Greystone Capital Management
Concentrated Value Investing

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Founders Letter

"When nothing seems to help, I go look at a stonecutter hammering away at his rock perhaps a hundred times without as much as a crack showing in it. Yet at the hundred and first blow it will split in two, and I know it was not that blow that did it, but all that had gone before."

- The Stonecutter's Creedo by Jacob Riis

Dear Investor,

Greystone Capital is a long only, equity focused Registered Investment Adviser located in West Chester, PA. The firm utilizes a fundamental research process focused on identifying mispriced small and microcap securities in order to build a concentrated portfolio of high conviction investments.

Greystone was founded by Adam Wilk, a Registered Investment Advisor, who serves as the sole Portfolio Manager. Given that this is the first letter I'm writing to current and prospective investors, I'd like to outline my investment strategy and principles that will guide our operations moving forward.

Greystone's investment process is centered around patience, good decision making, and daily incremental improvement. Our aim is to compound client's investment capital at the highest possible rates of return over long periods of time.

The quote at the top of the page, authored by photographer Jacob Riis, represents the cornerstone of my investment philosophy, strategy and way of thinking. Greystone was formed as a multi-decade learning effort centered around discipline, improving our decision-making process, and taking a long-term view. The idea of 'pounding the rock' embodies everything a long-term investor should be, with incremental improvement the daily mission, and with any success achieved serving as the result of all the work that has come before.

I was fortunate enough to be exposed to the Stonecutter's Creedo early in my career, and it has since served as a guidepost in my life and helped improve my way of thinking about patience, accomplishment, and how often times, persistence wins the day. While I was taught the philosophy in a different capacity than business or investing, it embodies much of what I believe to be the keys to successful investment results over time, including discipline, hard work, and focusing on long-term goals.

With that as a backdrop, the idea behind forming Greystone was to create an investment process built on those foundational principles, that is capable of outperforming the broader market over long periods of time. Our investment approach will differ widely from the current move toward low fee passive investment vehicles such as ETFs and index funds that own some of the most widely followed stocks and continue to purchase securities regardless of their price or fundamental value. In addition, Greystone does not charge high fees for low value-add, is not overly diversified, and will always own what our clients own.

It's my belief that the best investment results can be achieved by aligning interests. My family's entire net worth is invested in our strategy, and always will be. We eat our own cooking. My hope is that this will allow me and our clients to focus on long-term business performance as the best measure of our results as opposed to the daily or quarterly fluctuations to which stock markets lend themselves.

As mentioned above, I am building Greystone Capital to be a multi-decade effort, with the goal of taking on clients who resonate with my underlying philosophy and strategy, and who can adopt a similar, long-term view toward my investment approach. In order to outperform the market, we have to look different, which means the companies we own will be different, our fee structure will be different, our time horizon will be different, and our alignment of interests will be different.

Greystone Capital is certainly not for everyone. To find out if that is you, please read on. What unfolds in the paragraphs below represents my thinking about investing, my philosophy, what we set out to accomplish, and how we can achieve it.

Setting Expectations

I will be communicating with clients every three months via quarterly letters containing updates about our portfolio as well as any broad market commentary I feel appropriate to share. Although this communication will take place once per quarter, it's important to note that measuring our portfolio performance during each of these short periods of time, given our long-term approach, will essentially be meaningless. In addition, it will be fairly common to see the prices of some of our portfolio companies move up and down each quarter (sometimes each day). No matter the result, we can't read too much into these monthly price gyrations…. (easy for me to say).

Nevertheless, too much emphasis placed on short term results – which can include even one years' time – is a dangerous way to operate given our concentrated, lower turnover portfolio. Stock prices can change frequently and rapidly, while movements in the intrinsic value of a business, good or bad, take much longer to progress. Concerns over poor short-term performance, can often lead to making poor investment decisions and cause us to lose focus on what we are trying to accomplish. During each reporting period, it's my aim to help clients try to separate the performance of the various businesses we own from the underlying movements in their share prices – over short periods of time.

The short term movement in prices described above, known as volatility, and ***incorrectly*** equated with investment risk in academic and financial advisor circles, is much different than actual investment risk, which I would define as the ***chance of experiencing a permanent loss of capital as a result of a poor investment decision.***

It's my belief that changes in the *prices* of our portfolio companies, without regard to business value or corresponding economic developments is one of the worst ways to define investment risk. You won't ever hear me discuss a particular stock's ***'beta'*** (a term for the change in a particular company's share price as compared to the stock market as a whole), which has little utility to me when carrying out Greystone's investment strategy***.***

With that said, I want to make clear that given our concentrated nature, and small company holdings, our portfolio will periodically experience sharp and unexpected declines in the market value of some of our holdings. When this happens, it will hurt. The endowment effect and loss aversion will see to that. But once again, this is not to be equated with risk, but rather the price of admission toward achieving positive future returns, assuming we have made the correct investment decisions.

Furthermore, I don't believe that any particular down quarter or down year should provide a reason to panic. Warren Buffett, in one of the best lectures of all time about investing – The Superinvestors of Graham and Doddsville – notes that his peers, and some of the greatest value investors in the world, underperformed the S&P 500 once a year during every rolling three year period in which they were measured, starting around 1965 through the early 1980s. Each of these managers still handily beat the S&P over long periods of time, leaving their investors much wealthier than they were at the start, and much wealthier than they would have been if they had pulled their capital at the first sign of underperformance or price volatility. This data point goes hand in hand with another one of Buffett's popular sayings: ***'I'd rather have a lumpy 15% return than a smooth 12%'.***

In most cases, against the backdrop of a solid investment process, volatility can serve as a friend to the patient investor. I intend to take advantage of volatility in both the businesses we own by purchasing more, as well as entering into new positions in companies on my watchlist should they reach prices that may generate acceptable forward returns. As a result, my focus is much less geared toward stock price movements in short periods of time, and more on making sure my decision-making process and analysis are sound.

Over time, stocks will fluctuate (how's that for analysis?). Sometimes with no regard for positive business performance. Its within these times that opportunity can be found (how else would I buy cheap stocks?) and as long as we are approaching stock ownership as long term owners of businesses, we can remain focused on the fundamentals of those businesses and not the random, short term action of the prices of our stake in them. I hope clients will agree that sacrificing short-term comfort for long term value creation is a tradeoff we will be making as often as we can.

Investment Philosophy

Greystone was founded on the beliefs that occasionally the market will offer up shares of businesses at discounts to their fair value, that small companies tend to outperform large companies, that volatility is not the same as investment risk, and that investing with a margin of safety involves purchasing shares of quality businesses at a discount to their fair value.

In addition, taking concentrated positions in small companies with strong financial characteristics and long-term holding periods is an approach that hasn't yet been arbitraged away by quants, indexes or passive investing vehicles. These businesses can be identified through deep fundamental research – the cornerstone of my process – and often times possess characteristics that can be overlooked or misunderstood by the larger investment universe. It's my view that purchasing these businesses with a value focus and waiting for the market to 'catch up', can lead to material wealth creation over time.

For example, how many quantitatively based funds that are purchasing stocks based on algorithms, momentum or trading patterns are concerned with the quality of a management change? The value of a new subscriber to a business? Or the unit economics of a particular franchise? How many are able to own businesses with market caps below $100mm? Or where only a few thousand dollars-worth of shares trade per day due to illiquidity? How many large institutional funds are able to own businesses that trade outside of any indices? Not many. These are some examples I can refer to when talking about my preference to invest in small companies and misunderstood businesses. More on that below.

In line with the above, the current environment for investing is one in which the growth in popularity of low or no-fee investment advice, along with passive investing or ‘indexing’, has led to a large group of investors purchasing shares of businesses regardless of their price or fundamental value. This phenomenon, sure to end poorly when it does, can ultimately lead to opportunities for those with solid valuation methodologies who know how to value a business through the eyes of a long-term owner. With the majority of capital appearing to be chasing returns from a very similar group of large, liquid securities, there is now less capital interested in finding and purchasing our illiquid and misunderstood microcap businesses that are too small for larger fund managers and institutional money to own and therefore analyze. This can lead to wider disparities between price and value among these businesses as opposed to say, a large cap company in the S&P 500.

Developing an investment process tailored to the above beliefs is essential to carrying out Greystone’s investment strategy.

Investment Process

An incredibly successful investor once remarked that in investing, confusion between **process** and **outcome** is the single biggest source of error in the stock market. This is because the act of investing can present false narratives when it comes to examining investment results. In other words, one can make a **good decision** given the information at the time and still lose money on an investment (bad result), while the opposite can also happen, where one makes a **bad investment decision** yet still ends up making money (good result). These are common occurrences, so without a consistent investment process in place to track and measure the decisions that led to those results, both good and bad outcomes can only be attributed to luck.

At a high level, process can be considered the method for finding new investment ideas, and what types of securities one invests in, based on a strategy. Outcome can be considered what happens to the price of a stock following a purchase or sale (or what happens to the price of a stock following a decision ***not to*** invest). Given the randomness, complexity and unknowns of the market, outcomes can turn out to be a poor way of measuring the quality of a decision. Since investing is the ultimate decision business, there has to be a process in place to make it as easy as possible for your portfolio manager to make decisions and then evaluate those decisions. Process can be under my control. Outcomes are often not.

As a result of this, the most important aspect of my job is to develop a robust investment process that I adhere to at all times, during good and bad market conditions, that allows me to continuously and correctly identify and purchase mispriced businesses that fit our investment criteria. If I’m able to do this well, over time, rising share prices – making money – will be the outcome. But my sights have to be firmly trained on process.

Greystone’s investment process consists of the following:

- Identify small and microcap companies that fit my investment criteria and perform thorough research consisting of valuing those businesses using my valuation methodologies
- Develop a watchlist consisting of ‘studied-but-not-yet-owned’ businesses for which I’ve modeled forward return scenarios at various prices
- Only deploy capital when we’ve identified a mispricing. Use yearly and quarterly stock market fluctuations to purchase any businesses that fit my price and qualitative criteria

- Re-evaluate each situation as new information comes into play while focusing on the long term with the aim of holding until the mispricing corrects
- Document every decision before, during and after making an investment through the use of an investment journal

Unpacking the above points, the idea generation and valuation steps are incredibly important parts of the process. Here, I am turning over a lot of rocks, and making sure to avoid businesses and industries I don't understand. Businesses I like or that hit on certain criteria are placed on a watchlist, with special attention being paid to valuation criteria and forward return potential.

Moving to the next step of the process, the stock market is a game with no called strikes. I don't have to swing at every interesting opportunity that comes my way. By adhering to strict valuation and forward return criteria, as well as using stock market volatility to purchase shares in business I already know and am familiar with, I can avoid making poor investment decisions driven by the pressure to act.

Furthermore, although I have established time frames for holding investments, I spend plenty of time after the initial purchase constantly re-evaluating the investment thesis and monitoring the business. You can refer to this as 'buy and verify'. This is because when I purchase shares in a security, I am investing with imperfect or incomplete information. There is no way around this. I could spend 700 hours studying a particular business and still not grasp the nuances involved with the company or the people running it. Markets and companies are incredibly complex, and they are run by people, also incredibly complex. Unexpected things happen, people lie, businesses face serious competition, and I will occasionally be wrong in my evaluation of the economics of a business or industry. As a result, new information about the competitive landscape, business operations and the management team are constantly being factored into the thesis, as it relates to valuation and what has to go right for us to be successful.

Finally, documentation of investment decisions and the associated emotions around those decisions is being captured through the use of an investment journal. Over the years, I've benefitted from recording decisions in real time and documenting the reasons for making (or not making) certain investments. Being able to re-visit the decision-making process that led to a good or bad investment outcome can be a helpful way to eliminate the emotions associated with buying and selling securities.

To summarize, our process helps identify the highest probability investments with the lowest downside risks, and then then provides an opportunity for me to evaluate why and how a decision was made, independent of the outcome. In addition, with everything from where I search for ideas to my physical work location, I've set out to create an investing environment that makes this process as simple as possible for me to execute. I look forward to updating clients in more detail during future communications.

An additional part of the process not yet discussed revolves around constantly striving to improve my decision-making abilities. As mentioned above, investing is the ultimate decision business, and the greatest challenge for investors is the stupendously overwhelming mismatch between the almost limitless amount of data available and the incapacity of the human brain to know how to deal with it. One has to be trained in how to approach such tidal waves of information and also know how to identify problem solving and problem identification techniques for dealing with issues that arise. This includes having knowledge of cognitive limitations and cognitive errors, which human beings, myself included, are subject to on a regular basis. Millions of years of human evolution have wired our brains to work against us in the modern world (which is much faster-paced than say the deserted plains of early Africa) and to occasionally cloud our decision making.

As important as it is to find and make successful investments, its equally important to construct an environment where it becomes easy to recognize and not fall prey to cognitive limitations.

For me, this includes working alone, having long periods of quiet reading and thinking time, removing myself from most of the financial news media, and discarding any companies as potential investments that do not fit my strict criteria. I have no staff, no meetings to attend, and very few obligations that would pull me away from focusing on investment related activities. Greystone is structured to allow me to thoughtfully engage in analytical thinking as often as possible. This will allow me to avoid or cut through any 'noise' relating to our portfolio companies, focus on what matters, and on what will or won't drive our businesses forward. Determining the key metrics that drive a business, found through reading, thinking and deeply analyzing a company, combined with discipline during the initial purchases helps to create an adequate margin of safety for our investments. I can't get there by watching CNBC.

In my pitchbook for Greystone Capital, I jokingly refer to part of my strategy as 'doing nothing'. What I really mean by that is, because most businesses in our investable universe will not fit my criteria, I'm attempting to create an environment of fewer decisions altogether, in order to avoid dangerous shortcuts that can result in impulsive or detrimental behavior. Doing nothing most days, saying no to most ideas, and ignoring parts of the market I'm not capable of understanding should all help make the decision-making process and our investment process easier.

I view a large part of my job as an investor to try to be aware of where my brain is failing me, and where my cognitive limitations lie. To that end, in order to stay disciplined and avoid thinking pitfalls or behavioral errors, I've put in place a set of tools that may help me avoid falling prey to harmful biases and impulsive thinking. I spend time using scenario modeling techniques and investment checklists. I also constantly seek out disconfirming evidence for each investment and have adopted the use of an investment journal to track past and future decisions.

On the administrative side, Greystone currently manages Separately Managed Accounts on behalf of clients. This is done to keep overhead low and to provide full transparency into what you own. I do not need to take custody of your funds. Client funds are held with Shareholder Services Group (a subsidiary of Pershing), who serves as the prime broker, so your funds are secured and protected. In addition, I will be communicating with clients on a quarterly basis, and my phone line is always open.

Investment Strategy / What we are trying to accomplish

Greystone is attempting to outperform the market, or what an investor could accomplish on their own by owning a diversified index of companies set to perform in line with the broader market. We will be measuring ourselves against the S&P 500 and Russell 2000 indices, although our portfolio will look nothing like them. The reason for our choice of benchmarks is that today, investors can own those indices for almost no cost, providing them an option to achieve the same returns as the market, without paying management or performance fees. Greystone will have to outperform those averages in order to justify our existence.

Indexing, assuming a 'dollar cost averaging' approach, will always allow investors to achieve the average market rate of return. Nothing more, nothing less. We are attempting to do better than the average. As a result, we will have to look different. Building a portfolio of quality businesses with solid balance sheets and strong market positions uncorrelated with general market movements will make us different, and therefore provide an opportunity for outperformance. Furthermore, our holding periods and investment time horizon will be different. We aim to hold stocks much longer than the Wall Street averages of a few months. We are less worried about short term results. It's likely that we will be more volatile than the market. This is not a bad thing. We will also, without a doubt, experience periods of underperformance. However, over time, if we can beat the market by just a few percentage points per year, the differences in how your capital will compound can be enormous.

Over the next few decades, it would be fair to assume the S&P 500 or Russell 2000 will produce pre-tax returns in the range of 4% to 7% per year from a combination of dividends and capital gains. My job, then, is to pile up yearly advantages over the performance of the S&P 500 or Russell 2000 without worrying too much whether the absolute returns in any ***single year*** are positive or negative. It's my understanding in talking with our clients that you share my views. My expectation is that over long periods of time, we can outperform the indices.

While a few percentage points per year may not seem like much, relatively small differences in compound rates of return really add up, especially as one's time horizon is stretched. As you can see in the table below, even though we are shooting for a small advantage, that difference could amount to a lot more dollars over a long period of time.

The table below illustrates the value of $10,000 compounded annually at 5%, 10% and 15% over periods of 10, 20 and 30 years.

	5%	**10%**	**15%**
10 Years	$16,288.95	$25,937.42	$40,455.58
20 Years	$26,532.98	$67,275.00	$163,665.37
30 Years	$43,219.42	$174,494.02	$662,117.72

The differences are astounding. A five-percentage point difference between compounding at 10% for 30 years and 15% for 30 years results in the 15% compounder ending up with nearly **4x** as much money.

Described in more detail below, my investment process seeks to invest in companies with the potential to become three to five year 'doubles', where a stock that doubles within five years would represent a 15% return compounded annually. While consistently beating the market will prove itself to be incredibly difficult, and I will make my fair share of mistakes, over time I feel confident that we will do better than average in terms of our return profile.

To achieve this, client portfolios are managed by taking concentrated positions in small companies that are generally underfollowed, misunderstood, and can be too small for large funds or passive investment vehicles to own, creating the potential for mispricings. Viewing stocks as ownership shares in businesses, we seek to own these companies for years, or until the mispricings correct. I believe this approach, executed well over long periods of time, can provide a path to stock market outperformance.

My aim is to construct a portfolio made up of 7-12 securities, depending on the opportunity set and various opportunity costs at the time, with the top five holdings receiving the largest weightings. Determining position sizes is not an exact science, but rather based on conservative estimates of future return potential, downside protection, and overall risk/reward profile. We have higher conviction and more downside protection in some holdings than others.

Greystone will typically own two types of investments in a concentrated portfolio, core investments and special situations.

Core investments usually consist of what can be described as misunderstood businesses in niche product or service categories with widening competitive advantages, and incentivized management teams that own plenty of equity, able to be purchased at value prices. These are likely to be our longer-term holdings that are made up of higher quality businesses, and where the management teams are likely capable of increasing per share business value over many years.

Some of the characteristics I love to see for core investments include:

- Off the beaten path, uncovered by analysts, surrounded by pessimism
- Microcap size – market cap < $300mm
- Operating in a niche product or service category as the leader, or capable of becoming the leader w/ a high customer value proposition
- Long runway for growth within the industry with some favorable macro tailwinds
- Cheap valuation relative to peers and conservative estimates of intrinsic value
- Aligned and high-quality management team that owns a large chunk of equity, preferably founder-led
- Strong downside protection via cheapness, cash flows, assets
- Significant upside in take private value, M&A, asset liquidation, discount to peers despite similar growth and margin targets
- Clean balance sheet w/ minimal debt loads
- Opportunity for revenue growth and margin expansion

Portfolio weightings for core investments can be anywhere in the 8-20% range, with a 20% position size being very rare, and usually made up of a rising share price and additional purchases as opposed to entering into a 20% position size at cost.

Core investments are purchased with a large margin of safety based on cheap valuations, clean balance sheets, and discounts to peers. Frequent re-analysis of core investments is conducted, with special attention being paid to position size, investment thesis, and management execution.

Special situations can include but are not limited to business turnarounds, corporate events such as spinoffs, rights offerings, management changes, or businesses undergoing temporary issues that can be resolved by an experienced management team.

Special situations usually take the form of out of favor or overlooked businesses going through some temporary issues that I feel can be repaired by an incentivized management team. The odds of discovering mispricings in this area can be quite high given that many of these businesses come with some 'hair' attached. Some of these businesses will look ugly. Their profit outlooks are bleak. They don't screen well, and those are the kinds of things that open up opportunities for the patient investor. The inputs for these types of securities are not as neat and formulaic as our core investments, but the frightening aspect of a bad near-term outlook or uncertainty will likely give us the bargain prices that we seek.

Special situation investments often never receive portfolio weightings of greater than 5% at cost, but typically less than that given the lower quality and enhanced riskiness.

As a result of the lower business quality, we can try to mitigate the risk of buying such companies by looking for the following:

- Strong balance sheet – provides time and flexibility for the thesis to play out
- Unique assets – are the assets desirable to competitors?
- Multiple ways to win – we like to find more than one
- Alignment of interests – what are the incentives for management and the board?
- Price – demand a sizable discount to what we believe is intrinsic value

For both core investments and special situations, when we find a suitable investment candidate, we are attempting to underwrite 15-25% returns within a few years. This equates roughly to a 'doubling' of the share price of a specific business within a three to five-year timeframe. The portfolio is under frequent in-depth review to judge the likelihood of our target rates of return, and how our businesses performance is lining up with those targets.

Companies that do not fit my investment criteria are discarded as potential holdings, sometimes very rapidly. Companies that fit my investment criteria in most categories except price are put on a watchlist and monitored for periods of a few years, paying attention to business execution, valuation metrics, and forward return potential. This watchlist of 'studied-but-not-yet-owned' businesses serves as a reliable source of new investments, as yearly stock volatility will often times present opportunities to purchase shares in these businesses we already know well, at cheaper valuations. Occasionally, I will enter into small starter positions with companies on this watchlist, while I continue to study the businesses and watch management execute. Starter positions have caused me to miss out on opportunities to reach full position sizes with companies whose share price has increased rapidly but has also helped us avoid large permanent losses over time upon the realization of a mistake.

Moving forward, there is no doubt that I will make mistakes and occasionally be wrong about the timing of our return targets or the economics of a particular business or industry. The goal is to be right more often than wrong. If I'm doing my job, we will have a decent opportunity set for which we will underwrite patiently and selectively, while straddling the 15-25% return line as closely as possible.

Sample thinking of my research process can be found on our site, and my blog, Pound the Rock Investing, where I occasionally share research, writings, and thoughts on investing.

How do we know what to pay for a business? / when to sell?

"I've taught at Columbia for 23 years, and I always make a promise to my students on the first day of class—that if they do good valuation work, the market will agree with them. I just never tell them when."

\- *Joel Greenblatt*

Essential to any good investment process is a solid valuation methodology. Greystone was founded partly on the belief that occasionally the market will offer up shares of businesses at discounts to their fair or intrinsic value. Intrinsic value can be determined as part of the business analysis and valuation processes and is based on a businesses' future cash flows discounted back to the present, or what a knowledgeable strategic or financial acquirer might be willing to pay for a business with assets of similar quality. ***The most important part of the valuation process*** consists of correctly identifying situations that carry a large margin of safety, meaning that in the event I'm wrong about my estimates of the future economics of the business, the risk of permanent capital loss is minimized. This margin of safety can be achieved by underwriting new investments patiently, seeking wide discounts to peers, and avoiding areas of the market that I don't understand. In addition, companies that are highly cyclical, carry too much debt, or have high customer concentration are avoided at all costs.

The valuation process is more nuanced than a few paragraphs would suggest, but at a high level, Greystone's valuation methodology consists of the following:

- Performing extensive due diligence into a business, including digging through the financial statements, studying the industry, competitors and historical operating results
- Building a model outlining forward projections using conservative estimates of revenue growth, market share, margins and cash flow generation, which is based on normalized results as well as industry/competitor financials
- Estimating a forward return profile 3-5 years out measured against today's price, based on asset or potential acquisition value, future cash flows discounted back to the present using a 10-15% discount rate, and conservative growth rates
- Assigning a probability of the likelihood of my forward return scenario as well as probabilities for each of my bear, base, and bull case scenarios for cash flow growth. This is based on 'stress testing' the numbers, as well as the potential downside should my estimates of the industry or economics of the business be wrong
    - The forward return profile and margin of safety should reveal itself to be large at this stage

The key here is to be conservative, as I'm trying to avoid making a lot of mistakes during this process. Valuations are constantly changing, so its important to be flexible in this area, and let the market's valuation of a business over time – based on operating results, not short-term share price movements – help us understand how the risk/reward profile has changed.

As mentioned above, for core investments, I'm seeking to invest in businesses that are capable of doubling in value during a three to five-year period, which would represent a 15-25% return profile. I'd also like to do this with low downside risk, having protection in the form of tangible assets, clean balance sheets, strong cash flow generation, and wide valuation discounts compared to peers. Within this framework, I pay special attention to asymmetric risk/reward situations, meaning that if a mistake is made during the valuation process, the risk of permanent capital loss is minimized. The valuation process attempts to identify high upside, low downside investments.

Different valuation methodologies are used for different businesses, including discounted cash flow analysis (DCFs), peer and competitor multiples analysis, and asset value or replacement cost value analysis.

For discounted cash flow models, each cash flow is discounted using a fairly simple formula of [cash flow / (k-g)]. For cash flows, I use a company's free cash flow, and attempt to normalize the cash flows based on industry information, competitor financials and historical operating results. For our discount rate, the 'k' represents either the weighted average cost of capital (WACC) for the business, or something similar to the rate of return we are trying to achieve (12-15%) on our stocks. Higher risk businesses receive higher discount rates. Growth rates are always conservative, where I try not to assume too much, based on industry growth information, competitor financials and historical operating results.

To give a quick back of the napkin example of how this works: for a business generating $10mm dollars in normalized free cash flow, where I'm requiring a 15% return, and where I'm using a 5% growth rate, what I'm trying to do is cap the price we pay at $100mm, or 10x free cash flow. This is an overly simplified example, but helps give a rough idea of what the valuation process can accomplish. Special situations will be valued using similar methodology but may have shorter holding periods and lower IRRs.

The ongoing nature of the valuation process can also help determine when to move on from an investment. That line of thinking combined with past successes and mistakes have reinforced the following rules: I will not sit around and wait things out if I've been given evidence that I've made a mistake evaluating the economics of the business or industry. In addition, at times, especially in the microcap space, large returns in individual securities within short periods of time, given the uncertainty of the future, often necessitate reducing the position size, often at the expense of additional compounding. For example, a 10% position size that doubles, becoming a 20% holding, might then raise high expectations of growth or cash flow that our example business is not capable of producing. A re-examination of the valuation in a situation like this may not justify the now much higher share price. It might not make sense for us to continue to hold such a large position given the new forward return profile. High expectations of the future for a large position size are not always a good thing.

Moving on from investments, for good or bad reasons, triggers portfolio turnover. I'm constantly thinking about our turnover and how to improve as a portfolio manager in this area. I'll summarize my thoughts in the following way: I like the companies we own until I receive new information that says I shouldn't. While my aim for core investments is to reach a holding period of 3-5 years (for both operating results and tax reasons), hopefully we can reach our target rates of return a lot sooner! Were this to be the case, it would likely mean turning over companies in the portfolio a bit more frequently. Rest assured, that will not happen often. Because a large amount of time and effort is required to find good investments (and they do not come around often), I will always endeavor to have long holding periods for the businesses we own in order to minimize the effect of taxes and to let the benefits of compounding work to our advantage.

As outlined during the discussions of my process and strategy, I have strict rules in place regarding quality and valuation, and utilize checklists and the above rules to ensure that our businesses do or don't exhibit certain characteristics, as well as to identify warning signs that I want to avoid. Should those warning signs start to flash, it may necessitate cutting ties, sometimes shortly after entering into a position.

During quarterly communications and as you evaluate the results of your portfolio, if you read about a new position entered into during one quarter, and a few quarters later read that you no longer own it, remain calm. I have not morphed into a day trader or statistical arbitrage investor. In fact, be glad. It will most likely be a result of the realization of a mistake, or the understanding that a particular thesis rests on something I'm no longer willing to underwrite at the current valuation.

Broad Market Conditions

If you asked around about starting an actively managed long-only equity based investment strategy today, ten years into a massive bull market, with the various stock market indices reaching all-time highs, and at a point that many would consider to be the top of the business cycle, you'd probably be met with laughter or skepticism. According to the financial news media, there is always something to be worrying about. Today, one doesn't have to look far in order to find predictions of impending doom and gloom, or commentary from pundits and talking heads outlining a stock market or economic crash scenario in the near future. Add in the frequent confusing and erratic behavior from our President, and it wouldn't be hard to imagine darker days ahead.

However, when reviewing our current portfolio, I'm met with what appears to be blue skies. I see a group of companies that have the potential to double or triple over time, leaving us a large margin of safety from where we purchased them at wide discounts to their fair value. In addition, 85% of the businesses in our portfolio are not included in any indexes, and all but one have market caps below $300mm. These companies are capable of growing their revenues, earnings and business value quarter after quarter, and although in a general market wide downturn or economic recession scenario we may see the value of our holdings decline along with the rest of the market, we could use that volatility to increase our ownership positions, knowing that our businesses will continue to execute. Our portfolio is built to hold businesses that are generating cash, with strong balance sheets, reasonable debt loads, and incentivized owners who hold large amounts of equity, thinking long term. Many of our companies dominate their niche product or service category as well, to where an economic downturn scenario might actually open up additional opportunities to grow or expand.

It's my view that there are plenty of good investment opportunities available during all market conditions, its just a matter of identifying them and having the conviction to purchase them. If I was constantly worrying about the economy becoming worse than it is today, my mind would be clouded with discouraging and unproductive thoughts. Cutting through the noise can be difficult, but my job is to stick to my process and try to focus on what will or will not change within our investment ecosystem. In the meantime, the businesses we own are cheap, safe, and provide products and services with high value propositions that should continue to do well in rising or falling market scenarios.

While our cash position sits right around 10% of the portfolio, given our small size and patient approach, it wouldn't be unusual to hold a higher percentage of cash from time to time as I wait for favorable opportunities to present themselves. However, it should be noted that I don't love this approach. I equate this somewhat with trying to time the market, which I nor anyone else has the ability to accurately predict (a word of unsolicited advice: if you happen to come across an advisor who tells you to 'wait for the next recession' to slide in and purchase all the stocks you like at a discount…please run in the opposite direction). I am compensated for ***investing*** your money (meaning you are perfectly capable of not investing it) and will continue to deploy capital into good opportunities as they come up. Since the macroeconomic and political landscape remain unknown, my only aim is to stick to my process of researching misunderstood businesses with long runways for growth, incentivized management teams and widening competitive advantages that are capable of growing intrinsic business value over time.

***Of note, this letter and section regarding broad market conditions was originally penned in late 2019. Please refer to our Q1 2020 letter for my updated thoughts regarding the current environment and the impact of COVID-19 on our portfolio.*

Pounding the Rock

As mentioned above, the concept of 'pounding the rock' describes the impact that modest, but consistent effort can have over long periods of time. I was exposed to this idea during my time with the San Antonio Spurs, one of the greatest organizations in all of sports and business, and it was seared into my brain as an incredibly useful way of thinking. In both business and basketball, the Spurs embody this philosophy day in and day out, and the ideas of patience, continuous improvement, and getting better at your craft every day have been large contributors to the incredible success they've experienced over the past few decades.

The Stonecutter's Creedo is the philosophy that will be guiding the day to day activities of Greystone Capital. My goal is to clone that framework through continuous learning, improving my decision making, and allowing small bits of consistent effort to have positive outsized results over time. I've seen firsthand the enormous positive effects of gradual, daily improvement, and to that end, my aim has been to position myself to be able to take advantage of those effects. Unlike being a professional athlete, where your body eventually loses out to father time, investing is a practice where one hopefully improves with experience. As time goes on, and knowledge compounds, the experienced investor should be able to more clearly see patterns, analyze situations, and make good decisions, using the past as a guidepost. Most days, advancements in knowledge will be too small to grasp, but I hold dear the philosophy that small doses of daily improvement will eventually combine to form meaningful progress. The idea is to keep pounding the rock.

From the initial launch of the firm, my intention has been to seek out knowledgeable investors who believe in my strategy and way of thinking; in other words, those who want to ***help me*** pound the rock. I believe our current investors fit the mold. Prospective investors will have to as well. To reinforce their beliefs, we are and always will be invested alongside each other, aligning my interests with yours. I believe the structure we have in place – a small firm, long-time horizon, and clients that share my view on risk and opportunity – provides us with an extremely favorable advantage for long term investing. Thank you for the trust you've placed in me to manage your hard-earned money. I feel confident that over time your trust and our efforts will be rewarded.

Please feel free to reach out anytime, and if you know of any like-minded business owners, investors or individuals, referrals are always welcome. Thank you for reading.

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