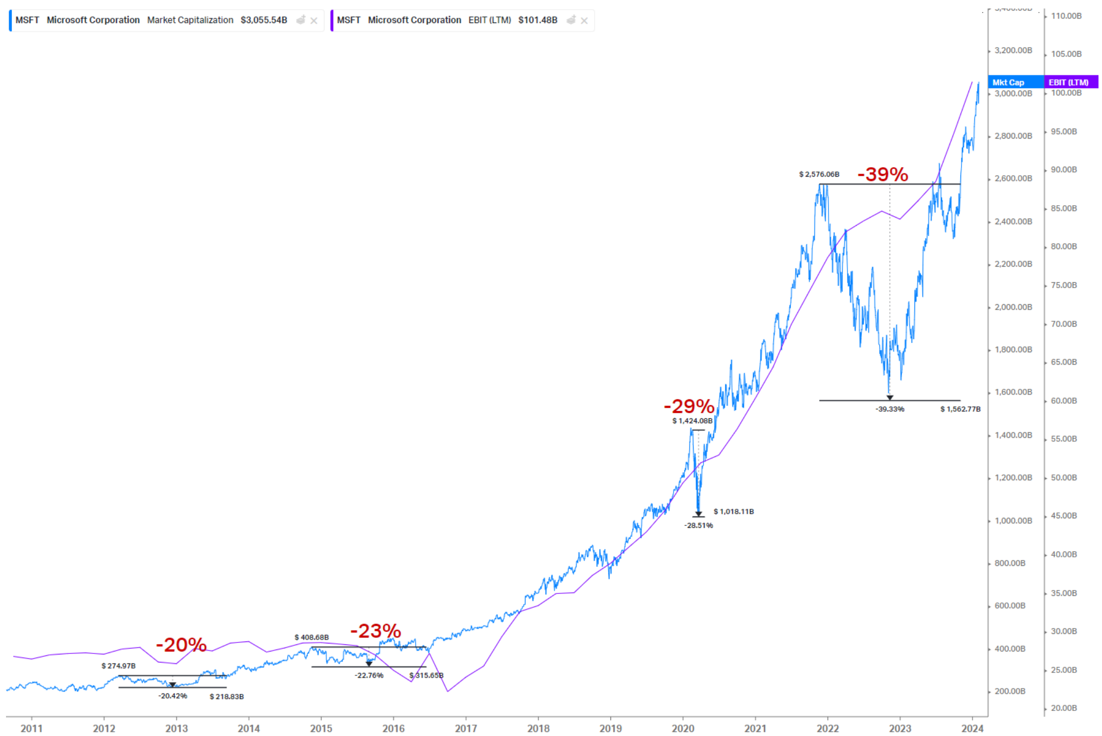
Ravenstone/Thomson Reuters Eikon

Over the past decade Microsoft has grown revenues almost three-fold, at an average annual compound growth rate of 11% to approximately US$212 billion. Earnings per share also increased at a similarly strong rate over the same time frame.

We first bought Microsoft, many years ago, when there was a long list of concerns – lack of growth, no plan for mobile phones, iPads to replace desktops, loss of market share to google docs, lack of innovation, etc. It is these concerns amongst others that contributed to a discounted valuation at the time. This is what gets us excited – a high quality business on sale. We started "looking under the hood" by initiating a thorough and exhaustive analysis of the business fundamentals. We felt Microsoft's dominance in its core business segment - productivity software (Office suite of products) was in an excellent position to continue growing and adding cash to the bottom line. Why? Because just about everyone uses their software. Microsoft Office products exhibit utility-like qualities (without the typical leverage of a regulated utility) that provide shareholders with consistent, growing cash flows – Microsoft is a "cash gusher". Our research also led us to determine the switching costs associated with moving core server workloads, the bread-and-butter of its Server and Tools business, left the company well positioned to grow with enterprise customers in the years ahead. At the time this represented most of the company's operating income. Despite concerns, Microsoft was still growing its revenues and earnings at a reasonable rate and was backed by a fortress like balance sheet. Within a few years, the company transitioned the business to a subscription-based model, became a dominant player in the cloud globally, and today is riding the trend in Artificial Intelligence (AI).

Microsoft owners, like us, who at the time ignored the noise and instead looked closely at the underlying business fundamentals, have been handsomely rewarded over the years. The stock price is up more than nine times. But it's entirely possible that many Microsoft shareholders didn't stay invested over the course of the last decade. That's because the journey wasn't anywhere near as pleasant as the thrill of arriving at close to a 10-bagger itself.

Over the last ten years, Microsoft's share price has fallen by 15% or more from the previous peak on thirteen separate occasions. Four times it has sold off by 20% or more, including its most recent decline in 2022. **<u>In the long run earnings is what really matters!</u>**



You can see from the chart above that prices move far more than earnings, mainly because of near term investor sentiment. Using the share price as an indicator of performance over short time periods would have been disappointing. Trying to avoid drawdowns and selling shares would have meant missing out on extraordinary gains.

Finding an excellent business isn't as difficult, as holding on to it over the long run. Investors, including us may be looking at the same stocks and have access to the same information, but most of them are unlikely to consider the same holding period as us. Time arbitrage is an edge in today's market. As long-term business owners, we are well positioned to continue taking advantage of this edge on your behalf.

Although, Buffett said the ideal holding period is forever, we don't just buy and blindly hold. We buy and continually verify. If a business is deteriorating, we will not hesitate to sell. When we make a mistake or if our thesis doesn't line up, we will also be quick to sell.

We hope you find this memo insightful. As always, please contact us at anytime with questions or if you would like to discuss this memo in more detail.

Sincerely,

Daymon, Adam and Paul