"MOTOR" INVESTING

A Forward-Looking Investment Philosophy for a Dynamic World

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Introduction

Motor Investing is an active investment philosophy where the goal is to outperform passive equity benchmarks. For U.S. focused active investors, the benchmark is typically the S&P 500, but the strategy is equally applicable across other developed market indices. The philosophy is grounded in two key constraints, which we will explore later: it focuses exclusively on ***developed markets*** and assumes ***minority ownership*** (see Part 1 of Appendix).

Before formally defining Motor Investing, we want to highlight a fundamental truth about our view on investing: we are in the *predictions* business. Many investors hesitate to admit this, probably because predictions inherently involve errors, probabilities, and uncertainty. Nevertheless, the core responsibility of every active investor is to develop a forward-looking understanding of the businesses they own. Success as investors depends on our ability to anticipate how companies will perform in the future. Motor Investing builds upon this foundational principle.

Our motivation for writing this is rooted in our own experiences, where we began to discover a perspective that felt distinct from existing approaches. We thought our approach could be interesting to a pool of investors like ourselves—those who have grown tired of stagnating schools of thought and a field that often seems stuck in a loop, endlessly rehashing value, growth, and EMH mantras. Motor Investing seeks to address the vulnerabilities of existing schools of thought by offering a forward-looking framework adapted for modern equity markets—characterized by high levels of dynamism and technological shifts.

Despite having confidence in our differentiated perspective, we initially hesitated to write this given the constant deluge of investing approaches that claim to be new or promise something different. More often than not, these are just repackaged versions of old ideas. Investors, in turn, have adapted—most instinctively categorizing anything presented as new into preexisting frameworks, even when it doesn't quite fit (aka representativeness bias). This is why, in presenting our approach, we have deliberately avoided jargon and focused on defining Motor Investing primarily by how it *differs* from existing schools of thought.

To mitigate the risk of presenting a philosophy that feels overly abstract, we have incorporated numerous examples, illustrations, and scenarios to provide practical grounding. If our work sparks a shift in perspective for even a few, we will consider it a success.

What Is Motor Investing?

Definition

Just as a motor powers a car, the "motor" in this context represents the driving force *behind* a company's ability to generate *value-creating revenue*. It is the combination of internal elements, like competitive advantages and strategy, and external factors, such as market trends, customer needs, technological advancements, and regulatory dynamics, that define a company's existence and influence its *future* trajectory.

In a dynamic world, a company's motor is in either one of two states: strengthening or weakening — there is no resting place for a company in a competitive economy. And this state only becomes conceptually visible though a comprehensive understanding of the interplay between a company's evolving capabilities and its environment.

A *strengthening* motor reflects a company building potential to better meet the needs and desires of current and future customers. This potential translates into future growth in the company's customer base and/or an increase in the value customers derive from its products and services. Over time, this leads to ***value-creating revenue growth*** — revenue growth that enhances intrinsic value. Conversely, a weakening motor indicates declining potential, with the company becoming less capable of growing its customer base or delivering value to its customers.

Motor Investing is a philosophy that centers on identifying companies with ***strengthening motors***.

Since the goal of the philosophy is generating excess returns, the investor's conceptualization of the company's future must be ***variant*** to the broader market.

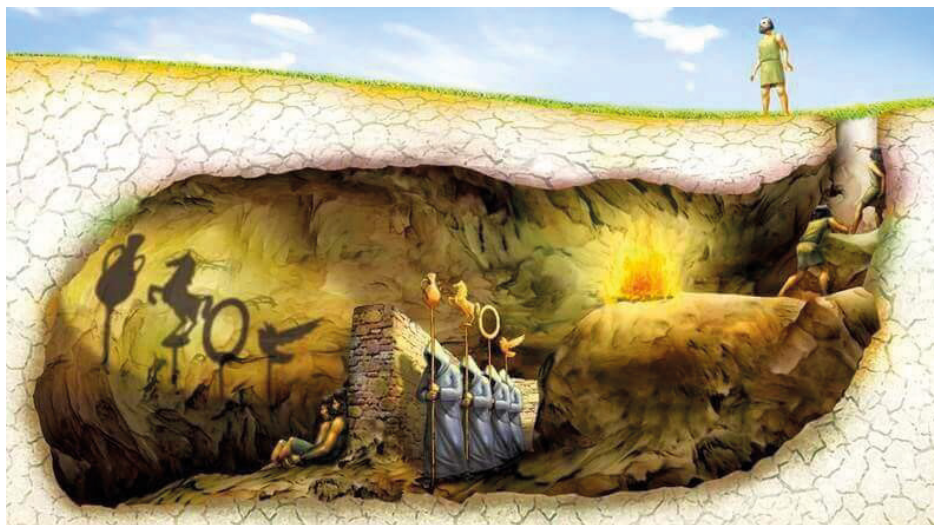
Variant Perception Requisite

It is not enough to find companies where the motor is strengthening and our view is widely held. *The opportunity to generate excess returns is only available if the investor has a variant perspective and is right more often than not*. The more variant the view, the more intrinsic value and market price will diverge and the greater the potential for excess returns.

Three Pillars of Motor Investing

1. The Hidden Motor

Companies function as transformation mechanisms, turning ideas, investments, talent, and collective human effort into products and services that generate revenue while (ideally) offering value to society. A deep understanding of how and why this process creates value is critical for evaluating the health of a company's motor.



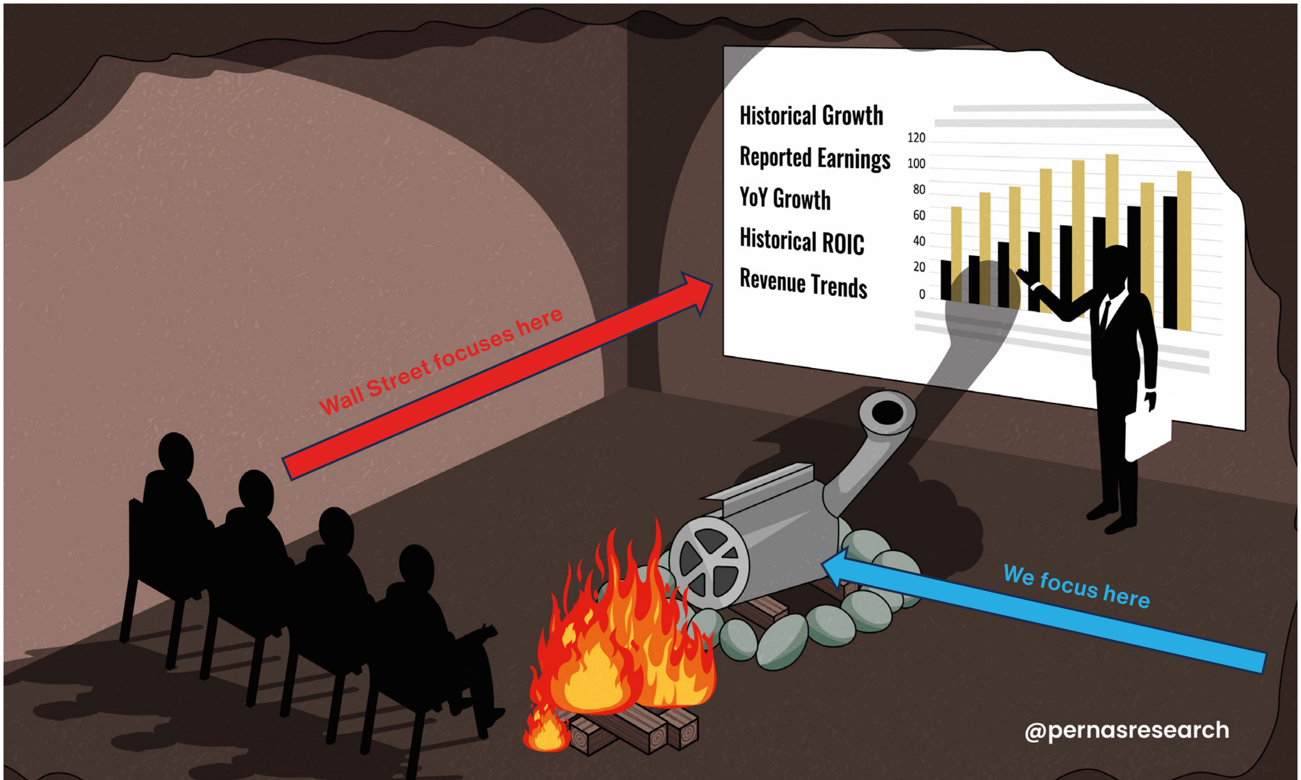
Plato's Allegory of the Cave: A Lens for Understanding

Plato's Allegory of the Cave aims to provide an illustration regarding the difference between observed reality and hidden truth. Similarly, reported financials are what we observe—empirical instances that attempt to reflect the true strength of a company's underlying potential. However, a common mistake among investors is conflating strong financials with a strengthening motor. The two often do not correlate.

A company may show impressive financial performance in the current period while its motor is, in fact, weakening. Examples include:

- A luxury brand overproducing, diluting its exclusivity and long-term appeal.
- A SaaS company masking churn through excessive promotions.
- A company riding an inflated upcycle or a trend that is nearing its end.
- A platform company raising its take rate too high, alienating future users.

In these scenarios, current financials may appear compelling—revenue and earnings are growing nicely, and ROIC is likely high. While this growth may initially boost the bottom line, it often comes at the expense of long-term staying power, contributing to a decline in intrinsic value or even sowing the seeds of terminal decline. Strong current financial results can mask a weakening motor, which will ultimately have significant consequences for future fundamentals. Investors who extrapolate these financials into the future are likely to be disappointed.



The Motor Investing version

The Motor is a "meta" concept that shifts focus to what truly matters: *the health of what generates the financials, rather than the financials themselves.* A strengthening motor will ultimately lead to improved fundamentals in the future, even if current financials don't reflect this. Examples of where current financials are not reflective of a strengthening motor could include:

- Conglomerate divesting a high-risk but profitable unit.
- Manufacturer ramping up investments in production efficiency.
- SaaS firm expanding into adjacent markets.
- Industrial business set to experience a growth inflection from favorable tailwinds.
- Discount retailer gaining market share during a recession.
- Commodity producer positioned at the bottom of a down cycle.

These are all instances where the current financials could markedly understate future fundamentals.

We have found by and large investors assume a high degree of correlation between the strength of the motor and current financials. This mistake is a source of never-ending opportunities for investors like ourselves.

2. Trajectory over Quality

We have established that Motor Investing is a forward-looking strategy focused on identifying companies with strengthening "motors." A company with a strengthening motor is one that will be better tomorrow than it is today. The criterion for consideration is the company's *future state relative to its current state: (future state > current state).*

This approach is **quality-agnostic**, meaning it does not rely on traditional definitions of "quality" like high margins or high ROIC. Instead, the emphasis is on the trajectory of improvement, NOT the current health or financial state of a business.

Consider a contrastive example:

- **Business A** has industry-leading profit margins, strong historical revenue growth, and historically high ROIC. However, through research, we identify beginning signs of share loss and a weakening outlook.
- **Business B** has a mixed revenue profile and is unprofitable today but, through our research, we identify signs they are gaining share, creating value, and scaling favorably (our variant perception).

Under Motor Investing, Business A is uninvestable, while Business B is investable.

Perhaps the key differentiator of Motor Investing is the **de-emphasis on the current state of the business**. What matters is conviction that the future state will be better, regardless of whether the company is currently "bad," "okay," "good," or "great." Companies improving from bad to okay, okay to good, good to great, or great to greater are all candidates for investment.

Conversely, no matter how impressive a company's current metrics or *how optically attractive its valuation may be*, if we cannot gain conviction in its improving trajectory (i.e., a strengthening motor), it is NOT a candidate for investment. *

3. Anti Extrapolation

While many analysts present future projections as part of their research, we find that these exercises often rely heavily on financial extrapolation. Few analysts develop real conviction in the future of businesses. Instead, most projections combine management estimates with straight-line extensions of historical financials trends—an approach we find deeply flawed. This "extrapolative pandemic" in finance leads many market participants—professional and otherwise—to mistakenly assume that past trends in company fundamentals are indicative of the future. Our research, alongside existing empirical studies[1,2,3,4], confirms past revenue growth, margin expansion, earnings growth or any other past movements in fundamentals, show little to no correlation with future changes. This holds true across various timeframes: whether comparing the last five years to the next five or the last 12 months to the upcoming 12 months. (The lack of correlation resembles fractals, where non-correlation patterns are consistent across different time scales.)

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*[The obvious exception is the rare case where a company's future state < current state, but strong cash flow generation and high payout ratios provide dividend investors with a high IRR.]

Why Extrapolating Trends is Misguided

1. **No Persistence in Growth Trends:**
   Revenue and earnings growth rates are highly inconsistent over time. A company's strong past growth often does not indicate similar future outcomes, as industries evolve, competition increases, and economic conditions shift.
2. **Non-Linearity:**
   Business performance is rarely linear. Periods of strong growth are often driven by unique or temporary factors, such as market expansion, cost-cutting, oone-time opportunities, which are unlikely to repeat.
3. **Cycles/Trends/Fads:**
   Company performance can sometimes be largely explained by riding a cyclical upswing, trend tailwinds or faddish consumer behavior that may be short lived.
4. **Principal-Agent Problems:**
   Management teams are oftentimes incentivized to boost short term fundamentals even when it comes at the expense of long-term performance.
5. **Luck vs. Skill:**
   Success in the past may reflect luck or timing rather than skill or repeatable strategy.

The role of past financials

If historical trends aren't predictive, are past financials useful at all? The answer lies in how they are interpreted. Historical financials are important not to serve as a basis for naïve projection but for the *contextual enrichment they provide about the present.*

Some examples of how past financials are useful:

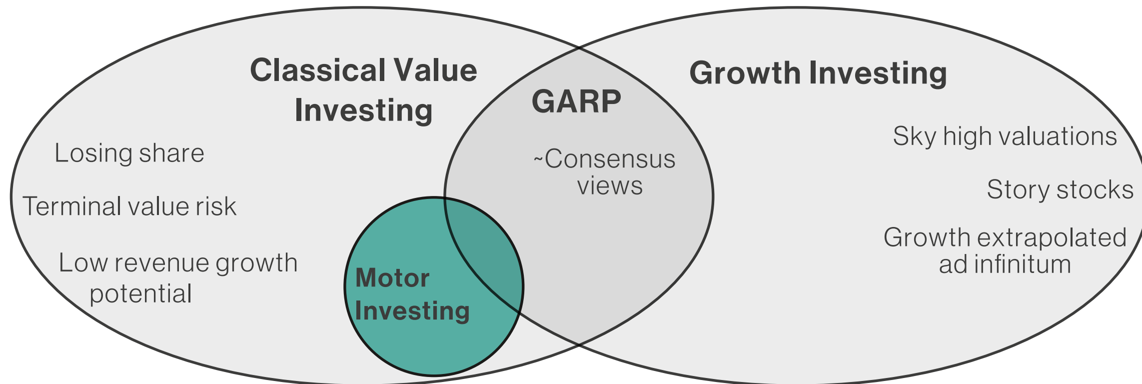
1. **Patterns and Trends:**
   Past financials can reveal where a company is in its lifecycle (e.g., growth, maturity, or decline).
2. **Path Dependencies:**
   Long-term investments, acquisitions, or strategic choices often lock a company into trajectories that influence future decisions.
3. **Cultural Legacy:**
   Historical behaviors often define a company's DNA, from its risk tolerance to its ability to adapt to crises.
4. **Management Track Record:**
   Leadership decisions in the past can provide clues about how management might respond to future challenges.

Financial history is a static record of what happened—not a multifaceted view of what could have happened, nor why certain outcomes occurred. A deep understanding of the "why" behind how past events unfolded enables accurate explanations, which in turn support better predictions. ***Explanation and prediction are cousins***; poor explanations of the past lead to poor predictions of the future.

Motor Investing vs Existing Schools

Motor Investing is a subset of *classical* value investing, which we define as any investment approach grounded in the concept of identifying companies trading at a discount to intrinsic value which is estimated by discounting future cash flows — an exercise that requires detailed, company-specific research. This contrasts sharply with mechanistic value investing, which we will address later (See Part 2 of Appendix).

Growth Investing, by contrast, primarily targets companies exhibiting significant growth, with little to no consideration for intrinsic value. GARP (Growth at a Reasonable Price) as shown in the Venn diagram below, overlaps both classical value investing and growth Investing. It emphasizes top-line growth while maintaining a focus on reasonable valuations. Importantly, all Motor Investment will qualify as classical value investment, but not all Motor Investments fit within the criteria of GARP or growth investing.



The table below highlights the typical focuses of investors subscribing to each school of thought — some of which we have already discussed. The rest of this section will provide additional context around these remaining areas of focus.

	Value Investing	Growth Investing	GARP Investing	Motor Investing
Free Cash Flow	✓			
Revenue Growth		✓	✓	✓ *
Catalysts	✓			
Extrapolative		✓	✓	
Intrinisic-Value Driven	✓		✓	✓
Quality-Agnostic				✓
Variant or Contrarian Views	✓			✓
Mean Reversion	✓			

***Provided the revenue growth is in the future and is value creating**

Revenue Growth vs. Free Cash Flow Growth

Motor Investing prioritizes *future* top-line growth, with the key condition that the growth is value-creating. While free cash flow growth is important, Motor Investing evaluates free cash flow as a *byproduct of value-creating revenue.*

This forward-looking focus on quality top-line growth gives motor investors the flexibility to consider:

- **Earlier-stage companies that are currently burning cash.**
- **Companies with currently challenged or declining revenues.**

The first group of companies is often avoided by value investors, while the second class is typically avoided by growth and GARP investors. Motor investing, however, considers both categories of companies as viable investment opportunities if there is potential for value-creating revenue growth.

Companies that grow free cash flow without corresponding revenue growth may indicate a weakening motor, often achieving temporary cash flow improvements through cost-cutting or other means rather than a genuinely strengthening business. Placing FCF at the top of the importance-hierarchy, rather than treating it as a byproduct of value-creating revenue growth, is the key reason value investors fall for value traps. This lack of a forward-looking framework often leads to overestimating the long-term performance of such businesses.

Do value investors care about revenue growth?

It is worth noting that by and large value investors tend to view forecasts of revenue growth negatively, considering them speculative and the most uncertain variable in the valuation process. Below are quotes from prominent value investors that reflect this perspective:

> Bruce Greenwald:
>
> *"Growth is the most uncertain and risky part of any valuation. To base an investment on speculative growth is to ignore the very foundation of value investing."*
>
> Seth Klarman:
>
> *"Valuation is rooted in conservatism. Relying on projections of future growth often leads to error because growth is the most difficult variable to predict."*

While we agree that growth can be uncertain and difficult to predict, we take a more nuanced approach and believe in certain instances growth can be highly predictable. The notion that all forecasts of growth are speculative is flawed. Investors should avoid hinging their valuations on precision, but modeling reasonable growth based on clear justifications is entirely appropriate.

[Important side note: It is not uncommon to hear an investor say, "I am looking for a company with growth." Terms like "growth" are often used ambiguously with regard to tense, making it unclear whether the focus is on strong historical growth trends, current yoy/qoq growth, or future potential. To eliminate this ambiguity, we always refer to "growth" in the future sense, unless otherwise specified. (The same applies for the words "growing" and "improving").]

For example, consider one of the few landfill companies operating in a region experiencing a significant influx of younger residents. As these individuals age, their incomes will rise and some will start families, inevitably producing more trash. This is a *concrete* justification for why the landfill company is positioned to experience growth. Ignoring this growth potential and modeling no growth would be a mistake, possibly leading to a missed investment opportunity.

Moreover, we find it inconsistent that value investors are hesitant to forecast growth while implicitly assuming that revenue will not decline. *This assumption of stability is itself a forecast* — and not an unoptimistic one at that. Why is it acceptable to have high conviction that revenue will not decline, yet unacceptable to assume with equal confidence that revenue will grow when supported by concrete justifications? In our view, avoiding growth forecasts because they are assumed to be speculative is neither logical nor conservative; it is just misguided.

Motor Investing Rejects Catalysts

Many investment approaches emphasize identifying a catalyst—a specific event expected to drive the stock price higher. While this approach makes good sense in special situation investing or trading, we believe it is largely irrelevant for broader investing. Predicting exactly when the market's psychology will shift or when the gap between price and value will adjust is impossible* to do reliably.

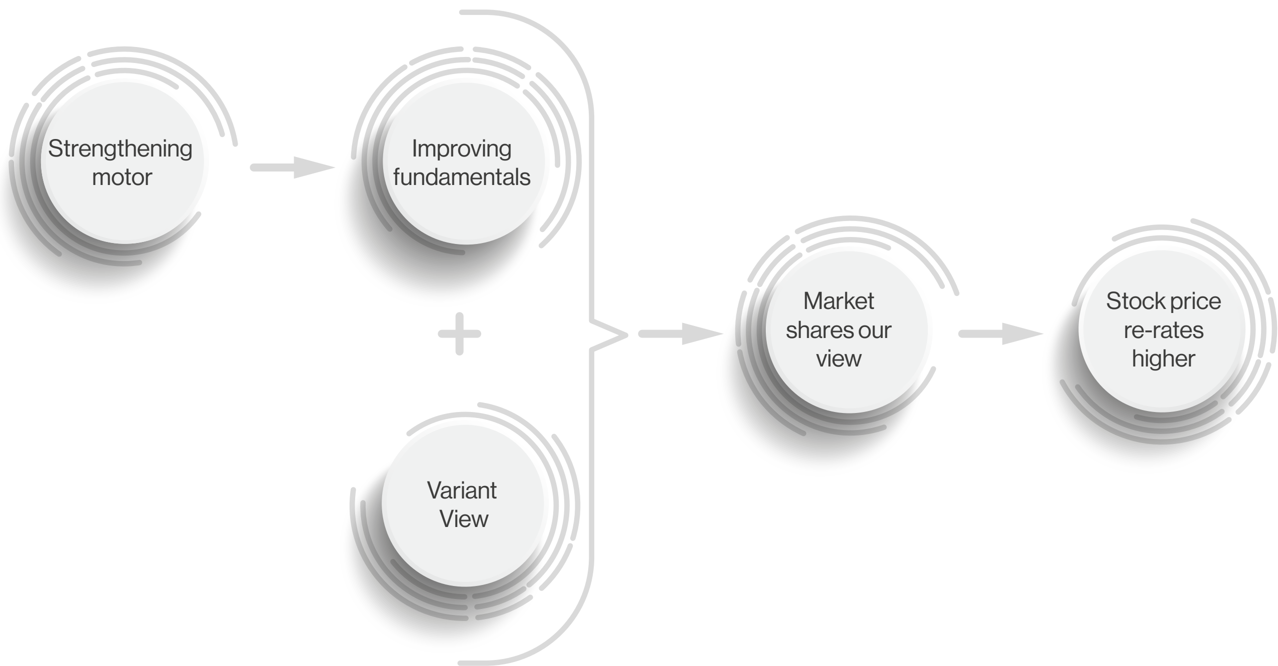
Motor Investing does not rely on traditional catalysts. Instead, the improving fundamentals of the business itself act as the catalyst. As the company's motor strengthens and its fundamentals improve, the market will eventually recognize its intrinsic value, resulting in a re-rating of the stock.

For any undervalued company in a developed market, improving fundamentals will inevitably trigger a re-rating, though the exact timing is impossible to predict.

This is why finding an undervalued company is not sufficient - the motor strengthening is critical. Strengthening motors lead to improving fundamentals, which, in turn, act as the mechanism that aligns the market's perception with the company's true value. *The dirty truth about investing as minority shareholders is that our ability to generate excess returns ultimately depends on other market participants recognizing what we see. The only force that ensures this recognition is improving fundamentals—the definitive "proof in the pudding."*

*We use "impossible" in a strict sense. The closing of discounts to intrinsic value typically depends on collective investor actions, which inherently involve an element of quantum unpredictability.

How Excess Returns Are Created



We amend Benjamin Graham's famous quote: "In the short term, the market is a voting machine. In the long-term, it is a weighing machine... *provided the business's fundamentals are improving."* Without improving fundamentals to act as the inevitable catalyst, gaps between intrinsic value and market price can persist indefinitely.

Mean Reversion and Motor Investing

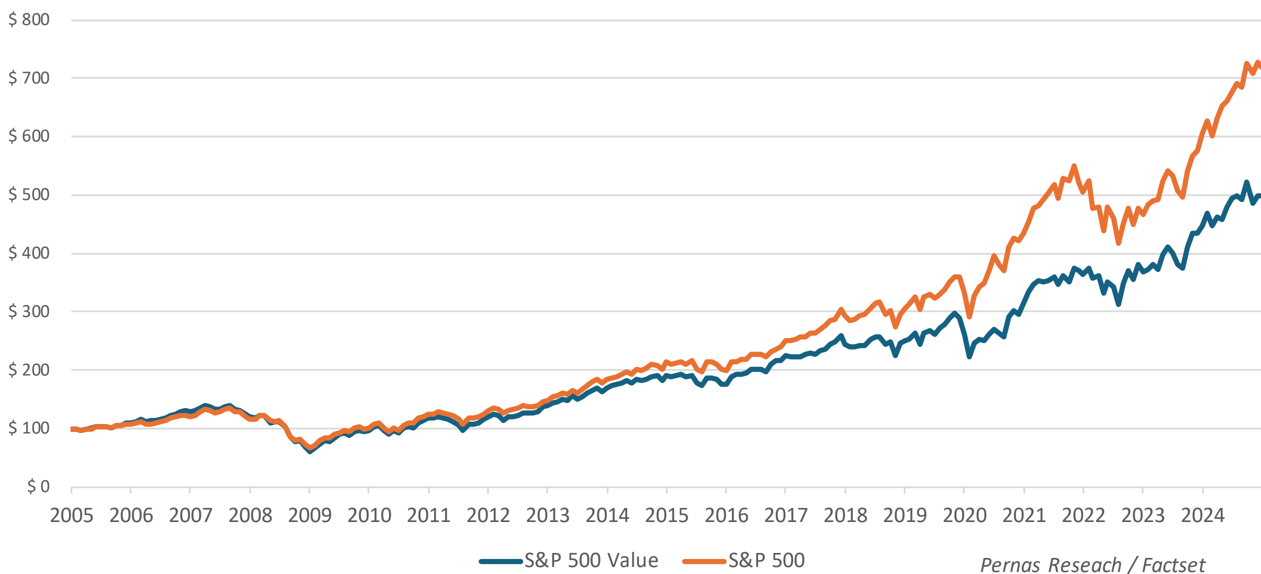
We have established why extrapolation — projecting current fundamental trends into the future—is a flawed foundation for investment decisions. Mean reversion, in particular, can be thought of as a form of reverse extrapolation: instead of assuming that current trends will continue, it assumes the opposite — that poor performance is likely to reverse simply because it has deviated far enough from the norm.

Investing in the value factor, whether via low P/E, P/B, or other metrics, is a *mechanistic* approach to value investing. This strategy posits that indiscriminate buying of these names will outperform due to the mean reversion phenomenon. Below is an explanation from Richard Pzena, a prominent value investor, presented at Columbia Business School in 2006:

"On average, companies do not go out of business. On average, poor companies do better, and on average, great companies that are doing wonderfully don't do as well. That is why value investing works: the markets extrapolate the same trends of high ROE companies continuing with the same or higher ROE while low ROE companies have lower or flat trends extrapolated into the future. People just don't get it (reversion to the mean) despite many years of evidence."

Proponents posit that bad news and poor fundamentals depress stock prices, leading to excessive pessimism and overshooting price action to the downside. Inevitably, the cycle turns, or new management arrives to improve operations, inevitably triggering a re-rating of the stock. This "faith-based" mean reversion belief by mechanistic value investors led to hundreds of billions of capital being funneled into an investment approach that does not consistently work—or, more accurately, works in certain regimes and not others. (See Part 2 Appendix).

Below is a chart of the past 20 years demonstrating the underperformance of value investing as a factor.



Motor Investing Rejects Mean Reversion

Motor Investing rejects the validity of the mean reversion concept unless supported by company-specific concrete justifications for why fundamentals will improve.

This aligns with Motor Investing's broader philosophy of rejecting both forms of extrapolation:

1. **Naïve forward extrapolation:**
   Assuming current financial trends will continue indefinitely.
2. **Reverse extrapolation (mean reversion):**
   Assuming poor performance will improve because fundamentals have strayed too far from their average.

No trend or pattern in historical fundamentals can reliably indicate whether future fundamentals will improve.

Motor Investing diligently analyzes past fundamentals only to contextualize the present, never as a basis for extrapolation or mean reversion.

Donnelley Financial Solutions (DFIN): A Case Study in Motor Investing

Business Description & Investment Setup

Donnelley Financial Solutions (DFIN) operates in the regulatory technology (RegTech) space, providing software and services that help public companies and investment funds manage financial reporting and regulatory compliance.

DFIN originated as the financial printing and compliance division of its former parent, R.R. Donnelley. The stock had declined almost 80% since its 2016 spinoff, as investors saw it losing share to digital-native competitors and believed the traditional IPO process was structurally impaired, reducing demand for DFIN's core services. The market's perception was that DFIN was a melting ice cube — a view we found to be deeply flawed.

Despite past revenue declines and share losses in certain segments, our research revealed that DFIN's motor was actually strengthening, leading us to take a large position in July 2020.

Description of DFIN's Motor: The Why & How of DFIN's Ability to Generate Value-Creating Revenue

DFIN plays a mission-critical role in regulatory compliance and corporate finance. Public companies, law firms, and investment banks rely on its expertise to ensure accurate and timely SEC filings. The complexity and risk associated with compliance create a high barrier to switching providers. The saying, "Nobody gets fired for choosing DFIN," underscores its entrenched position in the ecosystem.

Unlike a traditional Porter's Five Forces analysis, which focuses on industry structure, our assessment centered on evolving customer needs and how DFIN's unique positioning meets these needs:

1. **Essential Expertise in a High-Stakes Domain:**
   DFIN's services are indispensable for IPOs, M&A transactions, and SEC compliance. The regulatory burden continues to increase, reinforcing demand for its solutions.
2. **Recurring Revenue with Cyclical Upswings:**
   Regularized filings (e.g., 10-Ks, 10-Qs) provide a steady revenue base, while transactional filings (e.g., IPOs, M&A, debt offerings) create revenue spikes and introducing new businesses to its recurring services.
3. **Premium Pricing & Operational Efficiency:**
   DFIN charges premium prices for its services due to its reputation and deep integration within the IPO and M&A ecosystem.

DFIN's Strengthening Motor and Our Variant Perception

Our analysis uncovered two primary drivers of DFIN's strengthening motor that the market was missing:

1. **Strategic Shift to SaaS and Market Share Gains:**
   DFIN was not a digitally native player and had lost share to competitors, but it began to take important steps to address this vulnerability starting with partnering with Microsoft to develop its own software solution, ActiveDisclosure. DFIN's ActiveDisclosure software was quietly regaining market share. Through a random sampling of 20,000 SEC filings, we observed increasing adoption of ActiveDisclosure — well before it appeared in reported financials, providing concrete evidence of a digital transformation.
2. **IPOs Were Not in Structural Decline but at Cyclical Lows:**
   At the time of our investment, the prevailing market belief was that traditional IPOs were in permanent decline, driven by the rise of private markets and alternative listing methods such as direct listings and SPACs. This narrative was reinforced by headlines like:
   - *"The IPO Is Dying. Marc Andreessen Explains Why."* – New York Times (Oct 2019)
   - *"The Decline of the IPO and the Rise of Private Markets"* – The Economist (Mar 2018)
   - *"The Quiet Death of the IPO"* – Bloomberg (May 2017)

   However, our research suggested this IPO pessimism was misplaced:

   1. Public markets offer access to the largest pool of equity investors, enhancing valuation potential.
   2. CEOs value the visibility of public rankings — something private markets cannot replicate—along with easier access to debt and equity financing.
   3. Private company employees benefit from increased liquidity for their equity.
   4. Investment banks remain essential to the IPO process, leveraging deep asset manager relationships for marketing and credibility — an advantage that direct listings and SPACs lack.

These insights allowed us to correctly surmise that anemic IPO activity was a cyclical phenomenon and not a structural one, setting DFIN up to benefit when the cycle rebounded.

Conclusion: DFIN as a Motor Investment

DFIN exemplifies a Motor Investment because its financials misrepresented its future trajectory:

- The company was transitioning from low-margin print to high-margin SaaS, improving its intrinsic value even as reported revenue declined.
- The market incorrectly assumed IPO activity was permanently impaired, ignoring historical cyclicality.
- Investors focused on past revenue declines rather than the strengthening motor, which would drive improved fundamentals over time.

By identifying hidden strengths and variant insights, we recognized DFIN's strengthening motor before the market could see it come to fruition in reported financials — allowing us to invest when the stock was deeply undervalued. As DFIN's SaaS revenue grew substantially and IPO activity recovered, the market perception converged with our own, leading to a large rerating in the name.

Summary of Key Ideas

- **The Motor Defined:** The Motor represents the hidden force—the "how" and "why"—that enables a company to create value.
- **Strengthening Motors and Potential Energy:** A strengthening motor builds potential energy, which inevitably translates into kinetic energy through improving future fundamentals.
- **Two Motor States:** A company's motor is either strengthening or weakening. Only companies with strengthening motors are considered for selection.
- **Variant Perception:** Generating excess returns requires a variant perception of a company's future relative to market expectations.
- **Quality-Agnostic:** What matters is the future state of the business relative to its current state.
- **Developed Markets and Minority Investments:** The philosophy is constrained to developed markets and assumes minority ownership. (See Part 1 Appendix).
- **Growth Forecasts:** While growth is often uncertain, it can, in some cases, be highly predictable.
- **A Subset of Classical Value Investing:** Motor Investing is a subset of *classical* value investing.
- **Rejects Extrapolation, Mean Reversion & Catalysts:** Motor Investing relies on fundamentals to ultimately drive price action and avoids beliefs that have been empirically invalidated.

Final Thoughts

In this paper, we have outlined the core principles of *Motor Investing*, which we believe are better adapted to perform in an era of rapidly increasing complexity and technological shifts. The future of firms can look starkly different from their past, and investment approaches relying on naïve extrapolation or mean reversion risk being even less effective than in previous regimes.

While the philosophy is clear, the methods for identifying companies with strengthening motors will vary amongst investors. Our in-house research process is guided by our own core competencies, experience and informational resources. *We strongly encourage readers to review the appendix for key insights on foundational constraints and further critique of mechanistic value investing.*

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APPENDIX – PART 1

Constraints

Developed Markets Only

Motor Investing is limited to developed markets because only these markets provide the rule of law and regulatory frameworks necessary to ensure that value accrues to shareholders. A strengthening motor drives improving fundamentals, which act as an assurance mechanism, aligning market perception with our view of intrinsic value. This alignment leads to the rerating of the stock and serves as the source of excess returns.

In markets without robust frameworks — such as many emerging and frontier markets — this process can break down. Structural impediments like corruption, weak regulatory oversight, or governance issues may prevent improving fundamentals from translating into stock price reratings. Without the integrity and reliability of developed market systems, even if investors share our view, stock prices may never adequately reflect intrinsic value.

Minority Ownership

Flexibility to Enter and Exit

The second constraint assumes we are minority investors with the ability to enter and exit positions freely. This flexibility is essential to the Motor Investing philosophy, as our quality-agnostic approach requires dynamically adjusting our thesis based on evolving information.

Holding periods can vary widely from company to company. For instance, in industries lacking clear growth trajectories, we may hold an oversold company for 12 months or less if we believe its motor is strengthening in the short term but remain uncertain about its longer-term prospects. Conversely, in more predictable industries, holding periods may extend significantly.

While most updates to our thesis are incremental, significant developments—such as regulatory changes, technological shifts, or unexpected management changes—can prompt a substantial revision of our view. The ability to exit swiftly is crucial. This dynamic approach may not be feasible for investors managing large amounts of capital or have other constraints that prevent them from adjusting positions quickly.

Acquirers vs. Minority Holders

Perhaps more importantly, if we were acquirers of entire businesses rather than minority shareholders, our focus would shift. Instead of prioritizing value-creating revenue growth, we might center our strategy on maximizing current cash flow. In this scenario, we could justify acquiring cash flow-heavy businesses—even those in rapid decline—provided the purchase price and current cash flow yields generate attractive internal rates of return (IRRs). Here, the focus would be less on market re-rating and more on collecting cash flow during the holding period.

APPENDIX – PART 2

Mechanistic Value vs. Classical Value

The greatest mistake in the value investing community has been allowing the value philosophy to be hijacked by mechanistic value investing. Investors nowadays often fail to distinguish between mechanistic and classical approaches, leading to widespread misconceptions about the validity of value investing as a whole. This is explained by two phenomenon:

1. **Historical Success of Factor-Based Value Investing:**
   Early studies, such as Fama and French's research on the value factor, demonstrated that stocks with low P/E or P/B ratios outperformed (marginally) over time. Value was one of the original three factors in the Fama-French three-factor model, designed to explain excess stock returns. The concept of mean reversion was proposed as the primary explanation for why value investing as a factor would outperform over extended periods. However, this hypothesis has not held up. Over the past 20 years, the value factor has underperformed significantly, challenging its validity as a source of excess returns. This prolonged underperformance suggests that the value factor is, at best, regime-dependent and, at worst, a strategy that worked historically but is no longer viable.
2. **Institutional scale:**
   Fama and French's academic validation firmly established quantitative, value factor-based investing as a legitimate strategy to help outperform the market. The quantitative nature of the approach enabled institutions to scale these strategies efficiently through exchange-traded funds and index funds designed to systematically capture the value factor. These funds were often promoted as a "smarter way" to design an index compared to traditional market-weighted indices, which were contrasted as "dumb." As of 2023, in the U.S. alone, there are over 400 ETFs incorporating value-focused strategies, collectively managing hundreds of billions of dollars in assets.

This academic and financial institutional revolving door has propelled mechanistic value investing to overshadow and dominate perceptions of the value philosophy. The reality is that, despite the vested interests and efforts of academia and financial institutions, mechanistic approaches have proven to be poor substitutes for true classical value investing.

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