Eschler Asset Management LLP

Eschler Recovery Fund SP
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Q&A with Theron de Ris,
Portfolio Manager
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How has your background prepared you to run a fund independently?

I grew up in the US but spent the past 17 years in Europe in investment advisory roles at Goldman Sachs (5 years), Morgan Stanley (8 years) and Indus (various roles over the past five years). I've seen a few investment cycles, taken some career risks and developed some contacts. All these experiences help. But my desire to run my own fund was hard-wired in my early years. I can point to three influences. First, growing up in upstate New York we never had extra money, including for college. As a result doing well financially was my objective right from the start and I was working two summer jobs in my teens, landscaping during the day and waiting tables at night. There was nothing to fall back on and so I've always preferred saving to spending. Reading Ben Graham and Buffett 10 years ago naturally turned me on to investing and compound interest -- I only wish I'd discovered them 10 years earlier. Second, my dad was an architect and always in business for himself. I feel lucky to have had a career at large, successful companies but it was my dad who planted the entrepreneurial bug. The desire to work in a more entrepreneurial way was always there. The opportunity cost of starting my own business kept rising, but it was only going to be a matter of time. Third, I learned pretty early that if you set your mind to something you will get to where you want to be. I've always been fascinated with Europe and spent most summers there starting from my mid-teens financing travel with various jobs. I paid my way through college and landed in Frankfurt in 1994 with $400 in my pocket and no idea how I would support myself. Ironically, while dozens of local banks ignored or rejected my application letters, in the end of all employers it was Goldman Sachs in Frankfurt who decided to give me a shot. The key was not to give up.

What experience do you have investing?

The first two stocks I bought were Citibank and Cephalon, a biotech company. It was 1990 and I was 18. I learned two lessons: First, Citibank was at half of book and ended up going up a lot, but I sold way too early. Second, Cephalon's Lou Gehrig's disease drug received FDA approval and the stock doubled. I realized that luck played a role in investing. More recently, for the two years ending February 1st 2012 I managed Eschler Global Fund, a start-up global equity long-short strategy with $15mm in assets. The fund rose in the first year but fell in the second and investors redeemed a majority of fund assets on February 1, 2012. Warren Buffett's advice is to learn from *other* people's mistakes, but while I can claim some unfortunate external events, or bad luck, a post-mortem implies I could have done better. Learning from the experience informs my strategy with respect to Eschler Recovery Fund.

How has your experience informed your investment approach?

Value, concentration and keeping an open mind inform my approach. I have an independent streak and value investing, i.e. trying to purchase assets well below their fundamental worth and patiently waiting for the mispricing to be corrected, is most closely aligned with my nature. I don't mind running with the herd but confess to a degree of excitement when my convictions set me apart from the prevailing wisdom. With hindsight, I tried to bite off more than I could chew while running Eschler Global Fund: the portfolio was global and I maintained heavy exposure to Asia, where the fund lost money; the fund held 40-50 longs and 20-30 shorts; gross exposure was generally high (130-200% gross) with a large short book, and I regularly deployed options as hedges. I made a large (and early) bet on financial stocks in 2011. I am now intensely focused on doing only a few things well. The result is that Recovery Fund's universe is primarily North America where I have the most experience and best access to information, and made money; generally for every two ideas I find in North America I'm finding one in Europe, so my soft limit for non-US exposure is 30-35%. The fund only has 5-10 core holdings, 10% being a full position, with an option to go above that for the right opportunities. The fund maintains the option to use leverage though my target gross is now 100% plus or minus 25%. I don't make regular use of options anymore; attribution analysis from Eschler Global Fund proved this was money wasted, and so the bar is now much higher for deploying options and I will not tolerate annual losses from options exceeding 100bp of NAV. Diversification for me means combining several securities in different industries, not spreading the portfolio across many smaller bets.

Why did you launch Eschler Recovery Fund now?

At the time of the fund restructuring on 1 February 2012 the strategy changed to incorporate what I had learned, and remaining external investors agreed to this. After successfully testing the strategy for six months I thought it was the right time to start the clock ticking again. On 8 October we liquidated the Global Fund segregated portfolio and officially launched the Recovery Fund strategy in a new segregated portfolio. Since 1 February, the combined performance of the new strategy, linking both portfolios, is +26.7% net (as of 31 January 2013, unaudited), ~1000bp above the S&P 500 total return and above most hedge funds. Eschler NAV is also above its historical high water mark. I have all my savings tied up in the strategy and desire high compound returns on my capital. The new fund structure allows me to prove out that objective and offers investors the option to join me on the fairest terms possible.

What are you looking for in an investment?

My core approach is to invest in a concentrated portfolio of emerging or established businesses with franchise qualities (strong normalized returns on capital and earnings power) and special situations (discounted holding company, deep value and event-driven equities). Examples of the former currently in the fund include Greenlight Re (more below) and Chesapeake Energy. Examples of the latter include Dolphin Capital Investors and Daihatsu Diesel. I seek to evaluate businesses whose shares may be suffering due to a temporary weakness in earnings or NAV growth, or supply/demand imbalance for the shares, where my analysis implies a material mispricing. To build conviction I evaluate 1) management and the shareholder structure (ideally like-minded shareholders including, preferably, insiders); 2) catalysts that may spur a revival in per share earnings power or NAV growth; and 3) valuation: I want to purchase at a large discount to fair value using normalized earnings, or at a material discount to net tangible assets. I tend to find ideas in the following areas: quality franchises (cyclical or defensive) with temporarily weak earnings or the expectation thereof; quantitatively cheap securities on price/net tangible assets; out-of-favour countries or sectors; listed holding companies at discounts to NAV with motivated insiders or hard catalysts; micro-caps; equity-linked securities with attractive features; spinoffs or index deletions; post-bankruptcy equity. The strategy is market cap agnostic though skews toward smaller companies.

What is unique about your approach?

1) The position concentration in Recovery Fund is unique. My goal is to invest in 5-10 core positions with different investment drivers that I know well. Most funds invest in 4-5x as many securities. 2) My experience has led me to be less dogmatic about what defines value than many value managers are. I may evaluate potential investments where value is not readily apparent, or where the balance sheet is weak. It is often in these areas that one finds the biggest mispricing. Experience and judgement are now more important to me than value screens. The key is buying into attractive underlying businesses with strong normalized earnings power at high IRRs to equity vs. fair value. Catalysts must be present to close the mispricing. A portfolio of only 5-10 such diverse ideas can be made to be robust. 3) Determining the extent of macro or industry tailwinds affecting an investment is now more critical to my strategy; perhaps more so than for other value managers. I see my edge as evaluating individual businesses and I am not looking to "play" macro themes. Having said that, macro factors I have identified will determine the extent of success of a number of fund holdings. Strong company-specific catalysts must be present within a shorter period of time for investments that lack external tailwinds. 4)

Many value managers will engage with underperforming investees, taking an activist approach to create their own catalyst. For the investors with requisite experience, capital and resources this tool can make sense, but for the foreseeable future I will only invest in companies in whose management I already have confidence. My first preference is for management to be a major positive factor for my investment thesis. Alternatively, I would rather ride the coattails of an activist who has already done the heavy-lifting.

What are your thoughts on shorting?

My experience is that shorting requires more analytical and psychological effort than investing long. In particular, to generate material short P&L ideally one needs to dedicate extensive analytical resource to identifying, monitoring and trading each position. To be frank, I just don't have the time for this. While I contemplated completely avoiding all short exposure, I've decided it can play a limited role in the portfolio. After all, I know where to find ideas and I've had some good experiences in the past few years. Thus I envision a maximum single stock short exposure of 20% of NAV, i.e. 1/5th the size of the fully invested long book. This 20% limit excludes occasional use of market level hedges.

How do you manage risk?

The answer has a lot to do with the experience I've described above. My takeaways are: 1) generally maintain much lower gross exposure; 2) re-evaluate the thesis for losing investments and decide to increase or sell; 3) related to that, take portfolio level measures when overall portfolio losses exceed 10% relative to the beginning of the period; 4) stay within my circle of competence primarily analyzing investments in North America and, to a lesser extent, Europe; 5) diversify into different industries; 5) don't invest in cheap securities in a vacuum - identify catalysts to realize value.

Could you describe an idea in which you have high conviction right now?

I've deployed 10% of fund capital into Greenlight Re (GLRE US, $22.76/sh), an $850mm market cap specialty P&C reinsurer founded in 2004, underwriting since 2006, public since 2007 and based in the Cayman Islands. I like the business model, management and valuation and believe there is a trigger in likely fundamental improvement that will revalue the shares. **Business Model:** The average P&C reinsurer holds, say, $5 of reserves for every $1 of equity and invests equity and reserves in fixed income securities generating, say, a 4% yield. The average cost of reserves in the industry is 3%. This strategy currently yields a 9% pre-tax ROE and explains the price to book discount prevalent in the industry. GRLE is different. Gearing is very low (the lowest in the industry) with reserves less than equity, and 100% of reserves and equity are invested in David Einhorn's Greenlight Capital long-short equity strategy, a successful strategy with which I am very familiar. I like the prospects for long-short equity generally, and am attracted to reinsurance models set up to reinvest float in sound equity strategies. This is, after all, the business model that allowed Warren Buffett to turn 12% returns on his public stock investments into structural alpha yielding 20%+ per share growth in after-tax book value over 40 years. **Investments:** Effectively, investing in GLRE is like investing in the Greenlight Capital Fund with added leverage from float and zero tax liability which drive superior returns relative to the return that underlying fund investors receive. Daily liquidity is another feature. Other reinsurance companies with an investment focus on alternatives have been less successful because they did not maintain consistent exposure to the strategy. GLRE has never changed asset allocation and the investment yield has averaged 10.6% since 2004 (including -18% in 2008). As an aside, I found it interesting that there was only one question on the Q312 conference call, and despite the ability to ask David Einhorn any question, no investors did. **Operations:** I also like the strategy of concentrating on non-commoditized products in a small number of under-served or capacity-short areas. Management's trackrecord is only decent with a 3.9% cost of reserves since 2007 but clearly there is potential for them to do much better, and to generate a lot more float if external factors allow. GLRE has reported adverse loss development in the past few years related specifically to two commercial auto liability lines that didn't pan out. 98% of claims related to the first contract have been resolved but the second contract, totalling $90mm in premiums, is less seasoned. Like the first, management now carries this second contract at a 122% combined ratio and much of the hit has already been taken. Clearly, this bears monitoring and the market has not been pleased. The good news is that management has kept very low gearing and thus minimised the impact of this mistake, while no doubt learning valuable lessons. I like the fact that if a hard market materialised, and/or Greenlight Capital reverted to historic 20%+ returns, GLRE could dramatically expand float and book value per share. It is worth noting that GLRE has a structural advantage in that it pays no taxes. Notably, management compensation is completely geared toward long-term per share growth in book value. **Valuation:** GLRE trades at 6.5x 2013e P/E and 97% of Q312 book value. Since the IPO in 2007, shares have traded on average at 122% of book and other than today only ever traded at a discount to book in late '08 / early '09. For 2013, I assume a 100% combined ratio, 10% investment return, 1x reserves to equity, 38mm shares outstanding and 1.2x price to book. This yields book value per share of $27-28 and a share price in 12-18 months of $32.4 - $33.6. This is an IRR of 30-45% depending on the time horizon. In terms of downside, it is hard to get book value per share below $20 even with very adverse assumptions on underwriting and investment return. **Risks:** The risks to this call are 1) that adverse loss reserve developments continue, depressing the price to book multiple; 2) that management cannot identify, or the market does not offer the underwriting opportunities with attractive risk-reward necessary to expand float; and 3) that David Einhorn's Greenlight Capital does not recover from the lacklustre returns of the past two years.

What are fund costs, terms and liquidity?

The Class B shares of Eschler Recovery Fund do not levy a management fee. The Manager earns 25% of annual profits above a compounding 6% hurdle rate. This fee structure is superior for investors at all levels of gross return compared to standard fee structures of 1 and 20 or 2 and 20. In exchange, investors commit to annual liquidity, though investments can be made monthly. These terms ensure absolute focus on investment return as opposed to growing AUM or unnecessarily controlling volatility. At current AUM amortizing start-up costs related to Eschler Global Fund SPC are about 50bp annually but only for the next two years, and registered office/company costs are 24bp. These fixed costs as a percentage of NAV would fall with new subscriptions into the fund. I am paying the administration charge (60bp) and audit (45bp) out-of-pocket in 2013. The fund has temporarily deregistered from the Cayman Monetary Authority (CIMA) under section 4(4) of the Mutual Fund Law, allowing the fund to have a maximum of 15 investors but avoiding the material costs associated with paying directors, directors insurance and CIMA registration. As an aside, it is worth highlighting that Eschler Recovery Fund has received reporting fund status from HMRC, allowing UK resident investors to gross up capital gains and income in the fund tax free until they redeem shares. I'm looking for 11 good investors!

How do you plan to communicate with investors?

I plan to write one annual letter in January of each year, this being the first. I also plan to describe my investment thesis for certain portfolio holdings from time to time. I will disclose fund holdings (on Bloomberg, for example, ESCHREC KY Equity) but not positions that I am still buying of course.

Why is Eschler Asset Management a suitable fiduciary?

Eschler Asset Management has been operational since late 2009, has published three years of audited accounts and remains FSA registered. There is no outside influence on the LLP as I am the sole owner. Very low operating costs have been key. I have partnered with reputable service providers to the fund including Morgan Stanley as PB, Trinity (Dublin) as administrator and Baker Tilley as auditor.

Will you invest in Asia why or why not?

I have not excluded future investments in Asia but generally I do not intend to deploy capital further there for three reasons: 1) my experience investing in Asia was not favourable and it is now clear a local presence is key. 2) I've been researching North American equities 17 years and this geography, as well as Europe to a lesser extent, falls within my circle of competence. 3) Actual or perceived conflicts of interest with employer, whose investment focus is primarily Asia.