

Overview of AVI's Investment Philosophy

Introduction to the Strategy

Asset Value Investors invests in overlooked and under-researched companies, which own quality assets, and trade at discounts to NAV. This philosophy typically leads us to invest in structures such as family-controlled holdings companies, closed-ended funds and, more recently, Japanese cash-rich operating companies. However, our views on the types of structures through which we invest are entirely agnostic, and portfolio weightings are determined solely by the opportunity set and our judgement of the risk-reward potential.

Our research process involves conducting detailed fundamental research in order to: (a) understand the drivers of NAV growth; and (b) assess the catalysts for a narrowing discount. We often engage actively with management in order to provide suggestions for improvements that we believe could help narrow the discount or improve operations.

Holding Companies

When we consider a holding company as an investment, we seek several characteristics. The first is a high-quality portfolio of listed and/or unlisted businesses with the potential for sustained, above average, long-term growth. Many of the underlying companies that we have exposure to are world-famous brands, and include: LVMH, Ferrari, Stellantis, PlayStation, Primark, KKR, and many more.

Secondly, we look for the presence of a controlling family or shareholder with a strong track record of capital allocation and returns in excess of broader equity markets. Long-term shareholders provide strategic vision; many of our holding companies have been family-controlled for generations. This combination of attractive, quality assets managed by long-term capital allocators creates the potential for superior NAV growth.

Finally, we invest at a discount to NAV, preferably with a catalyst in place to narrow the discount. This provides an additional source of returns. We estimate that historically about three-quarters of our returns from holding company investments have come from NAV growth and one-quarter from discount tightening.

Closed-ended Funds

Similar to holding companies, we look for certain qualities when we consider a closed-ended fund investment. Most importantly, we look for portfolios of high-quality assets (both listed and unlisted) with good growth potential. Our portfolio of closed-ended funds gives us exposure to many quality companies, such as Chipotle Mexican Grill, Hilton Worldwide, Universal Music Group, Upstart, Babylon, BlaBlaCar, Voi, and many more.

We also focus to a great extent on the discount to NAV at which the closed-ended fund trades. In a nuanced distinction from holding companies, we usually insist on a high probability of the discount narrowing or vanishing entirely before we will consider making an investment. In accordance with this, our stakes in closed-ended funds are larger, and we engage with management, boards, and other shareholders to enact policies to help narrow discounts and boost shareholder returns. Historically, our portfolio of closed-ended funds has generated half of its returns from discount narrowing.

Asset-Backed Special Situations

The majority of this portion of the portfolio consists of investments outside of holding companies and closed-ended funds. For several years now, these investments have largely been in Japanese cash-rich operating companies. At present, we hold positions in 15 Japanese operating companies which have, on average, 97% of their market value in cash and listed securities.

Japanese companies have a reputation for overcapitalised balance sheets, but we believe that the winds of change are blowing in Japan. The Japanese government has been championing efforts to improve corporate governance and enhance balance-sheet efficiency, and this programme is beginning to have an effect. Major pension funds have signed up to a new Stewardship Code, boards of directors are guided by the principles of an updated Corporate Governance Code, and there is an identifiable uptick in the presence of activist investors on Japanese share registers.

We can see evidence of this change in increasing payout ratios, buybacks, and more independent directors. We believe that our Japanese holdings stand to benefit from this powerful trend, and that the market will assign a much higher multiple to these companies if it reassesses the probability of the excess cash and securities being returned to shareholders. We are active in pursuing this outcome and engage continuously with the boards and management of our holdings to argue for a satisfactory outcome for all stakeholders.

The focus is on quality, cash-generative businesses with low valuations (our current portfolio trades on just 5x EV/EBIT). These are the sorts of businesses that one should be happy to own; as such, we can afford to take a long-term view on our holdings as we engage with boards and management to create value for all stakeholders.

This financial year, we also invested a smaller tranche of the portfolio into high-quality economically sensitive property stocks which would benefit from the reopening of the global economy. These holdings are also classified within this category of Asset-Backed Special Situations. We discuss these in greater detail in AVI's performance review on page 28.

Summary

Our strategy centres upon investing in companies which own diversified portfolios of high-quality assets. In each case, we have sought to invest in companies where the market has misunderstood or overlooked the value on offer, and where our analysis shows that there is a reasonable prospect of this being corrected. The historic returns from this strategy have been strong and came from a combination of discount narrowing and NAV growth.