Genuine Investors ETF Owner's Manual

The Importance of An Owner's Manual

The success of any investment strategy depends on a mutual understanding between us as the manager, and you as our investors and partners on what our ultimate goal is and how we intend to achieve it. As such, the purpose of our Owner's Manual is to lay this foundation.

Much of what we are going to talk about in this Owner's Manual may appear simple at first glance and should approximate what any rational observer would deem as common sense. And yet in our experience, almost none of what we talk about can be found in the marketing material of many investment firms.

As a starting point we would like to make a very clear distinction between speculating and investing. Two words which are often used interchangeably in the investment industry, but which to us represent fundamentally different pursuits.

Speculation involves buying an asset in the hope that someone else will pay more for that same asset in the future – your return is solely from price appreciation and is therefore reliant on your ability to forecast the actions of other participants. In contrast when you invest, you allocate capital in specific assets in an attempt to generate a positive return in and of themselves. We participate exclusively in the second of those two disciplines.

There are many funds that occasionally deliver high returns (usually with hidden risks) running strategies that are more akin to speculating – investing in fads, themes, momentum, arbitrage, etc. Or even in assets in which speculation is the only possibility: commodities, currencies etc. Our fund is not one of them. Instead, we seek to invest using a "Genuine Investing" strategy. At its essence, Genuine Investing involves evaluating businesses as long-term owners would, where we establish an underlying real value for the business itself, based on our expectations of its long-term future.

It is through this approach that we will strive to achieve our end goal – seeking to provide our investors with attractive long-term risk-adjusted returns.

Our Approach: Genuine Investing

At its simplest – Genuine Investing focusses on businesses, not stocks.

Genuine Investing involves thinking like a business owner – every investment is a logical and careful purchase of a business, not simply a trade in a stock. Thinking like a business owner means being interested in owning only truly wonderful businesses; the sort of companies that sit within attractive markets, are steered by excellent and correctly incentivized management teams, and which possess a significant and enduring competitive advantage – so there can be confidence in consistent and growing cashflows well into the future. All these (and many more) features go into determining both the quality and the value of any business.

The first implication of our approach is that when applying such a threshold to business quality, the investable universe shrinks markedly. We believe that most businesses listed on the stock market simply do not meet the necessary requirements to be investable – indeed there are entire sectors and industries that we see as fundamentally un-attractive long term investment opportunities. Despite their inclusion in various indexes, we choose to simply ignore these sectors.

For example, in our view there are many industries so heavily regulated that individual companies have little control over returns, and many whose returns are determined by unpredictable commodity prices; there are others operating in declining industries, and many in markets so competitive that returns are miniscule.

Instead we continually seek high return potential, defensible businesses. We have no ability (and spend no time trying) to forecast many factors that feature heavily in some investment approaches, such as politics, regulation, commodity prices, market movements, sentiment, quarterly earnings or asset flows. We focus on finding and understanding truly great businesses and seeking to own them at attractive prices.

Whereas passive investors may own many of these lower quality businesses, Genuine Investors are comfortable concentrating their capital in only what we think are the most attractive companies and industries available in the market. As a result, our portfolio doesn't contain hundreds of stocks. It is our belief that just because something is included in an arbitrarily constructed index like the S&P 500 doesn't mean that we should own it.

This approach to investing has a huge impact on our research process. Whereas much of the investment industry relies on reported accounting numbers, screening tools, ratios, and multiples to make their investment decisions, we as Genuine Investors use accounting numbers as not only one small part of the overall process of understanding a company, but also remain aware that they are also often not telling us the true economic story. In our opinion there are many more important, more representative and often useful elements to consider: management teams, company culture, products and services, addressable market, competitive dynamics, regulations, etc.

And crucially, Genuine Investing requires understanding that underlying business value can be very different from a business's stock price. We believe the reason for this disparity is simple in principle, but often overlooked. In our view real business value (whether private or public) is derived from the future cash flows that can be produced for the owners over the long run. It is something that while subjective, can be estimated within a reasonable range and changes little over days, months, or quarters. Fundamentally, if you're the owner of a business, your business is probably worth approximately the same today as it was six months ago.

On the other hand, stock prices can be volatile with fluctuations as much as 50% in a quarter for no apparent reason. Why the disparity? Because stock prices are driven by underlying business value *plus* many other factors. And those 'other' factors are typically short term in nature, impossible to predict, and often irrelevant to real underlying business value. Think of things like sentiment, asset flows, index inclusions, prices of other stocks, 'style' popularity, accounting rules, ratios, multiples, etc. There are hundreds of factors that drive stock prices up and down every day but have zero impact on the value of the underlying business.

For us as Genuine Investors, we view this disparity between business value and stock price as a significant opportunity that can be exploited through a long-term mindset, with the view that over the long run stock price and business value should converge.

The reason for the confidence in our strategy is that if short-term factors are depressing the price of a stock, but the underlying business is grinding out consistent earnings growth, then eventually it is likely that either the market will come to appreciate that underlying business value growth in the stock price, or someone could just step in and buy the whole business.

On the other side when it comes to overvaluation, stock prices may trade far above our estimate of business value based on exuberant sentiment, high peer valuations or asset flows into that 'style', but if over time the underlying business fundamentals aren't keeping pace, those factors alone are unlikely to maintain the elevated share price indefinitely, or perhaps even company management will take advantage of the inflated stock price and issue more shares.

Genuine Investing embraces the disparity between price and value, by focusing on business value and using stock price simply as an opportunity to transact.

How we Manage Risk

Genuine Investing has a significant impact on portfolio risk management, an area we believe is an incredibly important part of successful long-term investing.

The prevailing view within the investment industry is that the way to measure and control equity risk is through volatility – which is a measure of the historic variation of stock prices. Meaning the risk of an investment is determined simply based on past movements in its share price. And what follows is that on this metric, portfolios of fewer stocks are deemed riskier than portfolios of many stocks, as they are typically more volatile. While that is the perceived industry wisdom – we firmly believe that it is fundamentally wrong.

In our opinion, the industry uses volatility as a measure of risk because it is easy and impartial to calculate and can be integrated into sophisticated modeling, which has the ability to provide a sense of false mental security for investors. However, we do not think that historic price volatility is the same as risk. Volatility is backwards looking, it assumes a normal distribution, and leads investors to make the wrong decisions at the wrong time (selling into a panic). But more fundamentally, the biggest problem we see is that volatility is solely focused on stock price, not business value.

We take the view that the real risk investors face is underlying business value risk. As such, stock prices moving up and down (volatility) is not real risk. We believe that long-term capital impairment is driven and caused by business risks, not short-term price movements. In our research, it is the underlying business value that has been shown to drive both long-term returns and long-term risks.

So instead of volatility we focus on the risks to the underlying business; whether that is from competition, pricing pressure, regulation, industry shifts, consumer demands, etc. It is this focus on business risk that allows us to make calm and calculated long-term decisions even when the rest of the market is panicking over increased volatility.

In our experience, Genuine Investing as an approach is not widely followed today because it is time consuming, difficult, requires considerable subjectivity and most importantly, it demands a long-term view in a world that is seemingly ever more short-term focused. But as with most things, taking shortcuts tends not to pay off in the long run, and we are far more focused on the potential ability to create long-term wealth than we are on short-term fluctuations.

What We Ask of You, Our Partners, and Investors

1. Think of yourself not as the owner of just a ticker on the screen, but as the ultimate owners of the real business assets that we hold in our portfolio. Our job is simply to attempt to allocate your capital to what we believe are the best businesses at the best price. The return you then receive will not come from your relationship with us, but from the relationship between the businesses in our portfolio and their customers. The better the businesses serve their end customers; the more aggregate wealth you will receive.
2. Understand that the long-term economic goal of our fund is to attempt to maximize the risk adjusted rate of return on the aggregate business value of our portfolio. This does not mean maximizing the return in any given period which can often only be accomplished by taking on ever-increasing risks to chase ever-decreasing gains in a speculative boom.
3. Knowing our goal, you should hold us to account if we fail in executing it. As such, we should be in alignment on what failure or success should be measured against. We suggest that the best way to measure the efficacy of our strategy is our performance in relation to the overall market over rolling 5-year periods. Partners should share this long-term mindset and be largely agnostic to the volatility realized over shorter time frames, which can vary widely.
4. The efficacy of our strategy is not tied to trading "activity". Our job is to buy what we think are the best businesses at what we believe are the best prices and then hold them for as long as we believe that remains the case. In some years, this could mean that we make few purchase or sale decisions, which counterintuitively we feel could be an advantage compared to what we view as the constant turnover found in the rest of our industry. We consider that mathematically the worst decision an investor can make is not the purchase of a business that goes to zero, but the early sale of a business that goes on to 10x or even 100x.
5. You should expect us to be candid in our reporting to you. We will let you know if we believe we made a mistake, got lucky, or otherwise permanently impaired your capital.

What About Fees?

The net expense ratio, after fee waivers contractual through February 29, 2024, is 1.0%.

Based on the yardsticks set out above, it will be very easy to see if we are adding value in excess of the fees we charge. If not, we should be fired as your manager.

Disclaimer

Investors should carefully consider the investment objective, risks, charges and expenses of the fund before investing. This and other information are contained in the prospectus and should be read carefully before investing. For a prospectus, please call 713-401-9048 or visit our website at: www.genuineinvestorsetf.com. Genuine Investors ETF is distributed by Northern Lights Distributors, LLC, member FINRA/SIPC. Northern Lights Distributors, LLC and GCI Investors are not affiliated.

IMPORTANT RISK INFORMATION

Investing involves risk, including loss of principal. Value investing involves the risk that an investment made in undervalued securities may not appreciate in value as anticipated or remain undervalued for long periods of time.

Non-Diversification Risk. The Fund is a non-diversified portfolio, which means that it has the ability to take larger positions in a smaller number of securities than a portfolio that is "diversified". Non-diversification increases the risk that the value of the Fund could go down because of the poor performance of a single investment.

Active Management Risk. The Fund is actively managed and is thus subject to management risk. The Advisor will apply its investment techniques and strategies in making investment decisions for the Fund, but there is no guarantee that its techniques will produce the intended results.

New Fund Risk. The Fund is newly formed and has no operating history as the date of this Prospectus. Accordingly, investors in the Fund bear the risk that the Fund may not be successful in implementing its investment strategy or growing to an economically viable size.

Lack of Experience of the Advisor. The adviser has no prior experience as an investment advisor to a mutual fund registered under the Investment Company Act of 1940, as amended (the "1940 Act").

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