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David Barr is President and CEO of PenderFund Capital Management Ltd in Vancouver, British Columbia, Canada. David spoke with the editors of the Ben Graham Centre's Newsletter about his experience being a value investor.

What led you to becoming an investor?

My undergrad was actually in cell biology and genetics, but I was always very entrepreneurial. I started a computer sales company, and my summer job was running student painting companies, so I gravitated towards business and decided I should probably go do an MBA. I chose Schulich, and in the first week, Tony Ariel from Burgundy Asset Management was one of the speakers. He talked about this guy, Warren Buffet, and I sat there thinking, *that just makes so much sense.* The next morning, I went to the library, picked out a book called *The Warren Buffet Way* and I think I finished it by the next day. That was really what started my journey into value investing. It was definitely a convoluted road because I had this deep love of technology, so when I came into my MBA program, I focused on venture capital and investing in technology companies. But with that Buffet kind of grounding, I really gravitated towards later-stage, more mature, venture-backed companies where I could see that they have revenue, profits and have a better approximation of what it's worth.

Has your investment philosophy always been value-oriented? Were there experiences that shaped your investment philosophy?

I've always been a value investor. My curiosity has always been on what a business is worth. There's a lot of different tools you can use to get there, and high growth companies are probably worth more than low growth companies. Maybe not if they're not profitable, but there's all these factors that come into it. It's really that curiosity—that drive to figure out what a business is worth to a third party. I think that's always been consistent with what we do.

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Does living in Vancouver impact your investment philosophy?

Absolutely! If you want to be a contrarian, the further away you are from the herd, the easier it is to stay away from the herd. Having that distance between us and the financial capital of Canada is a very good thing. The other thing that doesn't get discussed as much is the time difference; markets close at one o'clock in Vancouver and sell side is home by one-thirty. From one-thirty to the end of the day, there's nothing going on in the markets. You might get some after day earnings releases and events coming out, but you really can tune out so it's a period where you're not watching stocks go up or down and people aren't calling you. That gives you the peace and freedom to dig deep into the names you're interested in.

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Investing is often described as an apprenticeship business. Were there any individuals who influenced your philosophy?

I worked with a lot of people, but they were more businesspeople than investor types. My investor mentors were people I was reading about and trying to meet and emulate. The hands-on mentorship I got was all about business value creation. This is critical in the world we live in today. If you want to compound capital for the long term, you need to find businesses where the internal economics are going to compound for a long period of time. Understanding businesses at a deep level, and how that value creation actually occurs on a day-to-day basis, and how that translates into strategy and long-term growth of the business is really what I learned from these people.

You started your career in private equity. Does that impact the way you look at investments?

Definitely. When you start in private equity, you're starting off with a 10-year timeframe. First, if you're buying a company that you cannot sell for 10 years, the level of conviction you need is very different than if you can just sell it in the market the next day. That really drives a very deep process of due diligence and understanding the business opportunity. It also helps when you're working with the management team for three, five or 10 years helping build value within the company. This stops you from sitting there wondering what the company is worth on a day-to-day basis. What that's translated into in the public markets is taking a deep due diligence approach to understand the economics of the business we're investing in. This helps us tune out the noise and not worry about day-to-day stock price fluctuations. The key metrics we're always tracking are whether the business is adding value, driving returns, and generating free cash flow in the long term.

What caused you to transition from private to public markets? Has your investment philosophy changed?

There's a famous quote: "All I want is no competition or an unfair advantage." In the mid-2000s, there were a lot of technology companies that had gone public, then the market lost all appetite for technology businesses, causing a lot of these businesses to trade at distressed valuations. At the same time, I'm operating in the private space where you would get a tech founder come into your office who thinks that their idea is worth a pre-money valuation on their seed round of $10 or $20 million. Yet, you can look into the public markets and buy a company doing $20 million of revenue, free cash flowing $5 million a year, and $5 million of cash in the bank for a $10 million enterprise value. When you see that valuation discrepancy, it makes that part of the market very appealing. And there's not a lot of participants in that part of the market.

The real epiphany I had occurred when I read Phil Fisher's book *Common Stocks and Uncommon Profits.* The scuttlebutt approach he discussed was like a venture capital or private equity investor running a 10-stock portfolio—high conviction, being on the phone talking to customers and suppliers, talking to people within the company—doing that private equity level of due diligence, but deploying it in the public markets.

How do you conduct due diligence on investments?

It's about understanding the underlying unit economics of the business and the competitive landscape. What is the company's competitive advantage? How big is the market? For instance, when you look at a public company with a charming CEO and fancy investor presentation, but the CEO says, “the TAM is worth $X,” is it really? For us, it’s *how do you go fact check all that information?* You really have to nurture your industry sources and do a deep dive to gain an analytical edge. Getting a more complete picture by talking to more people and understanding the business more completely than others might—that’s where your due diligence comes from.

How do you find investment ideas within the small-cap space?

This has evolved over time. When we first started, it was screening. Now that we've been at it for over 20 years, the Canadian small-cap universe is well known to us and outside of the last two years, we've had a lot of companies go public. A lot of the companies are small-cap companies that are publicly traded, so a lot of our idea generation is not brand-new idea generation; instead, it's a company we've followed for three, five or 10 years, sometimes even 20 years. There's a company, Computer Modeling Group that was on our venture radar back in 2003. Today, it’s in one of our funds. A lot of our idea generation is understanding these businesses, but not wanting to own them for a particular reason. It's like documenting why we don’t own it so that when the facts change or something presents itself, we're able to move more quickly on a business that we do understand.

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Idea generation also comes through industry sources. Nothing gets me more excited than when I'm talking to a CEO, and he starts complaining about how much he hates his competitor. The reason the CEO doesn't like the competitor is because that competitor is winning. That probably tells you that that company has something that the company you're looking at doesn't, so talking to CEOs and industry sources is a great way to come up with ideas and understand which companies in the industry really have a competitive advantage, and which companies in the supply chain are the key piece of a supply chain. A lot of our idea generation is just recycling. Industry research is number two, and number three is a lot of other very thoughtful investors out there who I network with quite a bit. Also, every now and again, sell side surprises me and throws something at me.

The investible universe is large and complex. How do you narrow that universe down to a group that you’re confident to own?

If you start with a Canadian small-cap universe of more than 500 stocks, they're not all investible. There are a lot of bad companies out there, so you can short circuit it and there's probably 100 to 150 investible small-cap companies in Canada. We have a team of four on the small-cap team. Each of us covers between 20 and 50 names. We've always got 20 to 30 that we've got tight coverage on, so we can kind of cover that whole Canadian universe. You can narrow it down quickly.

You’ve said that many of your ideas are recycled ideas. Could you touch on a recycled idea turning into an opportunity?

A big one for us is a software company based out of Calgary. It sells ERP solutions to governments and the not-for-profit sector. They have strong free cash flow generation with 50% to 60% EBITDA margins, so it was spinning a ton of free cash flow. We owned the company back in 2011. We were the first institutional investor in there and we really liked it because the CEO approached us trying to buy one of our private technology companies. And based on how offensive the offer was for our company, I knew that when he made an acquisition, it was going to be a good one. We watched his acquisition strategy, and he was buying software assets really cheap. We made an investment in the company, then we started to see some things that made us uncomfortable. And if you own a small-cap company, you need to be very comfortable with the management team or have a plan for the management team. So I stepped away from it for several years and the stock actually did better after we sold it. It continued to go up, but then it kind of came to bear that the CEO and the management team was being compensated based on the wrong metrics. As a result, management cut R&D expenditure, cut sales and marketing, and kicked out tons of free cash flow. But what happens to the business longer term? If you're not reinvesting in your product, if you don't have a great sales team, eventually that's going to come home to roost and your business will move into decline. A new board came in 2020, reset the management team, reset management compensation, and a new CEO came on. Seeing that trigger, where governance had improved management alignment, and incentives had improved, that gave us an opportunity to revisit it. Now, it's a larger position in our portfolios.

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Value investing is often associated with low P/E ratios or similar quantitative criteria. What other checks do you use to ensure you’re making a wise investment?

When you think about traditional Ben Graham-style value investing, it was about low P/E ratios. But Ben Graham's book was not called *The Value Investor.* It was called *The Intelligent Investor.* And intelligent investing is all about understanding what the value of a company or a security is, and then buying it at a substantial discount to what that is.

We don't look for low P/E stocks. We look for high quality businesses trading at a very attractive valuation. For us, it's the process of understanding business quality, and asking ourselves, what are the unit economics of that business? What's the runway and how long can it scale for? At the end of the day, it is all about free cash flow. Discounted back, what is the value of that free cash flow? We're not like the classic low P/E value investors. I think that's a challenging part of the market now since the level of sophistication in investors is way different than it was in 1960. Everybody's combing through low P/E stocks, so for us to say that we're smarter than all the other value investors—that’s challenging. To add alpha, you have to be both contrarian and right. If the market is telling you the stock’s cheap and profitable, there's generally a ton of coverage, so having a unique insight on those, while not impossible, is a lot harder. We've had some great ideas with low P/E stocks because there are different reasons for companies to be misunderstood and mispriced, but I think it's a challenging part of the market now.

Does your investment strategy differ for mid-cap stocks?

On the small cap side, we rely very heavily on knowing the management team. One of our big positions is Copperleaf. It went public in September 2021, so they don't have a long history as a public company. How do you assess management if there's no history there? For us, small-caps give us the opportunity to get to know the management teams and create our own private track record, where you know if management exceeds expectations or overpromises and underdelivers. When you get into mid-cap companies and companies that have been around longer, you've got 20 years of conference calls and publicly disclosed information that you can screen through to get a better understanding of the quality of management and of the business. Small-caps—it's often under followed and they don't do conference calls because, sometimes just two people show up and they just get sick of doing them. With small-caps, you need to be meeting with management teams more. In mid-caps, not so much.

You've described yourself as a "true contrarian." How do you maintain a margin of safety while holding this attitude?

First, you must define what risk is. There are a lot of people that say volatility is risk. We must put risk ratings on our funds based on the volatility of the fund. Is that really risk? No, it's not. Instead, we talk about the "trinity of risk," which mostly boils down to business risk. Firstly, balance sheet risk. We try to understand the debt load of a company, especially in a market environment like this where we've got a recession and a lot of carnage in the markets last year. Companies that took on a lot of debt leading into this period of time are going to have a lot less options than companies that are very conservatively financed. That's understanding the balance sheet risk in companies. The second element where we spend most of our time is business risk.

Over the last 18 months our number one has been economic slowdown with increasing interest rates. So what did we do? We looked at our portfolio and said, who are the end customers? Who's buying stuff from these companies? If you're in our portfolio and you're selling something to Canadian consumers, and Canadian consumers have a whole bunch of variable rate mortgage debt, their discretionary spending is going to fall. This causes us to decrease our exposure to companies that have that type of risk. Whereas there's other companies like Copperleaf, which sells to utilities, which are on 20 year planning cycles, managing the assets out in the field, helping companies manage their capital expenditures—that's a much different risk profile. Those customers are still going to buy stuff.

When we look at risk, it's all about business risk. At the end of the day, competition and product obsolescence affects that too. It's really about knowing what things could actually hurt the free cash flow generation ability. The third area of the trinity of risk is valuation risk. That ties into margin of safety, where if you buy something at a great price, you can naturally negate some of these risks. But if you overpay for an asset, it doesn't matter how great the company does, you're going to lose money on it.

How do you manage the liquidity of your funds?

That's really important to us. I'm lucky to have our client team—they're investors and they love investing for the long-term. They do a great job of talking to the people who invest in our funds and explaining the process. They tell clients that we're trying to generate returns over a business cycle, and that in the short-term, we don't know what's going to happen. But what we do know is that over the long term, we are going to get the economics of the business and maybe a little bit extra because we are savvy, buying these things when they're trading well below their economic value and trimming them when they're well above their economic value.

> " March 2020 was a wonderful experience; we all thought we were going to die and nobody wanted to invest anymore. Small-caps were down 45%, and we had to go through every single thesis in our portfolio and say, *the world's changed. Which of these theses have been disrupted and which are potential beneficiaries?* You need to maintain enough liquidity to take advantage of opportunities "

It really comes down to our client relationships team and building the relationships with the right investors to participate in the growth of the fund alongside us. It's mainly about ensuring that the investors believe in the team of the fund rather than actively managing the liquidity of the fund. While we do both, it all starts with your investors. If your investors know what you're doing and your stocks go out of favor, you can call and give them an update. We can tell them that our portfolio is down, and that this part of the market where we see a bunch of opportunity got hit hard. But fundamentally, what these businesses are doing and why we have high conviction in them is still here. When you have the right investors, that conversation is a lot easier. You always have to be liquid enough so that you can move things around when the facts change. March of 2020 was a wonderful experience; we all thought we were going to die and nobody wanted to invest anymore. Small-cap stocks were down 45%, and we had to go through every single thesis in our portfolio and say, *the world's totally changed. Which of these theses have been disrupted and which ones are potential beneficiaries?* You need to maintain enough liquidity to take advantage of opportunities and deal with situations like that as they arise. For us, we have a fund of a certain size, so you need to pair your opportunity set with your fund size. If we have a billion-dollar company in our fund, we're pretty nimble trading around that. With a $200 million company, we have to be a bit more careful and we have to moderate our exposure to the micro caps in the portfolio to deal with liquidity.

How do you decide how much to allocate to a particular business?

We use a quant system. We run three to five scenarios based on the company we're investing in, and then we weight those potential scenarios, then come up with a projected IRR. That determines the initial weighting for us. We also have a bunch of quantitative and qualitative overlays. The company's management team, balance sheet risk, ESG factors, and the quality of the business all come into play here. If it's a high-quality business, we score it higher so it will have a higher weighting. If it's a lower quality business, we score it lower.

Many of Pender's funds invest in private companies. How do you understand the process of exiting those investments? Is there continuity between your public and private investments?

Oftentimes, there's cross-pollination between our venture team and our public markets team, where our public markets team will know who the potential buyers are of the company. We talk across teams about that landscape. We did see a period in 2021 and 2022 where tech IPOs picked up again, and Copperleaf, which was in our Pender Ventures portfolio, is now a public company. It traded to a valuation where we've now put it into our public funds as well. We had a distinct advantage with Copperleaf; Maria, my partner on the venture side, led the Series B financing in 2011 on Copperleaf, and she's now on the board. Our other partner, Rolf, sat on the board for several years, so we know the management team and company incredibly well. When it goes public and it's trading at a valuation that's ideal, we can execute on it very quickly. There are a few ventures that will go public helping us out. But most of the time, it will end in M&A. Maria and her team will often go to a company and say, “who are the logical buyers of this?”, in a sense, beginning with the end in mind. That's what our private equity approach to public markets is. We ask ourselves, *how are we going to make money on this? Who's going to buy it? Is the market going to respond to this? Is somebody going to buy it? And if they're going to buy it, how much are they going to pay for it?*

What is your attitude towards selling expensive, yet high-quality businesses?

With high-quality compounders, you don't want to sell it. We're faced with this situation with Magnet Forensics, a cybersecurity company that went public in 2020. It's a wonderful business—they have 40% top line growth rate, they're profitable, and it's going after a big market, so it's got a long runway. This last summer, the stock sold off and went down to $14. We started buying at $16 and built our position and our cost basis was well below $20. I was excited because I thought we'd be able to hold this company for 10 years, and it will never be below a 3% weighting in the fund. If it gets overvalued, we'll take it down to 3%, but we're going to hold on for a long time. Last week, it announced it's getting taken out by private equity and some people might be happy because it was up 15% and we added 50 basis points to our performance last week, but we're now giving up all that performance we expected to see over the next five to 10 years. We don't like selling high quality businesses, particularly Canadian tech, where we want to see the Canadian tech scene thrive. Having really large independent companies is fertile ground for people starting their career in these Canadian headquartered companies—getting experience and then joining smaller companies, starting their own companies—it's just great for

Canada. It's also great for our tech team to have companies headquartered here because a lot of the tech jobs are now Google, Microsoft, Facebook, and they're poaching engineering and developer talent, but they're not adding to the value creation of the economy here in Canada. We like to see these companies stay around longer. But back to our trading strategy; our max weight is 5% and our initiation weight is 2%. If a company gets overvalued, we will trim it down to 2% or 3% weighting. With our compounders, we run a fifth scenario: our "blue sky" scenario. If they hit it out of the park and exceed all expectations, *what's this thing worth?* That's our sell signal on compounders. With lower quality businesses, it's as soon as they get close to intrinsic value, we're moving on. You don't want to be sitting there holding a low-quality business for longer than you have to. Time is your enemy in low quality businesses because all you're trying to do is buy it today because it's cheap. When valuation normalizes, you get out.

> " It's important to be very open-minded and understand that there's a lot of ways to deploy an investment strategy successfully "

How does your investment philosophy change across Pender's different funds?

At Pender, we're business analysts. A common part of our investment process is trying to understand the quality of a business and what the fair price of it would be. It's no different from venture or high-yield credit. It's important to be very open-minded and understand that there's a lot of ways to deploy an investment strategy successfully. The important thing is understanding what your individual strategy is and deploying it consistently. When you deviate from that, you tend to get in trouble.

How do you add value to the management teams of public companies?

We're very engaged with management teams and boards of a lot of our portfolio companies in the small cap space. A lot of times, we're 5%, 10%, or even 20% shareholders. I've met with a couple CEOs recently and they've gone public in the last couple years, and they're not used to public markets. We say, *"here's how we can help you communicate to Bay Street. Here are the things people are going to be looking for. Here's how you can communicate."* We can help them learn how to speak to the investment community. Given our depth and network, we can often introduce people to the boards of these companies. Another thing we've done is when a public company has an acquisition opportunity, we will sign a non-disclosure agreement, and look at the opportunity with them and potentially help finance the acquisition. M&A is particularly tricky for management teams that haven't done it before, so it can be dangerous as a shareholder. When I'm starting to think a company's starting to go down the route of looking at acquisitions, we'll make an offer to help out. It's not always taken up, but there are some CEOs who we have good conversations with.

Does launching new funds strategies make you a better investor? Do you see overlap across strategies?

Yes, we've added a lot of like-minded people operating in different parts of the market who are all really smart, making us all better investors. For instance, when Magnet Forensics was getting taken private, our venture team knew that space really well—they knew what Thoma Bravo was doing. We had a great conversation about the fairness of the deal and whether they'll go higher. Assessing the opportunity, that also ties in nicely to our merger arbitrage fund, since when you got a company taken out in our portfolio, we know it well. Having the credit team around is great because a lot of high yield issuers are also small cap companies, so there's a lot of overlap. For instance, if your bond guy says, "wow, I wouldn't even pay 50 cents on the dollar for the bond," why are you touching the equity? There's a lot of red flag opportunities there.

Geoff runs our corporate bond fund. He's invested in some long-dated technology converts. At the top of the market, a whole bunch of these tech companies issued these zero coupon converts to be quasi equity. There's no equity value now with the NASDAQ down as much as it as is, so a lot of these things are trading at double digit free cash flow yields. They still have some equity optionality in them, too. What's your credit risk on one of these things? Well, traditional investment grade bond managers aren't looking at a convert, right? Like that's just outside their constraints. That's an opportunity we know very well, and Geoff's been able to execute on that. There's a lot of back and forth on idea generation and name discussion on our investment team.

You previously wrote that you're focused on companies that are distributing cash flow through dividends. Do you see that conviction changing with rising interest rates?

That statement was with respect to our small and mid-cap dividend funds. For that mandate, we're very focused on companies that are already generating free cash flow and are either paying a dividend or have the ability to increase that dividend. When you can find those businesses which are increasing returns to shareholders on the dividend side, it helps your return profile. Do we see that changing with economic headwinds? Yes, it will potentially impact it.

In a lot of our cases, if you've got a hundred percent payout ratio on your dividend, you're setting yourself up for some tough times ahead. We would gravitate to companies with more modest payout ratios, where CEOs are pretty conservative and setting the right dividend policy. In our portfolio, you never know, but given where we're at, we're feeling comfortable.

There are some companies that are going to have some surprises when things slow down, and then there's other companies like Mullen Group, a logistics company who cut the dividend in March 2020 and did a big buyback. If anyone's ever read the book *Outsiders,* that sort of behavior is wonderful for shareholder value over the long term. Even cutting a dividend sometimes isn't a bad thing. That's why it's fun being an analyst and looking at all these things and making your own opinion.

Do you feel that capital allocation skill is a critical skill for a management team?

I'm going to give you an answer that frustrates the rest of my investment team greatly. It depends. We have investments in our portfolio where the core strategy is M&A driven—Constellation Software, for example. To assess that, you need to understand the M&A discipline of that company, which is obviously amazing. But that's a company where you would be focusing on capital allocation ability. There are other companies where there's a lot of organic growth ahead of them and you're much more focused on the business operational skills of the management team. With small-cap companies, you'll often find management teams that are good at one or the other, but not both. That's usually a red flag when running M&A strategies; they buy something cheap, they fire a bunch of people, free cash flow increase, and they've got their "copy and paste" mindset of investing in R&D, sales, and marketing—growing your business organically is totally different. It's hard to square those two up in the same individual. There are people that can do it, but they're rare.

Would you prefer a management team that's more focused on their business or capital allocation?

Being a small cap investor, you want the businesspeople, right? Predominantly, I'm going to go back to *it depends.* You can generate tremendous value both ways. But doing it organically, investing in the business and building the business, is slightly lower risk. Building value through M&A can be riskier. We will invest in companies that are growing through M&A, but we're a lot more nervous about those ones than we are about the companies that are growing organically.

How should retail investors evaluate small-cap funds?

It's a tough question because every retail investor has different needs. You have to understand what the timeframe of a retail investor is. If it's five years, they shouldn't be owning small-caps. If it's 20 years, then it probably should be a part of their portfolio. I'm hesitant to make a blanket statement on what a retail investor should do. The thing about small cap investing is if you look at the returns from the

Russell 2000 over the last decade, you got roughly 11.8% annualized. But if you missed the best month, you're at 9.8%. Just by missing one month out of 10 years you've lost 200 basis points annualized. And by the time you miss the three best months, you're down to 6% annualized.

The key to small cap is stay invested. If you're thinking of pulling your money out, add to it because you know people don't add at the bottom. People pull out at the bottom. If you're doing the opposite of what your gut's telling you, you're probably going to amplify your returns.
Regarding choosing a manager, there's a lot of really great small-cap managers out there. I have a 10-year track record, and if you've got a strong 10-year track record, you've probably got a very disciplined process. You know what you're doing and there are periods of time when everybody goes out of favor. But you have to, because you're going to be more concentrated, you're going to be contrarian, and you're not going to get every contrarian call right. There's going to be periods of time where you're out of favor. If you can find a small cap manager with a great long-term track record who's returns have suffered over the past 12 months, that's probably a really interesting place to look at a small cap fund.

Do you think that small and mid-cap funds have an advantage over large-cap funds in the active management space?

We're in an interesting point of time with interest rates basically going to zero over the past 30 or 40 years, creating a liquidity bubble and the need to chase larger assets. A lot of that capital started moving into mega-cap stocks, creating a positive feedback loop where your five-year trailing number on your S&P 500 ETF is really good. You buy more of the biggest stocks, and it goes up more—everybody's feeling great. If that money's going into those types of pools, what's it coming out of? What's coming out of less liquid pools? You can read back over the last five years about how many small cap managers have been fired or firms shut down in Canada. There's money coming out of small-cap and going into a large and mega-cap.

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What does that look like going forward from here? I think it makes large-caps a stocks pickers market. You look at the S&P 500 trading at—I think it's 17 times next year's earnings right now—and small-cap markets trading about 12.5 times earnings. Small caps are always a stock pickers market. Large-cap is right now, too. If you're launching a large-cap strategy, now is probably a good time to do it because you have a higher probability of delivering relative outperformance at this point in the cycle than you would have had at any point in the last 10 years.

Is there anything else you'd like to add?

We're talking to a bunch of value investors, so it's good news; just maintain your patience. I used to just read about companies all the time, and early in my career I'm like, *I wish I knew more about companies. I wish I followed more companies.* And all of a sudden, 20 years later I follow a lot of companies and know a lot about them. It's just a game of accumulating wisdom, so be patient, but also have fun. Felix and I always joke around and say, “*are you going to do your hobby today?”* I say, “*oh yeah, I'm going to the office to do my hobby”.* If we weren't working at Pender, we'd be doing this anyways because we just love trying to figure out how businesses work and how much they're worth. Just make sure you're passionate about it and be patient because every 10-K you read, every prospectus you read, every quarterly results… they're adding to your mosaic, and you don't know how it's going to play out 10 years from now. The more of those little touch points you have, the better your decision-making process is going to be.