

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 leads us to invest in family-controlled holding companies, closed-end funds and special situations which, currently, we find in the theme of Japanese cash-rich operating companies.

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.

Family-backed 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: Ferrari, Pernod Ricard, Adidas, EQT, AstraZeneca, Mandarin Oriental, Cathay Pacific, Bureau Veritas, Zalando 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-end funds

The universe of listed closed-end funds is a rich and diverse one, with almost 300 investable funds in London alone, of which approximately 200 are trading at a discount.

Similar to holding companies, we look for certain qualities when we consider a closed-end fund investment. Most importantly, we look for portfolios of high-quality assets (both listed and unlisted) with good growth potential. Our portfolio of closed-end funds gives us exposure to many quality companies, such as Chipotle Mexican Grill, Starbucks, Hilton Worldwide, Time Out, North Sails, Nestlé and Minor International.

We also focus to a great extent on the discount to NAV at which the closed-end 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-end 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-end funds has generated half of its returns from discount narrowing.

Japanese cash-rich operating companies

This portion of the portfolio is currently invested in 18 Japanese operating companies which have, on average, 91% 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 this basket of stocks stands 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 3x 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.

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.