Dakon Fund LP

A new approach to an old approach

Snapshot

Classic deep value

- Dakon is a systematic, fundamentals-based, deep value fund.
- Long-only. Typically holds 25-35 positions.
- Average market cap is $4 billion.

With a twist

- Using quantitative methods, we stripped value investing to its core and eliminated all the things that don't matter.
- The result: a simple robust value philosophy which:
  - keys off the things in life that don't change
  - doesn't rely on low-percentage predictions about margins, industries, or "catalysts."

DEEP VALUE

What is deep value?

- Deep value refers to the cheapest stocks in the stock market. A value stock may trade at 13x earnings. A deep value stock would trade at 8x.
- These are stocks where the outlook is terrible, boring, or just not compelling.
- Often even value investors don't want to own these companies because they don't have a catalyst.

> **People are always asking me where the outlook is good, but that's the wrong question. The right question is: Where is the outlook most miserable?**
>
> **—John Templeton**

THE SUPERINVESTORS

- When we studied and ran regressions on the most successful investors over the last 60 years, we made a fascinating discovery.
- A surprising number of these investors weren't just value investors. They were deep value investors.

Early deep value investors
- Warren Buffett (the early years)
- Walter Schloss
- Ben Graham
- John Templeton
- Peter Cundill

Today's deep value investors
- Seth Klarman
- Armor Capital
- Mittleman Brothers
- C. Thomas Howard
- David Abrams

Why deep value works

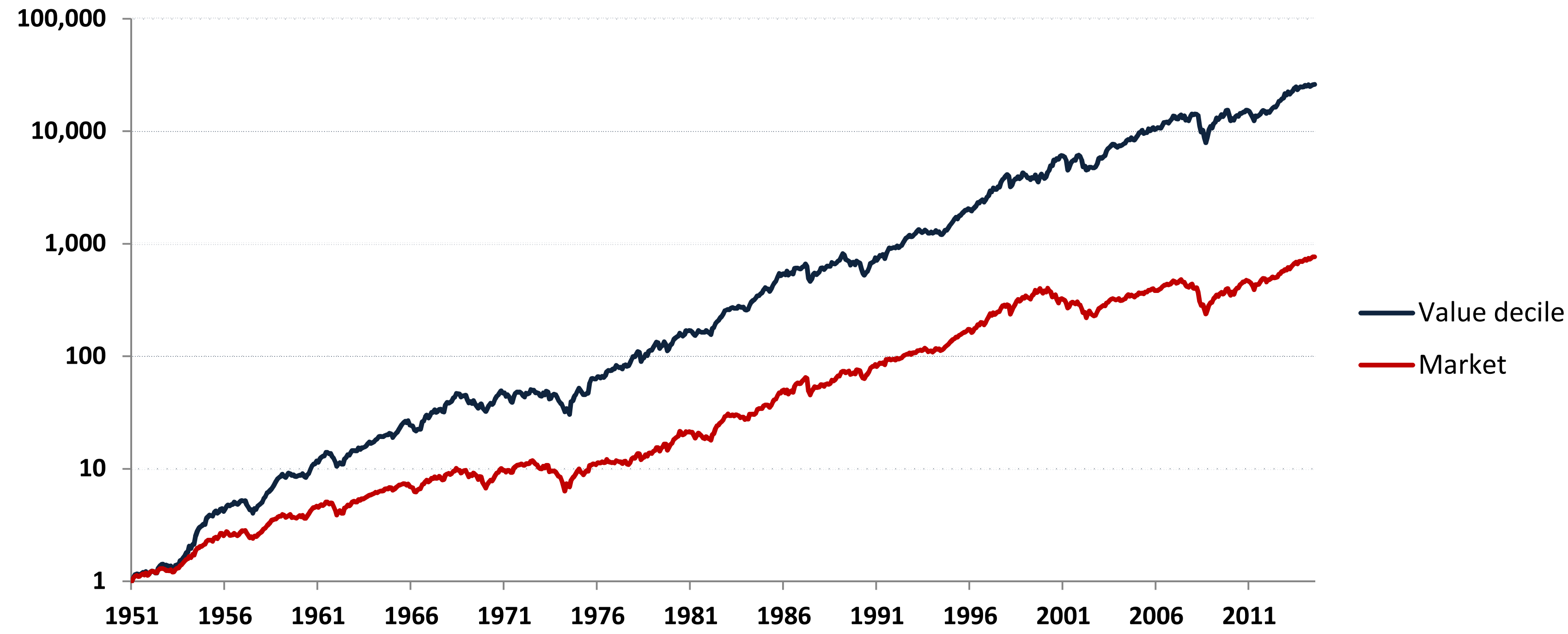
Returns by earnings performance (developed markets 1985-2007)

% per annum	Highest Growth	2	3	4	Lowest Growth
Value	19.8	21.6	17.7	15.9	11.9
2	20.6	18.0	13.7	11.0	10.9
3	17.8	14.0	11.6	9.87	8.10
4	15.7	10.5	8.55	6.67	6.12
Glamour	7.90	5.04	4.42	2.77	2.18

Source: SG Global Strategy.

- Over time, value trounces growth. Even the low-growth value stocks outperform high-growth glamour stocks.
- Value investing is about asymmetric payoffs. It's anti-predictions, anti-trying to be right all the time.
- And it's the closest thing to a golden rule in investing. David Abrams: "I've never seen people be successful over the years who aren't value investors."

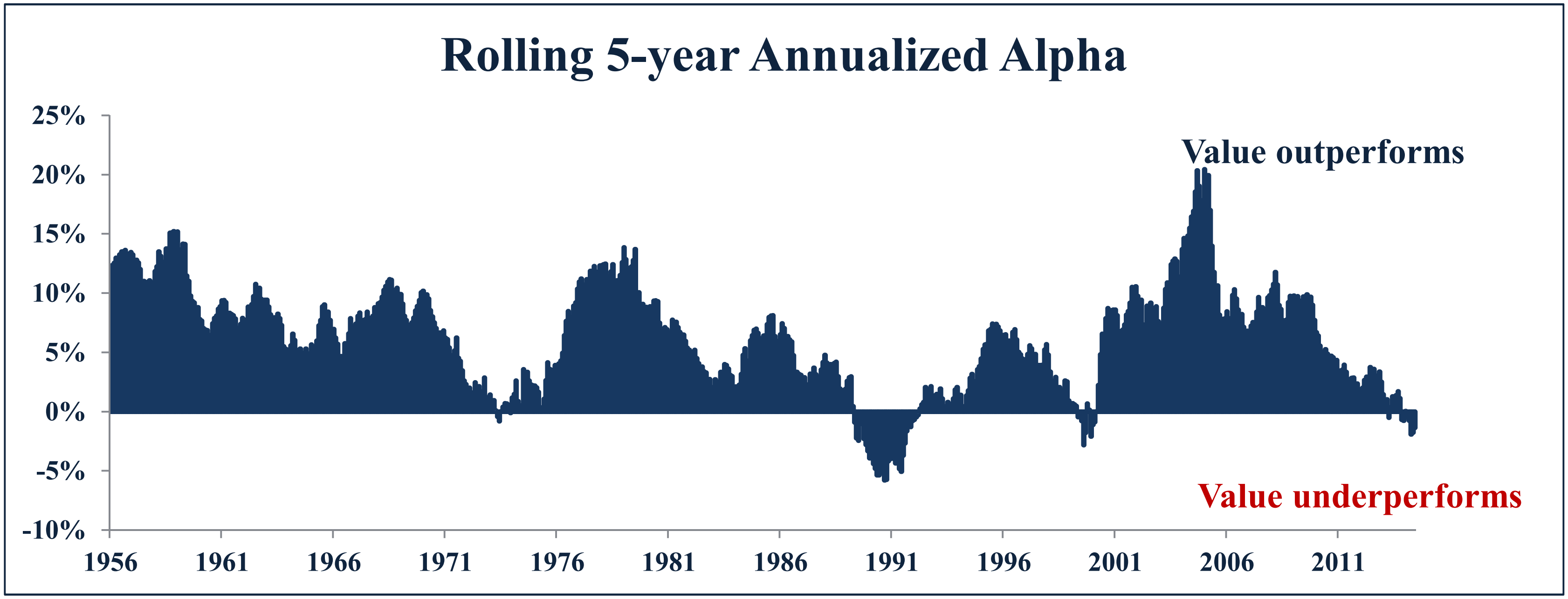
Deep value over the long-term



Source: Ken French data library.

- Value decile is cheapest 10% of stock market (market cap-weighted).
- Value decile returns 17% a year. The market returns 11%.
- Now imagine you picked the cheapest companies within the Value decile.

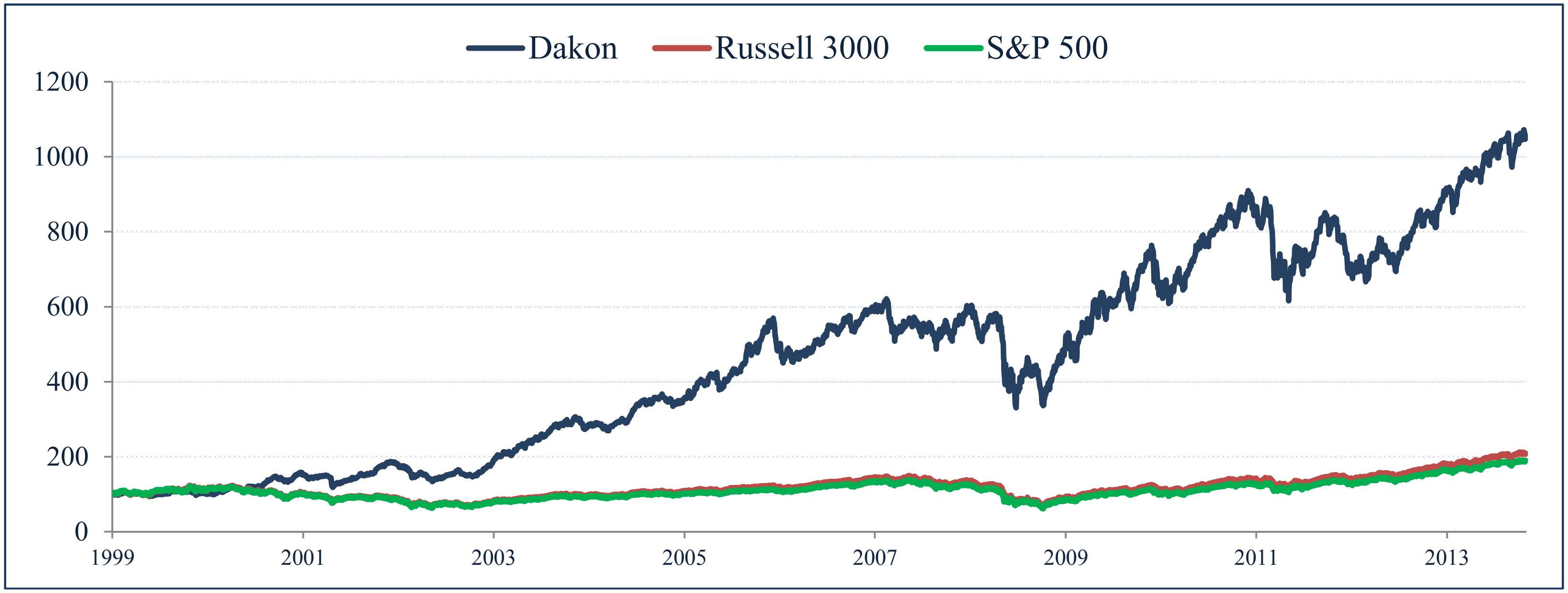
DEEP VALUE OVER MEDIUM-TERM



Source: Ken French data library.

- This shows alpha for cheapest 10% of the market versus the entire stock market.
- There are few 5-year periods in which value doesn't outperform.
- We're in one now.

BACKTEST OF OUR STRATEGY



Source: Compustat.

- Our strategy in a nutshell: buy good businesses with strong profitability where the outlook is terrible, boring or just not compelling.
- Russell 3000 returned 5% a year. S&P 500 returned 4%.
- Our strategy returned 17% a year.

OUR PROCESS

Look at the cheapest 10% of the market.

Eliminate companies that are unprofitable or have unsustainable results

Buy into the types of situations that have done well in the past

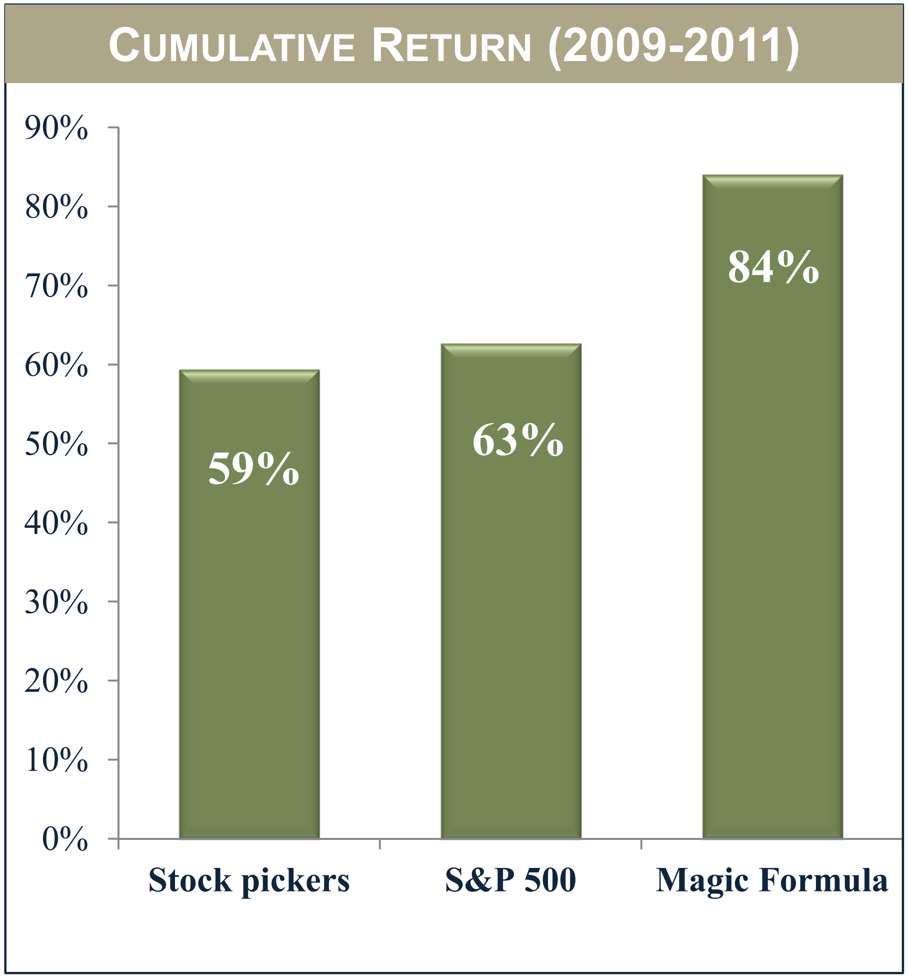
Buy before things get pretty.

EXELIS

- Everyone thought the defense industry would be permanently impaired by the sequester and the projected decrease in defense spending.
- Sell-side consensus: UNDERPERFORM.
- We didn’t know the future, but we thought this was a good business at a great price. Good things can happen.
- Held for a year and 15 days. 65% cumulative return.

The Power of simplicity

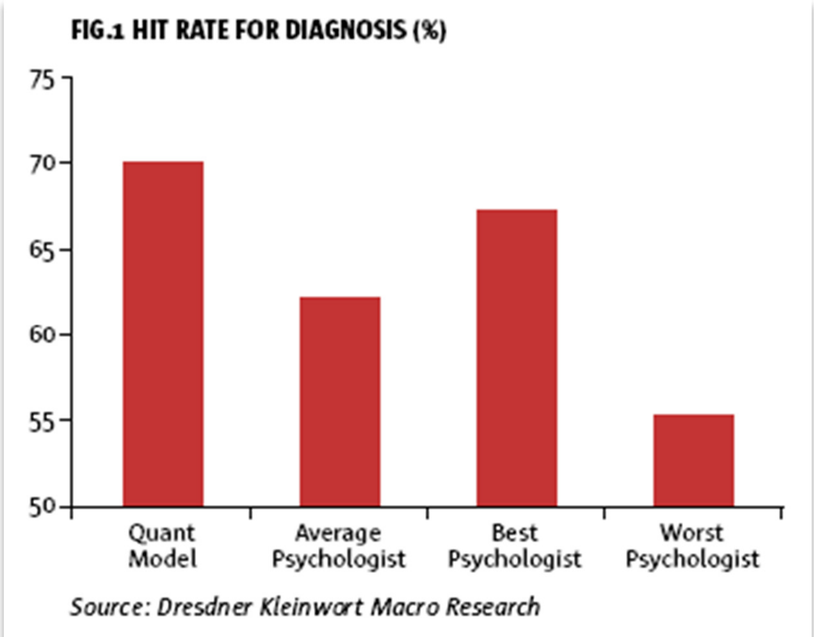
- Joel Greenblatt's Magic Formula picks stocks according to cheapness and quality.
- Greenblatt allowed investors pick the "best" stocks from list of Magic Formula companies.
- What happened? Investors systematically screened out the best stocks.
- They picked what looked best, which means they were long what everyone else already knew.



Source: Joel Greenblatt "Adding Your Two Cents May Cost a Lot Over the Long Term".

MODELS BEAT EXPERTS

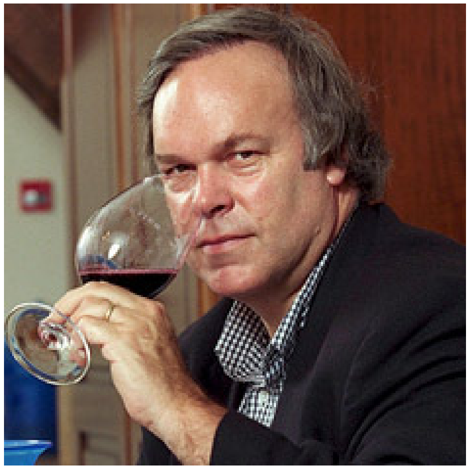
- Joel Greenblatt's simple model beat sophisticated investors, but we see evidence of this everywhere.
- Simple models:
  - out-predict baseball scouts.
  - out-diagnose even the best psychiatrists.
  - out-predict prison parole boards.



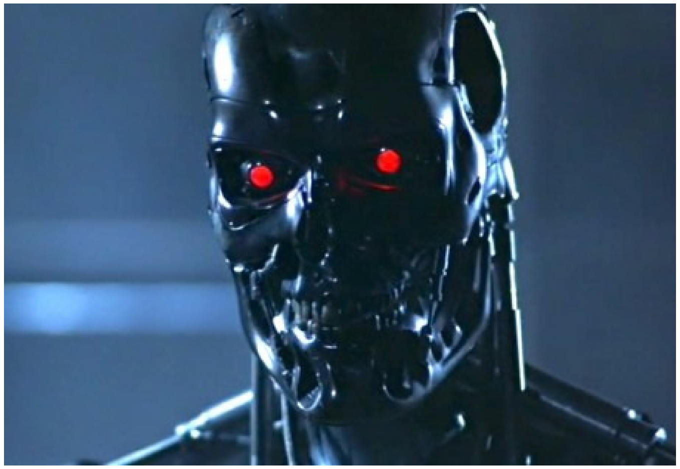
Classic 1968 study of psychologists vs model in determining whether a patient has a neurosis or psychosis.

MAN VS MACHINE

- Robert Parker, the most famous wine critic in the world, is paid to predict Bordeaux wine quality and its eventual price.
- Princeton economist Orley Ashenfleter created a simple model that also predicted Bordeaux wine quality, prompting Parker to call him a "sham."
- The model Ashenfleter created had only three inputs: winter rainfall, harvest rainfall and growing season temperature.
- This simple model out-predicts Parker and makes bold calls that have an odd tendency to come true. <u>Quant is about finding what matters and ruthlessly subtracting everything else.</u>

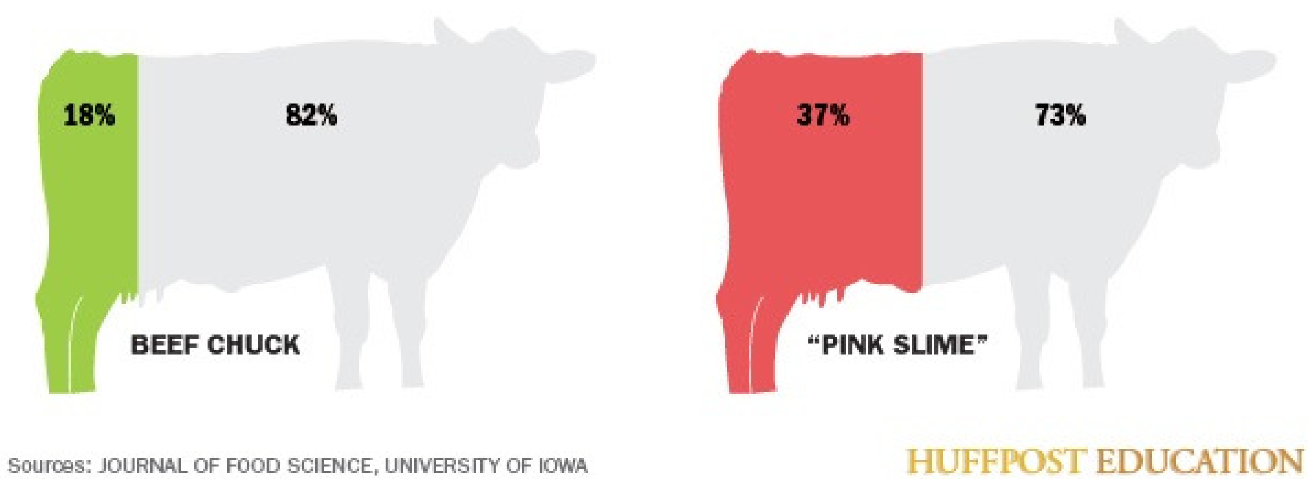


V.S.



FUNDAMENTAL FAILS—BUT NOT FOR THE REASON YOU THINK

- **Breakthrough study: the average mutual fund manager's top holdings actually outperform the market.**
- So if their best ideas outperform, why do 75% of funds fail to?
- Because as Charlie Munger and Bruce Berkowitz have pointed out, managers using fundamental analysis can only thoroughly research a handful of ideas at most. Rest of the portfolio is "filler."
- The problem with active management is not with stock-picking but with asset bloat.



More beef, less pink slime please.

THE SCIENCE OF FUND SELECTION

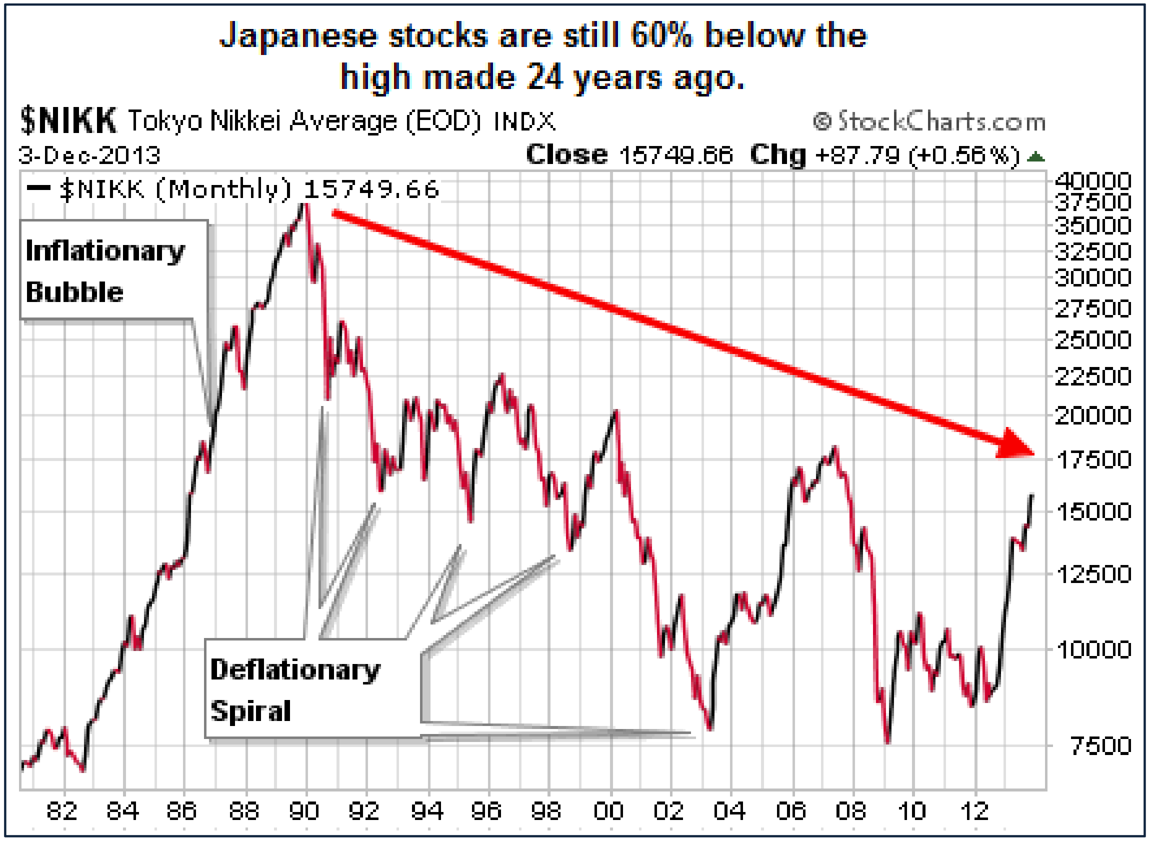
- Robust research shows that past performance has no predictive power.
- So what does?
  - Portfolio concentration
  - High tracking error
  - Low R-squared (i.e. less correlation with index)
  - No asset bloat (assets under $1 billion)

The science of fund selection

- When you apply these standards to the fund universe, vanishingly few funds come out looking good.
- In fact, we've only found six other managers who have positioned themselves to outperform over the long-run.
- We believe our own strategy exceeds all four criteria:
  - We hold less than 35 positions, which is concentrated.
  - Low R-squared is 70% or less. Ours is 66%.
  - Very high tracking error is 15%. Ours is 20%.
  - We view the fund as a family office vehicle. We will cap AUM, so we can compound capital—our own and yours—at the highest rate possible.

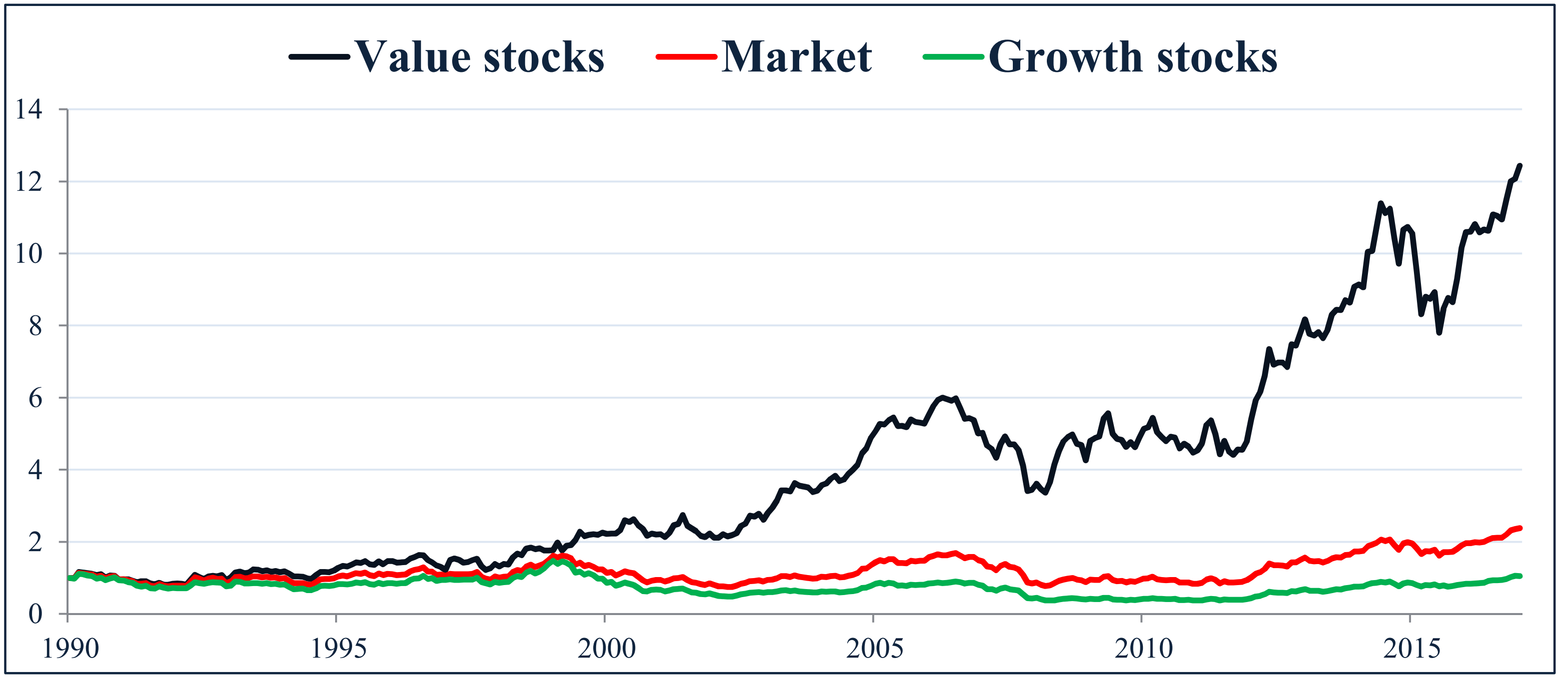
Stagnant markets

- The US stock market is now at one of the three most expensive points in its history.
- There is a very real risk that investors are in for another "lost decade."
- Japan has experienced something far worse. They've had a "lost 30 years."



VALUE IN A STAGNANT MARKET

- Here's how Japanese value stocks did over the period in which the Nikkei halved.



- Value stocks had a total return of 7% a year (market cap-weighted).
- The market returned 3% a year. Growth returned 0%.
- Meanwhile here in the US, growth has had an usual run. That is likely to change.

Returns before fees* (unaudited, 6/30/22)

	2017	2018	2019	2020	2021	Since inception
Dakon	7.5%	-24.5%	14.4%	-12.7%	33.6%	**4.5%**
Russell 3000	21.1%	-5.2%	31%	20.9%	25.7%	**12.2%**
R3000 Value	13.2%	-8.6%	26.3%	2.9%	25.4%	**9.7%**

- Value strategies don't outperform in bull markets, particularly not extreme ones.
- Seth Klarman trailed the S&P 500 by 6% a year leading up to the tech bubble. Our strategy would likely have done the same.
- In 2016, when value outperformed the market by 6%, we outperformed by 16%. Our strategy "loads" the value premium. This is valuable because historically value has generally outperformed growth over time.

*Management fee is 100 basis points. No performance fee.

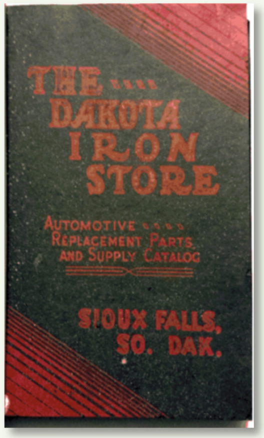
Why we started Dakon

- There are only a handful of managers today who we'd be excited to have manage our money for the rest of our lives.
- 2-and-20 is like a gun to your head. Hedge funds behave accordingly.
- Capital is created because someone worked harder than he needed to and saved the surplus. We think it's important to be a good steward of that capital. It's something we love.

Dakon is short for "Dakota Iron"—the family business started in Sioux Falls, SD in 1910.

This is what they sold

This is the catalog they published each year.



ABOUT US

Scott Reardon is an author and value investor. Prior to co-founding Dakon, he was the director of corporate development at a holding company pursuing a Berkshire/Leucadia strategy. Prior to that, he worked as a research assistant at Columbia Business School in the Value Investing Program. He is a *cum laude* graduate of Northwestern Law. His first novel, The Prometheus Man, was published by Little Brown in 2017.

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