Interview with Dan Abrahams - RV Capital Emerging Manager Meeting 2019

SPEAKERS

Rob Vinall, RV Capital
Dan Abrahams, Alfreton Capital

Transcribed by Joel Cohen of MIT Investment Management Company with assistance from Alisan Napier of Alfreton Capital. Bolded phrases are emphasis added by Joel Cohen of MIT.

Rob Vinall, RV Capital 00:01

So we are on to Dan, Dan Abrahams, who runs a firm called Alfreton Capital.

By way of a background, I receive a lot of emails and telephone calls from people who want to start a fund, or are just in the process of starting a fund, to hear about how I got started. And that was actually what gave me the idea for the event today, as I think I mentioned earlier.

One of the people who reached out to me about five years ago was that 2014, right? Dan reached out to me, and well, we can come in a second to where you were in your life at that point, and he came over to Zurich, and we met. And so that's how we got to know each other. Before that, I hadn't known Dan. Since then we've become good friends. And Dan is a wonderful investor. And we share a couple of investments: Ryman Healthcare I heard about first through Dan, I think you're also invested in Credit Acceptance, or maybe you were, I don't know.

So part of my work, I mean, for me, it's great to see someone become successful as an independent fund manager doing things the right way. And, of course, it's also great for me to be able to expand my network of thoughtful investors. And when you have a network, I think it's great if people are successful. It's much more fun to have people who are thriving as friends, as opposed to kind of failed analysts working in a second rate fund management company as a junior analyst or something. So it's a real pleasure to have Dan here today. So Dan, I'm sure a lot of people maybe haven't met you before. So maybe you could just say a few words, firstly, about Alfreton Capital.

Dan Abrahams, Alfreton Capital 01:44

First of all, I just want to say thank you to Rob, particularly for this weekend. I found out a couple of weeks ago that for the last three years, I've been to every one [of these events]. So I am a fully signed up RV Capital groupie.

Your story was a real inspiration for me when I was going through the setup process. I think I pretended that I had lots of important people to meet in Zurich and said “Oh Rob, are you free?” and then I got on a plane to come and meet you.

So Alfreton Capital, we're a small team. So a little bit different to Rob in that respect. We are four people and we've all worked together for a very long time. So Alisan [Cryer], we have as our assistant. I first met her in 2002. Charlie Stone, who is my business partner, I'm sure many of you may know him, and I first met him in 2012. And we have David Cockburn who heads up our back office, compliance and operations and I first started working with him in 2011. So everyone on the team knew what they were getting themselves in for when we got it off the ground, and that's what we do. We keep it very simple.

Rob Vinall, RV Capital 03:18

And the philosophy and the portfolio?

Dan Abrahams, Alfreton Capital 03:28

We're very concentrated, very long term, very research intensive value investors. And we are really trying to concentrate our capital into the cheapest, most mispriced, most misunderstood securities that we can find. We are investing in liquid equities in developed markets and given where we are, which is in a small village, just north of London, we do tend to have more exposure to Europe, rather than, say, the US.

Rob Vinall, RV Capital 04:04

Is it important for you to be outside of London? Away from Bond Street?

Dan Abrahams, Alfreton Capital 04:10

Yeah, I mean, **I tried to solve for a very resilient business that was sustainable and was low cost. So our office is about 750 meters from my home. My kids are at school within a one mile radius. And I think having that balance so that if you need to work the long hours, it's an entirely sustainable way of doing it. And of course, it means I have a cost structure that's just far lower. It's a fraction of what it would be if I was in central London.**

Rob Vinall, RV Capital 04:45

You said, you look for mispriced securities, which hopefully everybody does but there's lots of different opinions as to what constitutes a mispriced security. Some people are super focused on kind of statistically cheap stocks. Others are thinking, thinking way into the future, how a business can look. What for you constitutes a mispriced security?

Dan Abrahams, Alfreton Capital 05:06

Well, theoretically, it's when the price that you're paying is less than the worth of all of the cash that the business is going to pay you from now until forever. And so I'm really looking for businesses that have competitive advantages that are growing over time, that are getting more powerful as they grow. And I'm open minded as to what that might look like in terms of a multiple. In fact, I think probably more than half my portfolio would be reporting probably losses, even though they are cashflow positive businesses.

Rob Vinall, RV Capital 05:41

Isn't it amazing that that can be the case in the value investing community, compared to maybe five years ago?

Dan Abrahams, Alfreton Capital 05:47

Yeah. I mean, to be honest. **I'm not too bothered by labels. And maybe people don't call me a value investor. But yeah, I don't mind.**

Rob Vinall, RV Capital 05:58

Yeah, maybe it's better to be called a successful investor!

So the question I get most often from emerging managers is how I solved the chicken and egg conundrum that nobody knows about you. How are you supposed to get capital? Without capital, how are you supposed to start building a track record so people can get to know you? So that's the question I get asked the most. It was primarily through Norman [Rentrop] that I solved it in my case. But I know you had a slightly different story. So why don't you tell us a little bit about how you managed to get from A to B.

Dan Abrahams, Alfreton Capital 06:36

I started out at Arthur Andersen. Then I worked in investment banking and then I joined a start-up fund in 2007, before that firm had an office or even a fund. And I was a partner in that business, a junior partner. But it was a tremendous learning opportunity for me to see someone else go about building their business from zero. And I sat next to the Managing Partner there for five years and watched him go through all of it, including 2008. And it was just a tremendous opportunity to learn from someone else. It was about as close as I could get to doing it myself without actually making any decisions or taking risk. So that was a really wonderful formative experience, and he was very generous in sharing that experience with me so openly.

And I think in probably 2011/2012, the strategy of that firm was different to what I do today. I was an Analyst there. I wasn't a decision maker. I had no track record. But as I started to learn lessons and reflect on the investments I had been making, and what worked and what didn't, there was a certain divergence as I was thinking about what that main fund was doing. So I resigned from that partnership and had a conversation with them about whether it would be possible to stay on as a Consultant and share my research with them and in return, could they bear the cost of setting up a fund in a very frugal way that I could run on the side and incubate, and use their back office and use their facilities, and then one day I would become wholly independent. We worked hard on that deal and got that off the ground and then we launched the fund in 2013.

I always had the long-term aspiration to be an independent manager. And in fact I think in 2010 I set up our company to sell research to the firm where I was working and accumulate cash in that vehicle to one day be independent.

And then we had this deal in 2013, where I committed to stay at the firm for three years and that really suited me because I felt I had a lot to learn still. And actually it was tremendously valuable I thought to be under the radar, and to not have to meet any investors for three years, to not have to think about paying bills for three years, and importantly, to build out a team and create a portfolio that was then fully invested. And I thought three years was about the right timetable. And in particular Charlie [Stone], who many of you probably know, Charlie, is a really wonderful guy, and he moved continent to come and work on this project with me. I'm not sure how I persuaded him to do that. But spending the time working together and learning how each other worked and what our relative strengths were, was just a really important gestation period for us.

And actually, what happened was that, in that main fund, the Managing Partner in that business decided to retire and step back from the industry. And the partners there had done phenomenally well over the last couple of decades. So it came to April 2015, and the main fund that should have been paying the bills, was no longer paying the bills. And I should mention in 2013, when we got started, we started the fund with just over $937,000 I think. So it wasn't really a viable proposition. And I think at the end of 2014, we were about $2 million in assets. So still very small, and I'd never done an investor meeting and I still didn't have a track record. So we took the bold decision then to give it a shot. And then we got up to about $7million in assets under management. I still focused very much on the portfolio, rather than marketing and we downsized the cost base. And basically took the costs down to almost zero. We ended up with a breakeven number of about $10 million under management.

Rob Vinall, RV Capital 11:35

A very stressful time having this sort of [thing] forced upon you years before you were kind of probably economically in a position to do that. But in hindsight, what an opportunity, I'm sure, that's the kind of problem a lot of people here would love to have, you know, being forced to create a firm.

Dan Abrahams, Alfreton Capital 11:52

But you know, I think, in 2011-12, when I'd been thinking about this, this deal was obviously a tremendous opportunity in this arrangement I had, but there were obviously risks associated with it. So I spent a year meeting different service providers. I spoke to at least 60 emerging managers or people who had tried to launch a fund and failed – or people that had worked with them – to really try to learn what had happened in their businesses. Why had they or hadn't they succeeded? What happened? And I wrote a very detailed business plan in 2012, or maybe it was more appropriately called a contingency plan. You know, what are the items that are actually critical? Who are the service providers and what do they cost? If we do get into this kind of panic situation, who do I need to call in what order?

So it took us a couple of months actually to just port the Fund from my previous firm into a new independent firm, because we'd done all of that preparation in advance. It's a bit embarrassing now to confess, but the level of preparation that I did back then was a little absurd. It wasn't just the business side of things. I went for a full 12 month period and I looked at every item of household expenditure. There was one day when I found myself thinking about the relative price of Kellogg's cornflakes versus private label cornflakes! And I wanted to really stress things. I didn't know if 2015 was going to be like 2008. **So I didn't want to rely on luck. It just had to be belts and braces. We were renting out car parking spaces on the front drive of our home because we lived close to the train station. I was undercutting the train station car park.**

Rob Vinall, RV Capital 13:39

But did you ever sleep on someone's couch in one of your friend's houses when you were visiting companies?

Dan Abrahams, Alfreton Capital 13:55

[laughter] No I didn't go that far.

Of course, the reality was that switching to private label cornflakes never really moved the needle. **But it was more about having that mental framework of resilience and toughness. And I think that helps in a crisis. If you go the opposite route, which a lot of managers do, having fancy offices on Bond Street and lots of staff and traders and stuff, you are probably going to feel very nervous in that situation when your performance is down.**

I think a really important point to make there is one of my lessons from the 2008 experience, is that when it is the best time to be buying stocks, actually, you can be so distracted by an onerous cost base or by an investor base that is not aligned with the way that you invest so you're having to field calls from your investors and your down 10%, 20% or whatever it might be. And so rather than focusing in those early days on marketing, or actually on the portfolio, the thing I've focused on most was setting up an organization that was structurally well positioned to compete and was incredibly well aligned for the long run. Because those are the variables that are so hard to change once you put them in place. Whereas the portfolio you can change it in a day, especially when you have only $937,000. So getting those long term structural things rights and being incredibly stubborn about the long run but being very open minded about the short run, I think was a business approach that that served us really well.

Rob Vinall, RV Capital

Yeah, I think it's an incredibly smart decision to kind of develop things that way.

What I always emphasize to young managers is you have to get the structure right on day one, because like you said, other things can be changed later. But structure can't.

So talk a little bit about marketing, though, because you were at $7 million when you had a breakeven point of $10 million. So clearly, you don't want to be marketing, on the other hand, you are fighting for survival. So how do you kind of solve that conundrum?

Dan Abrahams, Alfreton Capital 16:06

So we had to go out and speak to people. And I'd say we still didn't push the metal to the floor on it. I think in six years, I've done three marketing trips, so I'm probably not the best person to speak about marketing. We didn't have a CRM system or anything like that. So you know that that's going to be challenging. **And I think that's why it's so important to have a cost base that means that you could carry on indefinitely. You know, the difference between $7 million and $10 million in AUM - fine I was burning a little bit, but it was OK.**

But actually, another important point. I think there is a heuristic amongst allocators that it's tremendously important for the manager to have all of their net worth or a large part of their net worth invested in the fund. And, frankly, for me at the outset, that would have been an incredibly reckless decision. In fact, most of my assets were invested in index linked UK [government] certificates and I only had a small amount of money in the fund. In fact, I was the minority investor within the $937,000 in the fund [on day one]. And that's because I never wanted to have to give up my long-term aspiration because of short

term liquidity or solvency issues. And over time, I've increased my investment in the fund. But I could have carried on for five years without raising cash, probably longer if I had positive performance. I just wanted to take that risk off the table.

Rob Vinall, RV Capital 17:47

I made the exact same calculation, how many years of runway I would have.

So scooting forward to today, where the situation is a much happier one with solid assets under management. But, you know, and I'm sure you're now in a situation where you don't have to worry too much about where customers are going to come from. And perhaps the tables have turned now and, you know, there's more people that would like to invest and, or you can at least be a little bit more choosy. So how do you think about which partners you have in the fund today?

Dan Abrahams, Alfreton Capital 18:22

Well, maybe we had an over optimistic or false sense of self belief. But even in those very early days, we were incredibly choosy about who we took as investors. I think we were $2 million bucks and someone or someone offered as a seed deal with $30 million in assets, and we said no. And they looked at us, like we were absolutely crazy. And I think having the right investors on board is just tremendously important. The variable that we've most focused on is the duration of our capital. We were very fortunate to have very long duration capital in the fund. And aside from legal protections, and those types of things, it's an investor base that's very philosophically aligned with how we invest, which is a very long-term approach. And I think that is so important. I think at the margin, there are some other variables we thought very carefully about. So because I wanted a very low cost structure and a very simple structure with minimum distractions, we had a strong preference for investors that were not US taxable, for investors that didn't require us to have a managed account, because in the jurisdiction that we're in the compliance burden is actually more onerous when you have a managed account. And there are some conflicts of interest that also arise when you have investors that have very significant direct equity portfolios of their own. There can be some mitigating circumstances there but at the end of the day, we avoided that as well.

Rob Vinall, RV Capital 20:07

That must have taken incredible fortitude. I mean, seen from today's perspective, probably every day you wake up, the first thought is, thankfully I didn't take seed money and giveaway economics in the fund or whatever. But I can imagine in the earlier days, and perhaps some of the younger managers here could feel very tempted to maybe give up 50% of the economics and take that ticket, which allows you to kind of pay the bills.

Dan Abrahams, Alfreton Capital 20:31

Yeah, I think one lesson from a lot of those people that I met in 2012/13, who had succeeded or failed at doing this, there is a natural conflict of interest that goes with taking a seed deal, where you have this passive shareholder, that is extracting value from all of your other clients' fees. There's a natural misalignment there, where they want you to grow assets as quickly as possible. I met a lot of people that raised a lot of assets very quickly, and then five years later were out of business. I think the median fund does go out of business within five years. And I think one consolation that I used to tell myself is, if you're going out there trying to raise a fund and you don't raise any money at all, the one thing that's definitely worse than that is going out and raising a lot of money from some very noble institutions and then losing it for them. So, you know, even if I didn't raise anything, I felt I wasn't the worst.

Rob Vinall, RV Capital 24:51

So obviously, a lot of emerging managers here and some are also watching over the coming months on YouTube. So is there any advice you would have for them - maybe if they're in a position where you were sort of five or six years ago, what you would advise them to do, or obvious pitfalls to avoid?

Dan Abrahams, Alfreton Capital 25:09

You know, I had some red lines. I think alignment of incentives, alignment of interests with you and your partners, your clients, and your service providers team is super, super important. And we've worked incredibly hard at that. And I think that’s absolutely critical for the long run, I think having a clear understanding of what's important, and what's not. So keeping the business as simple as possible, as low cost as possible. Not necessarily because you have to, but because doing so really maximizes your flexibility and minimizes distraction, and helps you be choosy even when it may appear like you're not in a position to be choosy.

I think one point that goes to misalignment of incentives would be just thinking about adverse selection here. It's very easy to structure terms or contracts that are so one-sided, that only an idiot would sign up to them. So, if you go down that route, don’t be surprised if you end up working with people that are idiots. So, no, I think trying to be fair minded about these things, and certainly as it relates to say fees, or team, and service providers. We spent a lot of time on that as well.

Rob Vinall, RV Capital 26:37

Yeah, I think it's wonderful advice, because a lot of the stuff is obvious and intuitive when you're setting up a fund. But being selective about who the partners are, isn't intuitive. When you're starting out, you probably think the more the merrier. So that's, really good advice. And a lot of the point is, what about the alignment? In investing, it's great to find a situation in companies where there's great alignment. And of course, if you’ve done that through your own company in the way you set yourself up, you're much more likely be able to recognize it in others if you live it yourself.

Dan Abrahams, Alfreton Capital 27:10

I think the last point that I'll make, which maybe echoes some of the things that Norman was saying, is just think about the language of finance, which for example is “bonds”, “covenants”, “security”, “equity”. Think about that – the whole language of trust and integrity. I think it's very easy for you not just to make structural compromises in your business in the early days when you’re under pressure, but also to make compromises in terms of your integrity: perhaps you poach employees from your former employer, or you take their IP or poach their clients. But if you make some kind of ethical compromise like that, I think other people on your team, if you do that kind of thing, they end up having a little bit less respect for you.

So being as straightforward as possible, and being honest, I think is absolutely key. I was actually thinking about this this weekend. I was going through some emails from 2012 when I first met Charlie Stone, my business partner, and I honestly, I had no cash to pay him back then. And I didn't know him so I couldn't make him a partner straight away. I couldn't give him any equity. So I was upfront and I said “all I can pay you in is friendliness!” But it worked out!

Rob Vinall, RV Capital 28:35

That's awesome. So we've got about 10 minutes. Do you mind taking some questions from the people here?

Audience Question 28:49
Thank you very much. In past meetings we've heard that often the most successful fund management companies are run by one person. Can you give us some advice about how you and Charlie built and maintained a strong working relationship?

Dan Abrahams, Alfreton Capital 29:13

Thank you. So, you know, one of my red lines in the early days was not just that I would never do a seed deal, but it was also that we would be a firm where there would just be one decision maker. And I think I’d really echo Rob, in terms of **we are a one captain ship, even though I think we have a collegiate and collaborative culture. So the mistakes are wholly mine. And I think it's very important to have that clarity, that accountability. But I don't think that that extends to having to work on your own. I think there are tremendous benefits from working with other people.** You know, I'm not the best person at everything, that's for sure. And even if you are someone that thinks you are the best at everything, you probably have some relative strengths, where it makes sense for someone else to focus on something else. **So that's how we work. And I think, candor, straight talking, and a culture of intellectual honesty, curiosity and constant learning are very important things to embed in a team in this business, and we work very hard at that, it's probably one of the most important things we do.**

Rob Vinall, RV Capital 30:31

So, a lot of times, the more a firm grows in terms of assets, the more people they hire. Is that the kind of curve you would expect for you? Or are you happy with this as it is?

Dan Abrahams, Alfreton Capital 30:41

We're just fine. That’s an important point, actually, because I think you need to have a coherence between your business strategy and your investment strategy as an investment management firm. I think one reason why I own these very long duration businesses that I can own for many years and have low turnover, rather than lower quality businesses, you know, relying on a price to book reversion or whatever, is that with the latter, that's a strategy in which you need a rich pipeline of far more ideas, you probably can't take such large positions. And liquidity becomes a constraint far earlier. So if you need more ideas, you need more Analyts, you then end up with perhaps less conviction, because you're not doing your own research. So your position size ends up smaller, so you need more names, you need more Analysts, and that thing has a very different trajectory to the strategy that we run, where, you know, Charlie certainly reads all the research I do, and he does his own research, but I do all the research that

I need to do to have conviction in an idea. This isn't an outsourced analytical function. It's having a sparring partner that is almost replicating what I'm doing. And we debate it as fully informed people. And actually adding more people into that dynamic could have adverse consequences, as well as positive ones.

Audience Question 32:09

Thank you very much. I just wanted to ask about your relationship with Charlie, is he basically your employee or does he have his own fund as well? Could you maybe elaborate on this?

Dan Abrahams, Alfreton Capital 32:31

So it's great question, because we are a little bit unusual, with how we're structured. So Charlie and I are members of a UK LLP, which is the investment manager to the fund. We both wrote working capital cheques to get the business up and running, which I set at quite a low level at about 10% of our trailing income. And neither of us are a fixed cost in the business, we only take out a fixed dollar amount if the business is profitable. And then we have a percentage profit share, and then there is an allocation that is at my discretion. So there is a spectrum there between salary-like, right through to discretionary compensation from Charlie's perspective. Our business has no equity value. Neither of us can sell it and neither of us can have a share in the profits if either of us leave. There is no "business". The LLP is simply a tool that is a way for us to efficiently share resource and a tool for us to learn to become better investors. But there is no "business" in any conventional sense.

Audience Question 33:55

My question was actually relating to your fee structure, if you could elaborate on that, and then what's your take on the Buffett partnership fee structure?

Dan Abrahams, Alfreton Capital 34:14

So there's a related point here that goes to what jurisdiction you choose to domicile your fund in. If you are based in the European Economic Area, and your investors are likely to come from the European Economic Area, then I think it's probably quite important to have a fund structure that's within the European Economic Area, like Rob's. If you choose a fund structure that's outside the European Union, then it's actually very difficult to describe publicly the nature of the fund because of the European regulations around that. But to answer your question more indirectly and to think about, in general terms, fee structures, I think in Rob's case, depending on how Rob performs, he is going to earn between maybe 1% and 3 or 4% of the value of AUM and, I think that's a very reasonable structure. I think in common with Rob, I think that a hurdle is appropriate for a very long-biased strategy. I think if you've got long duration capital as we have, I think it's important for there to be alignment between when the performance fee crystallizes and when your investors are able to redeem. So, if you've got three or four year money, but you're crystallizing performance fees every 12 months, it's probably a bit inappropriate. And in terms of your question, on Buffett terms, look, I don't think zero management fee terms are appropriate for an emerging manager. There is an element of business resilience, that's absolutely important. And you will have years like 2008, maybe 2018, where you don't have positive performance, and you still need to live. I think the last point I'd make on that is that I think if you're taking a very incremental and gradual approach, as we have, then there is some merit to a sliding scale management fee that is perhaps high in the early years, and then trails down as assets increase. And it's also important to think about the expenses in the fund. So in the early days, we were writing checks to the fund every month to make sure that the expenses didn't exceed a certain amount that we'd agreed with our investors. And, again, it goes to the point of fairness and doing the right thing by your pipelines.

Rob Vinall, RV Capital 36:51

Yeah, I would echo that, I think alignment is really the key. So often people ask me, what is the right fee structure? And I don't think there's a right or wrong answer, in terms of what the actual numbers should be. But alignment is the key principle. So it has to be aligned with your investors so that when they look at it, if they're smart, reasonably minded people they think, well, this is a fair structure, like Dan said earlier, if it's something an idiot would sign, then obviously, by definition, only idiots are going to sign, but also has to be aligned with you. So, you know, if, you know, the 0% management fee, obviously, you know, worked for Buffett and was very in line with his personality and situation. But you know, the markets could theoretically, you know, they could spend a very long time in the doldrums and for me, personally, I'm not sure I would have slept as well if, especially in the early days, if that fee was zero. So, I think the key message is alignment with you and the type of investors you're looking for, but also alignment with your own situation.