

Getting Comfortable with Discomfort

As value investors, we often have to make the challenging decision to buy and hold a business that is out-of-favour. When faced with the opportunity to buy shares in an unloved company, the easiest option can be to avoid it altogether – along with the criticism, stress and fear that can come with deploying capital into the investment. However, we recognize that these can be the opportunities that have allowed value investing to prove its worth over the long term. As Warren Buffett regularly reminds us, investors must *“Be fearful when others are greedy and greedy when others are fearful”*, if they want to build value over the long term.

We know that investing in these opportunities can cause discomfort for many. At Sionna, we emphasize certain practices so that we have clarity and peace of mind to actually seize them. Three of these practices include:

- Doing our own homework,
- Debating investment ideas as a team, and
- Building a culture of candor.

The first practice we undertake is to conduct our own in-depth, bottom-up research. We carefully assess each company’s financial statements and meet directly with its management team. We conduct our own fundamental analysis to help us establish a reasonable estimate of a company’s intrinsic value and do not rely on sell-side recommendations to value any potential investment. These sell-side recommendations tend to be indicative of how fearful or euphoric the broad investment community is at a specific point in time. They are not however reliable measures of a stock’s return potential, and are therefore of limited value to us. We believe the disciplined and unbiased perspective we have is far more effective on this point.

By gaining a deep understanding of a business and its management team, we become comfortable with investing in companies that may be facing serious challenges, but are trading at attractive valuations and large discounts to intrinsic value. To better understand individual businesses (and industries), we turn to Sionna’s Research Questionnaire, which guides our research process. The Questionnaire is broken down into 18 sections, each of which targets a different aspect of the business, including earnings quality, quality of management, and corporate governance. Each of the 18 sections is further broken down into a number of relatively simple, straight-forward questions. It functions as a sort of “checklist” to help ensure we do not overlook any relevant information about a potential investment. In Atul Gawande’s book *“The Checklist Manifesto”*, he argues that, contrary to intuition, checklists are exceptionally useful in a variety of industries since they allow for careful and systematic analysis. His evidence shows that pilots, doctors and investors can more creatively and successfully respond to difficult and stressful situations when they use a checklist as a starting point.

Specifically, with respect to investors he writes that, *“They improve their outcomes with no increase in skill. That’s what we’re doing when we use a checklist.”* We believe that the use of Sionna’s Research Questionnaire parallels his observations since it helps us make tough decisions that improve outcomes for our clients.

Another practice that helps us become comfortable with challenging investment opportunities is our team-based approach. Sionna makes investment decisions by consensus; we acknowledge that this process can often be lengthy, but we believe it results in far better decisions. When an investment idea is presented, the entire investment team critiques and dissects the research report: looking for what was overlooked, what risks were minimized, and what biases the author has brought. Collectively and individually, the team looks to find all the weak spots in the investment idea and ensure they are addressed.

An additional tool we use to further dissect an idea is the “pre-mortem”. As a group, we contemplate the myriad of factors that could drive a potential investment down to zero. Sometimes the results can be a little far-fetched, but overall we gain a better understanding of the potential outcomes and, hopefully, avoid failing to consider a sufficient range of possibilities. In the end, team-based decision-making increases our level of confidence in an investment idea since it heightens our awareness of the downside risks that may exist. We can invest with eyes wide open and not with our heads in the sand.

Going through this process can also be very difficult for the individual proposing the investment idea. The author must be confident enough to defend his ideas, but also open-minded enough to take in and reflect on the feedback he is receiving. When hiring, we specifically look for both of these traits, which in our experience are actually very difficult to find in an individual. As part of our hiring process, we have all potential candidates present a report to the team and experience our team decision-making process. We in turn observe how the candidate reacts and responds to the team dynamic. We have found this to be an excellent tool in determining whether someone is a good fit for Sionna.

Finally, we recognize that team-based decision-making does not work in the absence of candor. Without candor, our decision-making process would turn into a rubber stamping of the opinion held by the team’s most senior member. We therefore encourage candor in a number of different ways. To start, we do our best to take hierarchy out of the decision-making process. Ray Dalio of Bridgewater writes, *“There is giant untapped potential in disagreement, especially if the disagreement is between two or more thoughtful people.”* This potential can be lost when team members defer to seniority instead of being candid and willing to disagree. In evaluating any potential investment we always have the most junior person opine first, and then move up to the portfolio managers. This step is undertaken to ensure that the views of the portfolio managers do not influence the opinions of newer team members. We want to get their honest opinions and perspectives, and not simply have a senior member’s views

regurgitated. We appreciate how valuable an unbiased and fresh perspective is to the process.

We also rotate sectors from time-to-time to ensure we do not end up with a single expert on a sector who cannot be challenged. As a result, we have multiple team members who know a particular sector(s) very well, and bring their individual and differing perspectives to the discussion.

We need challenging investment decisions to be debated, picked apart and looked at from all angles. Without candor, there is no guarantee we will get our intended result.

By doing our own in-depth research, by debating and dissecting investment opportunities as a team and by building a culture of candor at Sionna, we gain the confidence and courage to make uncomfortable yet crucial choices. Some of our most challenging investment decisions were the purchase of companies like Loblaw, Manulife and Thomson Reuters. We invested in Loblaw when it was struggling to compete against Wal-Mart. We purchased Manulife when it was being pummeled by the impact of low interest rates and weak equity markets. We bought Thomson Reuters when it was wrestling with integration of a large acquisition. While the decision to purchase each of these names was challenging, each of them has been a significant and positive contributor to Sionna's portfolios.

When we look at our portfolios today, there are other names that would fall into the category of "uncomfortable investment decisions." Although challenging to buy and at times painful to hold, we remind ourselves that it is precisely due to the short-term circumstances that these companies face that we have had an opportunity to invest in them well below their intrinsic value. In order to continue striving to achieve long-term outperformance, we remain steadfast in our willingness to make challenging and uncomfortable investment decisions. Our confidence in Sionna's process and culture gives us the courage and comfort to make them, and believe that they will continue to serve and benefit our clients over the long term.



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