Hardev Bains

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Hardev Bains is the President and Portfolio Manager of Lionridge Capital Management. Hardev spoke with the editors of the Ben Graham Centre's Newsletter about his experience being a value investor.

What has been the single greatest key to Lionridge's success?

I guess first of all the question is if there is one single thing. I would say one of the factors is the firm itself was entirely built around a single philosophy. As opposed to investment sales organizations that are always coming up with different things that are sellable, we just stick to one thing. So we specialize in something I have a lot of conviction in.

Another success factor is being an independent firm. That gives me and the firm independence to practice value investing in a very pure way which is not always easy to do. The institutional environment you are in can put constraints on how you manage money, especially if you want to be a contrarian of sorts, having the independence to do that is a big advantage.

You had a variety of experiences in banking and law before you founded Lionridge. What made you want to pursue this entrepreneurial venture?

Well, the entrepreneurial side came from a lot of my experiences where I dealt with entrepreneurs and I also worked for one entrepreneur in particular. I just found that whole thing very inspiring of taking something where you know you can do well, or that you think is a useful service/product to provide and then building something with that. So it was really a combination of being inspired by entrepreneurs that I had observed or studied or worked for and then also being committed to value investing and wanting to do it in a pure environment.

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You have had a career in finance spanning all the way back to 1994, including experience at AIC. What are some of the key lessons you took away from that experience that you've applied now at Lionridge?

Going back to the entire finance experience, one of the key lessons is - and this just sort of comes if you're in any industry or if you've been in the business world long enough - in this world you have to be very skeptical of the information people provide you with. You really have to question sources, question biases and motivations of the people or organizations providing information, and just don't take everything at face value. Also, in a different aspect of finance, one thing I've taken from that is that risk management is really a crucial

element to any form of managing assets whether it's business or investment assets. Really having a focus on managing risk as well as creating and growing profits is very important.

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This question is from a student perspective. You have spent part of your career in law and on the corporate finance side before going into investment management. I can say for all of us that we are likely to start on a similar path with the ultimate goal of going into the management side. So, I was wondering if you had any advice on those early couple of years and what type of mindset to approach them with?

Well, I would say in the early couple of years, it's really important to get into a situation of being in a professional or business setting and just learning how to handle yourself, your time, and the work. And then prove yourself, demonstrate yourself to be a reliable and levelheaded person. You'd asked about my switch from law to finance. As a young person, it's very good to be flexible and not get locked into something just because you initially pursued that. And not a lot of lawyers make a switch into finance. When I was a young lawyer, I really didn't practice very long, but it did give me a window into the finance world, which I found very interesting. That's what led me to just make a wholesale shift and move into pursuing a career in this field.

Do you look up to or follow any investors, both when you were young and up to now? Amongst them who are your greatest mentors and how have they impacted your career?

That's a great question. And what's interesting is I came into investing solely because I got attracted to the idea of value investing. It wasn't the other way around. I didn't get into the investment world and then find value investing. Now, I came into finance without really knowing about value investing. But I started in different areas of finance, initially in corporate finance and merchant banking. This is going to sound very cliche but, I literally got interested in this because I read an article about Buffett and I didn't know much about him at the time - and I'm going back to the late nineties now. I read about his approach and I found it very interesting. And I pursued it and started reading more. And information was a lot harder to come by back then. I remember I literally had to go downstairs in the office complex I worked in and there was a bookstore and I bought the Roger Lowenstein book on Buffett. And I read that over a weekend. Then I had to go back to the bookstore, buy another. Now of course you can get all kinds of neat stuff online. That led me to value investing and reading up on people like Warren Buffett. I used to go down to Omaha for the annual meeting - I still go on occasion but, for many years, I went every year - I think I've been about 15 or 16 times, and you would find a community of other value investors down there.

If I look at the list of people who've presented to your class, I mean, frankly, it's a little bit humbling for me because a lot of them are the people I looked up to and a few of them I've met and had conversations with over the years. And it is very useful to follow different value investors because there's different approaches within value too. I'm going to talk about that a bit tonight as well. And you always want to see what they're doing and follow the commentaries when they publish them.

Many of the investors I've followed, and many who've presented to your class, have written books. I'm sure you've all read many of those books. And a lot of them are good on a technical side of things. A lot of them are very good on the anecdotal side of things. But for young people like yourselves getting ready to start your career, I would say one book I would really recommend, and you probably all know of it anyway, is Guy Spiers' book (who's been a past presenter to your group). He really gives some interesting lessons that he learned the hard way on the realities of the finance world and

the lessons he learned. I really recommend reading his book.

Other than that, is there any advice you would have for students looking to enter the financial services industry to set themselves up for a good career? Also, what are some questions they should ask themselves now to determine if this is the right path for them?

First of all, in terms of advice, if you've come to the decision that this is what you want to pursue, you have to be patient. Because the reality is if you decide today that this is what you want to do, it's very unlikely that your first job is going to be in value investing. And it's not because you're not good enough to be in it, or it's not that you don't know enough to come in at an entry level, but as you will find out in a very frustrating way, if you do want to pursue it, true value firms are few and far between, and the reality of these businesses is that they're very scalable.

So, once a firm's got a team in place it's not very often that they need to add new people, it is not like the investment banking world where every year they bring in a certain number of people because every year a certain number of people go out the other door. My point being is, it's unlikely that your first job will be in value investing - I'm not saying don't pursue it, pursue it if it's your passion, but just getting out there in the work world in any kind of professional capacity is good experience itself in developing good habits and work ethic.

Ideally, you can do anything involving financial analysis, and that means it could be on the sell side or it could be buy-side elsewhere in a non-value situation. It could be on the commercial banking side, corporate banking side, credit analysis, it could be within a company in a corporate financial department, treasury department, there's all kinds of roles that can lead you to a spot with a value investing firm. And you have to be patient and even kind of creative. And in terms of starting to do your own investment research, frankly, you're already learning the basic concepts.

If you've taken intro accounting, which I assume you all have, then you can work your way through a financial statement. You can start following companies on your own, even if you don't have the capital to invest in them, just doing it on your own and finding ideas. Look at what other investors are owning, do reverse engineering of their portfolios, do all this stuff yourself. And then in the meantime, start working on your CFA and then a lot of it is being the right person at the right time, but the more you spend time doing those things the better the odds you're going to be the right person. If you're truly committed, you make an effort to do the networking over time and meet people in the industry, et cetera. And if you really want to do value investing you will eventually do it. But your first job probably won't be in it, but don't get discouraged by that.

This question revolves around candidates who look to join your firm. What qualities and skill sets do you look for in these candidates? What are the common mistakes first year analysts typically make?

Well we don't necessarily need someone who is some finance superstar. In fact, the amount of pure finance theory someone has in their heads can often work against them in terms of effective investing. But we're obviously looking for people who seem bright, eager, have a good attitude, have confidence, and have demonstrated ability. If you have a commerce degree, there's a level of assumption that you can read financial statements and be comfortable working with numbers, et cetera. So a lot of it is really just attitude. Any kind of evidence that a person's got a good work ethic and attitude and that sort of thing. Obviously, an interest in the firm is key. And then again, a lot of it is just timing.

I get lots of really good people contacting me and sending resumes on a regular basis. And any one of them would be perfectly worthy. But if you don't have the spot, you don't have the spot. And as I was saying earlier, openings are few and far between, but those are the basic attributes we would want. I would imagine anyone coming out of Ivey with the HBA is going to have those attributes generally speaking. And in terms of mistakes, we don't really put analysts in a position where they can make sort of big decisions that could cause big mistakes. And so it depends on how you define

mistake. Analysts will come up with ideas and express opinions and I might not agree with them. But that's not a mistake per se. If you want to use the word mistake, I would say the biggest drawback one sees in a new person out of school is they're coming out loaded with a lot of theory that can be very focused on the science of it.

There's always a science to it - We're based in realities and the mathematics of the value of cash flows and all that, but there's an art to it too. It's not just art, but it certainly isn't just science. So it's not like there's magic formulas where you just plug in data and they show you the investments to buy. There's a lot more nuance to it, again, developing that nuance comes with time.

We see a common theme in the investing world nowadays of having really high commission fees for capital management. But Lionridge's philosophy of zero commission charges is unique in that way. How has that come to be, and how has it affected the fund throughout its life?

First, I would say that I appreciate the extra credit, but it actually isn't really that unique. The investment management side tends to be management fee-based as opposed to transaction commission-based. So in that sense we're just following the general industry norm in investment management. But it is important nonetheless, the fact that we don't get paid for doing transactions creates a better alignment of interests with the clients.

I have no motivation to buy something or sell something because that's not how I make money. I always tell clients, the only way I can increase my revenues from any individual client is to either get good enough returns that they want to give me more money or grow the size of their money that they have with me. And so I think they're pretty happy with me having those kinds of incentive.

> “We're based in realities and the mathematics of the value of cash flows and all that, but there's an art to it too. It's not just art, but it certainly isn't just science.”

Last April you noted in the middle of the big April sell-off that the market was still overvalued based on the metrics you look at. Since then the market has not only rebounded but surpassed pre-pandemic levels. I wanted to get your take on this and whether it has caused any difficulties in finding opportunities for Lionridge?

Absolutely. We went into the beginning of 2020 with quite a lot of cash, about 35%. I was very busy looking for opportunities but did not find a lot. I came out of that with about 25% cash in late March. So yes, I was able to put some money to work and found some new opportunities but overall it wasn't like the equity markets were on sale by any means. Since then, our cash has gone back up, firstly because of a stock I turned around and sold in two months because it went up 30%, which was heartbreaking to me because I wanted to hold on to this company for years. So I went back to 28% very quickly. Then of course for the rest of the year, the cash went down not because I was putting it to work but because the market was going up. Due to recent sales, we're back up to about 30%. So that's been the dynamic.

I don't base my cash position on some kind of estimate of what I think the markets worth, I am just looking for profitable opportunities. I don't care what the markets are worth, if I could find the right 30 stocks I would be fully invested. So at the start of 2020 when I was at 35% cash, it was not because I had some magic formula. It was a byproduct of the fact that we had been through a bull market and I had been doing more selling than buying. The fact that I had 35% cash was a symptom of markets being high, but markets being high weren't a decision factor in me having that much cash.

Then we went through Q1 and it appeared to me that by the end of March, as dramatically as the markets had come down, they were still not cheap. Maybe we went from being quite overvalued to a

little overvalued. After that it was becoming even more overvalued. You've probably heard from many people that it's been a tough while for value investors… absolutely. The last couple of months have been a lot better, but it certainly has been hard to find opportunities. Evident through our cash position.

> “If you understand the dynamics of investor psychology and are not subject to them, that's half the battle.”

You mentioned that "this summer was a great example of a common emotional factor that drives bull markets – fear of missing out (“FOMO”)". Would you say keeping discipline within this environment is easier said than done / were there moments of temptation within some sectors that you thought were only "modestly overvalued" during the initial bear market?

I personally don't have an issue with it, but there's a couple of reasons for that. Firstly, it has to do with my own temperament, I'm just kind of wired differently. When things are going up, I get cautious, when things are going down, I get interested. I'm not particularly disciplined in other areas of my life, but when it comes to investing I am. If you understand the dynamics of investor psychology and are not subject to them, that's half the battle.

Going in the opposite direction, are there any investments that you've missed over the years and what have you learned from them?

For sure, it still happens, but you can't beat yourself up over those. In terms of lessons, just because something may be a good idea and looks like a value opportunity, if the company's not in your circle of competence and you can't truly get your head around the business story, what the projections mean, what the company will look like in 5-10 years - that's a good reason not to buy. So you take a pass, and the stock goes up, but you can't look in the rear-view mirror with regrets.

The other lesson is that if you have to move on. The worst thing you want to do is chase missed opportunities. A lot of that comes with experience. In the beginning you're going to want to spend more time on an idea, but with more experience and judgement, you come to realize you don't have to understand 100% of the story, you can get to 75-80%, and you can more quickly make a decision.

What I've learned is once you have the comfort level, make the decision, don't wait. Markets are eventually efficient, and opportunities don't last forever.

How do you recommend investors build the discipline to delay investing when there may be an external pressure to buy even while opportunities are sparse?

It's easy to delay or avoid buying if you don't have any money (laughs). You all have the skillset to take a stab at estimating intrinsic value. There's nothing really stopping you from doing that. But over time you develop more confidence and judgement on your valuation which really comes with time. Even when you're in a position where you don't have capital to deploy, you can still follow companies, follow what other investors are doing, and reverse engineer a list of what stocks you think could be a good buy for different reasons. You can kind of run a notional account on your own - nothings stopping you from doing that.

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Have there been any times where maintaining a value focus (i.e. keeping 30% in cash recently) has caused issues with your investors? How have you dealt with being one of the last few self-proclaimed value investors in a world that increasingly cares less about price?

I wouldn't say it's all clients, but some clients. It gets more frustrating too, because when you have good clients even if they are loyal clients to you, they're always getting approached by advisors and brokers. And as soon as it comes up, you know, I'm the guy with 30% cash, that gives our competitors something to jump on. I would say, we have gotten many more clients than we've ever lost, so something's working. But it is a challenge, which is why not a lot of people hold a lot of cash.

We've seen a shift in assets under management, from active strategies to passive strategies in terms of ETFs and things like that. How do you view that at Lionridge and what impact do you think that has on market efficiency? Do you think that there may be an opportunity for value investors to take advantage of?

I think eventually it'll provide opportunities. The whole passive investing thing has also coincided with more money coming into the equity markets. That, plus a number of other factors, have inflated asset values. So that's made it more challenging for value investors in the past few years, but the pendulum swings both ways. So I think the level of money that's coming into passive strategies will also cause a lot more volatility swinging the other way. It certainly doesn't make markets more efficient by having money going into passive strategies.

When I first started in the business in the late nineties during the tech boom, one of the Canadian market darlings was a company called Nortel. Nortel had been around for a long time; it was this boring company that made telephones and telephone equipment and stuff. And then it got into the whole tech boom and without getting into details, it turned out to be a bit of a sham in terms of their accounting and how they were showing growth. But the point being is when that story started getting legs, what happens in a country with a shallow market like ours, where a lot of managers had a passive strategies, suddenly when Nortel goes from being a fraction to 1% of the index, they all have to buy. And that pushes up the price higher. Then it's 2% in the index. Now they all have to buy more, et cetera. That's what we saw last year with Shopify. It'll be interesting to see how that story ends. That's also what we saw with Valeant.

My point is that I think the increase in passive investing presents more inefficiencies in the markets. Those inefficiencies are what gives investors like me opportunities, but they don't give us opportunities all the time. Right now, those inefficiencies have caused guys like me to pull some hair out or have my hair go more gray than it was two years ago.

Bringing up Valeant and these other companies leads well to our next question, which is how do you go about evaluating management and for retail investors, what are some tips for us to evaluate management when we don't have access to a lot of the same tools that institutional investors have?

It's a good point. First of all, regarding managers who are spending time with management, there's nothing wrong with that, but the benefits of that can be a little overblown. There's actually an investor psychology phenomenon where when investors do meet with management, they might tend, just for that reason, to develop an overly positive view of the management. When I used to work for a larger company and spent more time going to conferences and the like, and you would see these people presenting and you could always get into the conversations with them during the smaller breakout sessions or informal coffee break conversations. At these large companies, they're going to be very polished and also very controlled about what they say, partly because of legalities. They can't just talk about anything because of insider trading and regulatory rules. So the point being, it's very hard to tell, just from having a conversation or a sit-down meeting in someone's office, that some person is a good manager.

But the kind of things that you can look at are available to you. First of all, just look at what the company's done under current management over the last number of years. Does it make sense? Have they acted rational and are good capital allocators? Are they people who are growing for the sake of growing, or making moves just for the sake of generating interest and pumping up the stock price, as opposed to moves that are really good in the long term for the shareholders. You obviously want to avoid companies where the people running it have a checkered past, which you can readily find out these days. And the reality is when you're dealing with mid cap and large cap companies those people are already under quite a bit of scrutiny before they even get the job let alone while they have it. So it's really more involved in vetting management with very small cap companies.

I was wondering if there's any geographies where you found uncharacteristically high returns or any geographies that going forward, you're very bullish on.

That's a great question. In terms of companies we invest in, we tend to stick to those domiciled in mature developed markets. I think that economic opportunities are definitely still with the emerging markets in terms of growth. What I don't want to do, and some managers do this, is to zero in on a given emerging market and try to learn what are the best local companies in that market and buy some of those because many developing markets don't have the most reliable legal systems or the standards for accounting or high levels of market integrity. What I do want to do is to find companies that are located in established markets but are in a good position to do business in those emerging markets, are already doing business in them and are well-positioned to grow their businesses in them. So that's how I look at global investing and that can even be US or Canadian companies.

There's a million different ways to think about risk. And you've mentioned previously that one thing you'll do is model out the most conservative baseline of the company. Is that one keyway that you manage risk? And is there anything else that you suggest we think about when thinking about risk and an investment?

Well, the first thing is what not to think about. Don't worry about short-term volatility in price. I don't look at that. In terms of risk management, I'm looking at the inherent characteristics of the companies we buy and what the risks are to the businesses. Looking for companies that are well established competitively, have a strong profitability, have good balance sheets and are well-entrenched competitively.

And those stocks are going to tend to be less volatile anyway, but that's not a factor. So really, we're looking at business risk of the companies. What are the competitive threats, what's going on with the business, what are their end markets, what are their substitutes? Do you guys in business school still talk about the Porter model of strategic analysis? That's useful stuff that's more important to me than anything I learned in the capital markets theory. We look at the business risk and we look at the financial risk of the company. Things such as liquidity in the balance sheet, the access to capital, the need to access capital. If a company's business plan is based on continuingly being able to issue stock in the stock market, that's a pretty risky situation. I don't want that. I want companies with good balance sheets.

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And then I'm also looking at valuation because what you pay for a company versus what it could be worth intrinsically is crucial. The best you can do is kind of come up with a reasonable range of valuation and then ask yourself, how does the current price compare to that? And of course a big factor of risk management is to make sure that the price you're paying is reasonable, no matter how good the company is. That doesn't mean it has to

be cheap in terms of general, back of the envelope kind of value metrics, but using a range of valuation methods does the current price make sense? And that gives you downside protection.

I think that's a good segue into the topic of investment philosophy. In past conversations, you mentioned Buffett and Ben Graham. They're two different schools of value investing. Deep value versus quality companies. Has your investment philosophy changed over time? I know one that is rising is growth at a reasonable price. Has your investment philosophy stayed true to the characteristics that Ben Graham talks about and do you still think that's relevant today?

I have all the respect in the world for Ben Graham, but I believe it may be difficult nowadays to replicate what he did. That was at a time when he had an information arbitrage, when they were just companies trading at liquidation values or below liquidation values. People weren't paying attention the way they would now. Those opportunities have been arbitraged away in the market. So, it is more difficult to do the Ben Graham kind of investing. And it comes with more risks. The term cigar butt investing, I don't know if you've come across that term, it's not some great going concern business, but it's like some old cigar you found on the street corner - there's still a value because there's 50 cents worth of puffs left in it and you can get it for a dime. The idea that you have a company and it could be a declining company, but its assets are worth X dollars and you can buy them for cents on the dollar. Even if your analysis is right, you better hope that by the time the company gets liquidated that the asset value hasn't eroded. I don't even know if you can really do that these days. I don't even try, but it's more of a shotgun approach.

So, you own a whole bunch of these because statistically, enough of them will do better. That's not our thing. And then there's some approaches that are much more quantitative. Where the method is simply to buy the lowest bottom quintile in terms of price to book or whatever, and own a large number of companies and statistically they will do better than the markets. That's actually one of the approaches that we studied when I was at Ivey. We didn't have your course. We didn't have Dr. Athanassakos, unfortunately. So that's why it took me a lot of years to actually get interested in investing because of what we were taught and I'm not slagging the school because so much of the stuff we learned in finance was crucial and critical. But I remember the one course we had in investing, it was more of this quantitative stuff.

I think I'm getting away from the question, but even from the beginning, I understood there are important takeaways from Ben Graham. As we talk about those chapters 8 and 20, it's more of the perspective. First of all, the concept of Mr. Market being a moody person. If you can take advantage of Mr. Market's mood, you can make money. Secondly, the whole idea of price versus value is a relevant concept we learn from Graham. But I generally focus on going concern value as opposed to liquidation value and I believe it's a lower-risk way to invest.

What are some of the best things that we can do as students to learn more about value investing? Were there any kind of resources that you came across that you thought were really valuable when you were studying this?

Well there's some good books to be read, like the first book about Buffett. It's by Roger Lowenstein, that's worth a good read. Snowball's not bad either. You've probably come across that one. That was the later book that was written about him by Alice Schroeder. Read Munger too. But read about businesses too, and be interested in businesses. Just study businesses, and coming from Ivey, you're already coming with a good grounding for business analysis. Ultimately, stocks are pieces of businesses.