Our interviewee today is **Matthew Peterson**, managing partner of Peterson Capital Management, LLC. Matthew is a seasoned investment professional, with a CFA designation, and work association with some of the best names in the securities business, including Morgan Stanley, Goldman Sachs and Merrill Lynch. His firm Peterson Capital Management LLC operates an absolute return oriented hedge fund, adopting the bottom-up approach of stock picking, while focusing on long-term returns.

**Questions for Matthew Peterson**

1. Could you please share your professional background with us?

Matthew Peterson: Hi Nitiin, it is a pleasure to be here.

My passion for investing began in childhood. After several early finance and economics roles including starting a financial planning business during undergrad, I moved to New York to work on Wall Street. Following a brief stint with Merrill lynch, I accepted a job with Diamond Management Consultants consulting in the market and credit risk divisions at Goldman Sachs. Over seven years, I worked in both the US and UK offices. Goldman remained my primary client and I also spent periods with a handful of other institutions like Morgan Stanley and American Express.

I earned my CFA designation in 2007 and in 2011, I launched Peterson Capital Management and the fund Peterson Investment Fund I, LP.

2. That's quite an impressive background, Matthew. Has such varied exposure - running a financial planning firm, working with and consulting Wall St. banks, payments firms and insurance companies - helped you develop investing expertise in any particular style, or industries or strategies?

MP: Certainly. My experience, and particularly my role as a consultant in some exciting and demanding environments, prepared me well for running a fund.

My passion for value investing and the CFA designation helped me recognize and develop the structured value aspect of our value investing strategy, while working across a wide range of product lines at Goldman. My interest in Warren Buffett and value investing began in the late 1990s. **I first attended an annual Berkshire Hathaway shareholders meeting in Omaha in May of 2004**. Integrating my knowledge of structured products with traditional value investing techniques became a passion that allowed me to significantly enhance the returns of my portfolio.

Frankly, the operational demands of running a fund are generally underappreciated. There's simply a lot of work that needs to be done, when managing a fund. **Consulting reinforces the ability to work very hard and simply get things done. So, consulting trains you to execute, while exposing you to many unique situations.** Similarly, Value investing is a cross sector style. So, expanding your circle of competence in unique ways is essential to success.

3. Sure. Well, Matthew, my background work seems to indicate that you prefer to focus on your firm's best ideas. Typically, how many stocks do you track and invest in, at any point in time?

MP: That's a great question, Nitiin. Our portfolio has traditionally held between 10 and 15 positions. Often 3 or 4 holdings will make up 50% or more of the portfolio. In 2015 at the ValueX conference in Zurich, I spoke on the Kelly Criterion as an optimal capital allocation strategy for long term compounding. The secret, if you do the math, is that you can build a very well-diversified portfolio with relatively few positions. In fact, Charlie Munger talks about needing 4 positions. Furthermore, the more positions you hold, the more your results will approximate average returns and the more difficult it becomes to outperform.

The challenge with optimizing the portfolio for long term compounded returns is that the portfolio will exhibit some short term volatility. This requires us to have experienced limited partners who understand that the short-term price fluctuations are not to be feared, but instead can offer further buying opportunities.

4. How many stocks do you actively track at any point in time? Do you have a kind of universe that you look at, regularly?

MP: Absolutely. I have a watchlist that's ever evolving. And consistently has many dozens of companies that are monitored on a regular basis. Most of these companies are excellent businesses that we would be interested in owning, if the price were right.

5. Fair enough, Matthew. Your research process places substantial importance on reviewing what leading value investors are buying. Well, while this approach may ensure quality of ideas, could it also not pare your returns, since security prices could have already moved up, by the time you decided to invest, as these big investors would already have taken up stakes in these companies? Secondly, would this approach also restrict your universe to the index stocks or large cap stocks, again impacting your fund's potential returns?

MP: Nitiin, that's an excellent question. The most important lesson here is to develop and execute a sound process.

Our objective is to uncover the few market securities that are so deeply undervalued by the marketplace that they warrant a long-term position in our portfolio. Today, approximately 10,000 public securities exist in the U.S. alone. The NYSE and the Nasdaq list over 5,000 actively traded companies. Most are fairly valued, most of the time. So, without implementing tools to efficiently narrow the scope, our fund might search for years before identifying a single desired "cheap" stock.

**So, our initial filter is to evaluate positions in the portfolios of the top value investors in the world: what are they buying, and what are they selling.** Within the high turnover environment that eclipses most of finance, this would be completely ineffective. However, value investors build positions over quarters and years and might hold a single position for a decade or longer.

The buying activities of these superinvestors are publicly available and they deliver hundreds of positions for evaluation each quarter. These opportunities have been filtered through the greatest minds in finance. Many of these investors have very concentrated portfolios of 10 or fewer securities - so they have enormous conviction. Surprisingly, the shares often do not immediately appreciate and can even decline in price. Using this filter to narrow the scope reduces the mistakes, it keeps us focused on better businesses and has been proven very effective in academia.

6. Sure. Could you please describe your methodology for evaluating business models, with a long-term perspective? And, do you conduct formal channel checks, for this purpose?

MP: Sure. When evaluating business models, I think it is vital to examine the entire ecosystem. So, understanding the customers, suppliers, competition and all available substitutes as well as the sustainability of any competitive advantages is instrumental to understanding the long term durability of that business.

**You know, management of a company has only five ways to allocate capital. They can reinvest in the business, they can acquire new businesses, they can pay a divided, they can buy back shares or they can pay off debt.** Identifying positive feedback loops can be particularly interesting. Finding firms with a high return on capital that have the ability to reinvest in their existing business can be particularly interesting when selling at a reasonable price.

7. That makes eminent sense, Matthew. Let's move to the next question. What constitutes your circle of competence? What are the qualitative factors which you consider when researching and shortlisting stocks? If at all you were to go beyond the above framework, what kind of rigorous filters would you apply when shortlisting non-index stocks, or stocks not invested in by leading super investors?

MP: I don't want to disappoint you, Nitiin, but most of the firms we invest in are entirely obvious opportunities. They are not always obvious because they are simple, but they fall within areas I have focused on for many years. Working in the financial industry for nearly two decades and earning a CFA designation prepared me with a breadth and depth of capability for quantitative analysis. And most financial mathematics is relatively simple.

So, making an investment involves taking the opposing position of a counterpart - buying what a counterpart is selling or selling what a counterpart is buying. Qualitative analysis involves both understanding the business model beyond the financials and understanding why a counterpart might be taking a particular opposing action. Forced selling or short term thinking can present opportunities to a long term value investor. Similarly, buying when others are irrationally fearful can present an opportune buying opportunity. An understanding of human psychology and behavioral finance aids us in this type of decision making.

We utilize also an ever-evolving checklist of potential pitfalls before making any investment decision. This forces examination of important quantitative and qualitative aspects and keeps investments within our circle of competence.

8. Sure, sounds great Matthew. Do you consider investing themes such as spin-offs? Though you are a long-term investor, would you be willing to be opportunistic at times, in terms of investing in special situations, or for the short term?

MP: Certainly. Spin-offs can present opportunities when they are designed to unlock value. Often times, spin-offs sell off for a brief period while owners of the new unrecognized shares liquidate the equity in their portfolio. This, in itself, can actually undervalue the company. In this situation, we will act quickly at times to take advantage of special situations and mispriced securities.

**In terms of themes, additionally, companies selling below their intrinsic value and aggressively repurchasing shares present opportunity.** With each share repurchase, the percent ownership of the businesses for an existing shareholder increases. Furthermore, **there is no taxable event when a company uses its cash to buy back their own stock and thus repurchases can offer more value than paying a dividend**. Often, however, share repurchases are done at too high a price and this destroys value. So it is not enough to see a company buying back stock, it must be that buybacks are executed strategically at a price below the intrinsic value of the business.

9. Very well articulated, Matthew. Please explain your "structured value" strategy, which I believe to be an industry-first. I am sure the audience would be keen to understand the strategy in detail.

MP: Absolutely. A strategy I identify as "structured value" combines modern portfolio products with the time-tested application of value investing principles. When uncertainty prevails, we may find an opportunity to piece together options to provide insurance on stocks that we wish to own. This is distinctly different from most uses of these products. Instead of trading the contracts for short-term gains, we receive immediate cash in the form of premiums with the desire to purchase the undervalued equity far into the future.

This structured value method requires extreme patience. Rather than making outright stock purchases through limit or market orders, we sell insurance on the shares we want to buy, and that might extend for 24 months or longer. Today for example, the contracts we are looking at, expire in the year 2019. We engineer these contracts by combining various put options or related products and selling the contracts to counterparties. We collect a premium for the contracts immediately and commit to purchasing their undervalued securities in the future, if they remain below our specified price. Because market conditions are volatile and counterparties can be fearful, owners of stock are sometimes willing to overpay irrationally for downside protection on wonderful businesses. So, when there are opportunities to obtain a large insurance premiums on quality firm, at attractive price, we sell the contracts for a premium.

So, structured value provides us with an advantage over the traditional buy-and-hold strategy. We are paid a premium up front that reduces our net purchase price to a level that is often below the market price. Sometimes we are able to purchase stock for a net price lower than any that has ever existed in the market. It's quite remarkable. As shares appreciate, of course, a lower entry price ultimately leads to higher compounded returns. A really simple formula depicts how we achieve this lower net cost:

Net Cost of Stock = Commitment Price Paid (–) Premium Received.

The counterparties that buy our contracts vary - they could be companies or other funds, or perhaps speculators betting on equity declines. For example, a life insurance firm may wish to protect their portfolio of stocks from a market decline to maintain liquidity for potential claims payouts. They could use our contracts to achieve this objective. In exchange for risk mitigation, we gain a premium and access to the underlying stock at a discounted price. One additional, subtle advantage of this strategy is that it actually forces our hand to buy when others become fearful. As you know, you want to buy low and sell high. However, it's often challenging to buy when there's extreme concern within the marketplace. It feels uncomfortable at times when we've been put the shares. But in the long term, that is the right time, to be buying the share.

So, structured value will be very attractive at times and less advantageous at others. We will not participate in any market unless the prices are in our favor. We remain fundamentally rooted in value. We may purchase equity via traditional means at times. And if there are no structured products that exist, we will not hesitate to make use of market and limit orders when it is beneficial to our portfolio.

10. Sure Matthew. Just a quick follow-up question. How long did you take to develop this particular strategy and what kind of back-testing did you do and for what period in the past?

MP: I have been using this strategy to purchase shares for many, many years, far before I started running my fund. The strategy in itself was a bit of an evolution. Because originally, back in the 1990 I might to have conviction on a security that I wanted to own. Initially I began with the use of a call or a put option as a way to get exposure to that business, perhaps by just buying a call option. It took me some time to reach the conclusion that many of the value businesses that we own, were quite volatile in nature due to various uncertainties, the price would swing and because of that and because of the nature of value investing being that you're looking to buy a security at the lowest price possible. It occurred to me that when volatility was high, the prices of these contracts were jumping to extremely irrational prices and I began taking advantage of that by selling the right to have the counterpart put shares into my portfolio at a very high, irrational price. This began more than a decade ago.

It actually is extremely effective, but there are some challenges, one of them being that if the portfolio or a stock appreciates significantly, you will not end up with ownership of that business and you'll be left with only the premium and I back-tested this. It's actually been back-tested in niche areas of

academia. You can find some articles online that show the true alpha that's been created. Many academic articles simply address using this strategy against indices and Warren Buffett himself has sold these contracts against various indices. If you actually focus on individual securities, the volatility is very localized and you can have even greater results.

11. You stated that in your fund portfolio, you believe in having fewer stocks and concentrated positions. How do you control the risk of unexpected, unfavorable developments in industries and companies, or black swans, which can quickly, severely and permanently impact stock prices, and your fund's performance?

Yes, as mentioned previously, we manage a relatively concentrated portfolio of approximately 10 to 15 positions because that method allows us to concentrate on our best ideas and compound capital at the greatest rates of return. Buying with a margin of safety and using structured products to engineer a purchase price below market price helps protect against unforeseen events. So, you have to look at the future as a range of probabilistic events and identify leading indicators to help evaluate which outcome may ultimately come to pass.

Unfavorable developments will occur and part of the advantage of having a more concentrated portfolio is you can watch key developments more closely. If the thesis on an investment is altered significantly or we recognize the intrinsic value of the firm might be impaired, we can move very quickly to adjust the portfolio exposure. A fund with 100 holdings has a much harder time watching and evaluating each market development.

12. You've got it right absolutely, bang on spot, Matthew. Would you continue to hold stocks, even if your target price were achieved? In other cases, what are the factors which would drive you to exit a stock completely?

That's a great question. Our target price is based on the intrinsic value of the businesses. So we would continue to hold the investment beyond the original target price if the intrinsic value of the business has gone up. Many of the best investments are those selling for less than their intrinsic value at purchase, while the intrinsic value is growing.

An increasing intrinsic value also provides further long-term downside protection. A simple example is Berkshire Hathaway. Warren Buffett has repeatedly indicated that Berkshire's intrinsic value is between 1.2 to 2 times book value. So, purchasing at or below the low end of the range is particularly advantageous because of the firm's ability to compound book value at such high rates. The gains in examples like this can be particularly impressive, because the stock price can ultimately reflect growth in book value, in addition to the price to book value multiple expansion. So, we would continue to hold the shares, if the intrinsic value has gone up.

BQiT: So you mean to say Matthew, that you always manage to extract more bang for the buck?

MP: Haha, that's one way to think about it! You know, turnover has a negative impact on portfolios, particularly the taxable events associated with them. Some of the greatest opportunities are ones you can hold on to while the businesses themselves are compounding and increasing in value. So certainly, having growing intrinsic value and an undervalued security is a very powerful combination and something we definitely look for.

13. Matthew, please describe a couple of cases where investee companies surpassed your expectations, and maybe a few where you were in for unpleasant surprises (we don't require names).

Sure, there are at least two ways in which an investment has surpassed our expectations in the past. The first is where internal developments and our investment thesis has played out better than expected. This might be observed in the financials through increased sales or margins. Over time, this will be reflected in the price of the stock. Another situation that we have experienced is when a buyout offer is made on one of our holding at a price above our expectations. This has the advantage of both lifting the stock price and enhancing our annualized returns by compressing the time required to achieve the gains.

The buyout scenario described above also presents one of the pitfalls that I alluded to earlier, to our structured value approach. Because we may initially own the right to buy shares at a price but do not actually yet own the stock; we may not receive the full benefits of a buyout if it occurs early on. But typically, this is not a concern as we still make a significant return from the premium. However, in this situation the gains in the stock price may be greater than the gains from the premium.

Unpleasant surprises can also occur. Again, we look at a probabilistic range of outcomes. These unpleasant surprises can occur if there is a mistake or an unwarranted development. The most common that I have encountered is a situation where management is making unforced errors that is hindering the business.

14. Matthew, what are your views on shareholder activism? If you thought that some decisions of the management were against the interests of minority investors, would you question the management in shareholder meetings, or just exit the stock?

That is an excellent question and I think there are several points for consideration:

First, I would certainly question management to a limit. Whether or not our fund would accumulate shares, complete the regulatory filings, and move into an activist campaign would depend if the activism can be performed in a friendly manner. I have no personal desire to be in an investment where a positive outcome requires me forcing someone's hand against their will. This honestly is not necessarily a moral decision but simply recognition that, at this point in my life, the work involved with unfriendly activism is just not something that I am interested in.

Second, there are many successful career activists and they provide a valuable service. If I recognize that an activist campaign will be successful and bring value to a business, I will monitor progress closely and if the price is right, make an investment.

Lastly, in the event that management is taking illegal or immoral action that is destroying shareholder value, I will certainly stand up for the rights of shareholders and do everything in my power to right the course and recover lost capital.

15. What are your risk management strategies as far as portfolio construction goes? You have mentioned that already, but just to get more color on that. Do you restrict exposure to a single stock in relation to portfolio size, or are you a believer in concentrated holdings? Do you place any restriction on sector allocations?

PM: Yeah, that's a great question, Nitiin. Obviously, risk management is a vital aspect to portfolio management. It is necessary to understand that the definition of risk varies among managers. One particularly academic view is to define risk as volatility. I consider this to be an incomplete definition. It is certainly uncomfortable to experience major price swings in a portfolio, yet price movements are not risky if the underlying security has a value greater than the price. Risk to us is defined as the probability of a permanent loss in capital.

We maintain an optimal level of concentration in our portfolio and as I mentioned, we use methods like the Kelly Criterion to derive this capital allocation strategy. Applying Kelly does not minimize volatility, but instead maximizes long term compounding. Furthermore, as our holdings appreciate, we do not liquidate the holding simply to trim the size of the position.

Our positions have historically been well-diversified across sectors, market capitalization and geography. Due to our low turnover strategy, our portfolio will likely maintain this broad exposure for many years in the foreseeable future. Our view on capital allocation is based on the opportunity cost of a holding. I do not restrict concentration in any particular space. If a massive selloff leaves a particular sector or region particularly undervalued, we are likely to concentrate more in that space. But again, with a long-term view and guidance from models like the Kelly criterion, we are likely to hold diverse legacy holdings and allocate portfolio cash to new opportunities in the most undervalued securities.

16. As a portfolio manager, do you place limits on the maximum of your fund's corpus that can be deployed at any point? In other words, do you keep cash aside for investing during market selloffs, such as the one on the Brexit vote, and the recent one preceding the Presidential Election?

Great question. One of our advantages is that we are extremely nimble. We are not trading frequently, but when an opportunity presents itself we can execute very quickly. Most of our portfolio consists of multiyear positions and we patiently hold through bumpy periods without liquidation.

The cash we hold is a call option on future investment opportunities. Today we have about 10% of our portfolio in cash and another 10% is partially hedged that will liquidate at a future date for strategic tax purposes. If markets dropped far enough, we would put 100% of the cash to work in a single day. In fact, the fund often has several orders in the market that will buy specific securities in the event of irrational moves like a sudden deep flash crash. When I say buy specific securities, we have several orders in our portfolio today, that would sell irrationally priced long dated leaps or put options on securities that we wish to own.

We often use cash secured put writing to enter our positions. Declining prices and increased volatility presents us with opportunity. Several contracts were purchased from us during the market volatility prior to the US presidential election and obviously, that's been very advantageous and beneficial, given the follow on increase in the price of the securities.

17. Yes, again, this rally post US Presidential Elections, I am sure your fund would've done fairly well, which brings me to the next question. Do you restrict yourself to US-listed stocks only, or in Emerging Markets or Frontier Markets too? If yes, could you name a couple of non-US markets you're positive on, and share your outlook on these? Have you looked at India? How much of your fund's corpus would you be willing to allocate to EMs/FMs, going ahead?

Yeah, that's a great question. We have a global portfolio with current holdings headquartered in four nations (US, UK, the Netherlands, South Korea). Furthermore, many of these firms operate on a global scale with revenue and income attributed to numerous countries around the world.

In addition, I have spent significant amount of time in Turkey over the last decade. Recently, I began coordinating with a world-class portfolio manager, **Mesut Ellialtioglu**, who I met in Switzerland. We are developing a product that provides an extremely cost effective method for US investors to buy a portfolio of undervalued Turkish securities. Like many developing markets, India included, Turkey stock prices are less efficient and an excellent value investor can find wonderful opportunities among those mispriced securities. You know, academically speaking, you would certainly allocate 20% of 25%

of any portfolio to gain a broader international exposure. It would actually reduce overall volatility while enhancing your gains if you look at it from an academic sort of CAPM perspective.

We have no regional restrictions in our portfolio. However, it is imperative to understand the markets in which we operate.

18. Alright, Matthew, this brings me to the last question for the day. Recently I was reading "100 Baggers", the investment classic by Christopher Mayer and in fact I came across your name in it, and I would like you to kind of describe how it all happened and how you ended up getting mentioned in an investment classic.

MP: Fantastic. The situation was a pleasant surprise for me. I was invited to speak at VALUEx in Switzerland, which is an investment conference run by Guy Spier. Christopher Mayer was in the audience and I was actually speaking on the Kelly criterion and the value of portfolio concentration. Christopher was working on his book, 100 Baggers which is an absolutely fascinating and enjoyable read. I was pleasantly surprised that he included me, my firm and the presentation as one of the topics in chapter 10 of his book. So, that's how the arrangement occurred.

Sure, great. Nice to hear that. Alright, Matthew, this brings us to the end of this wonderful interview. The insights you have provided are definitely a great value add for any value investing audience across the world. I must say, I have learned a quite few new things from what you shared with us. Good luck with your fund.

MP: Thank you very much, Nitiin. It's a pleasure to be here.