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Managing What Can Be Managed

By the time the mid 2000s rolled around, I finally caved and accepted that I needed to pack up and throw away my 90s clothing. What was I thinking? How did the term "fashionable" come to mean short shirts, glitter and fake tattoo chokers? I guess the joke's on me, because all of those things are in vogue again. Clearly, I wasn't thinking long term enough.

The term "fashionable" has been in use for a long time, but what it refers to changes every few years. Likewise, in finance, we come across a lot of terms that get used like they have a constant meaning, when in reality they convey different ideas depending on the person, industry or time period. Given that we are likely near the later stages of this equity bull market, a company becoming "de-risked" as an investment thesis gets pitched a lot. At first glance it seems simple enough – an investment is less risky today than it was in the past and is hopefully still at a similar valuation level. But we would argue the meaning of de-risking, just like what it means to be fashionable, could be more varied than you think.

To many, an investment is de-risked when a highly levered business demonstrates they can grow out of their debt. To others, when a negative external factor begins to shift in a company's favour (higher auto sales, for example), an investment in that company gets de-risked. In the oil and gas industry, de-risking means you have drilled enough wells on a piece of land such that you can tell investors that future wells on this land will be as good or better than the first few (oddly enough, this doesn't always work out). Certainly, all these factors could be reasons why we would pursue an investment, but we would not necessarily call an investment de-risked due to those factors alone.

Martinrea is a global auto parts manufacturer. It is a recent example of a popular "de-risking" story (to be fair, there are several "Martinrea like" investment ideas out there). Martinrea in 2014 had no senior management, very low margins and too much debt. New car sales at the time looked like they were peaking, and we all know what happens to an auto parts manufacturer's earnings profile if new car sales drop sharply. Three years later, the dreaded drop in new car sales never materialized, Martinrea has filled its management roster and profit has increased by over 60%. Martinrea's share price is well off its lows, although from a valuation perspective Martinrea is still at a substantial discount to its peers. While we would agree elements of Martinrea are certainly more investable today than in 2014, we would disagree that the company has de-risked as much as we like. Martinrea has added a cumulative ~$400MM of additional profit from 2015 to 2018, but has only paid down $10MM of debt. We view Martinrea as economically sensitive, meaning it has less control over how much money it makes compared to other portfolio holdings. To us, we would like to see Martinrea manage this major, controllable, factor (financial leverage) before we would agree that the company has sustainably de-risked itself.

To give another example, we recently initiated a position in Element Financial (N. America's largest fleet management company) in our small cap strategy. The company has been under significant pressure due to fears of a potential write down that could affect their leverage ratios. A glance at some sell-side research reports likely results in a conclusion that this company is far from "de-risked". After all, we still don't know how substantial the write-off may be and, realistically, there isn't much any management team can do to prevent a write-off at this point in time. The reason why we remain comfortable in our investment is that we believe that a strong CEO has been appointed with a good track record of change management and cost discipline. While a largely uncontrollable factor at this point in time has not been resolved (a write-off on Element's JV investment), we believe that Element's new CEO will be able to effect change and will be focused on all controllable aspects of Element's business in order to de-risk the company over the long term.

So what would we consider to be an example of "de-risking"? Our view is that the more management demonstrates a focus on controlling *all* controllables (both operationally and financially), the more flexibility and less risk the company will have. We believe that relying largely on growth and/or positive macro economic trends is a less sustainable way to de-risk a company.