

O Fortuna A Letter to Investors

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“Whatever Fortune has raised on high, she lifts but to bring low.” – Seneca

In its heyday around 2500 BCE, the Mesopotamian city of Ur was home to a half-million Sumerians living at the forefront of culture and technology. Viewed from the heights of the Ziggurat, roads teeming with people led into and out of the city, intersecting rich and fertile surrounding farm lands. Situated at the mouth of the Euphrates, Ur attracted traders from distant lands to partake in its commerce. Over time, as the course of the Euphrates shifted away from Ur, the city’s fortunes began to wane. The desert slowly covered the tapestries of the once-prosperous city as it fell into ruin around 450 BCE.

Early 20th-century archaeologist Charles L. Woolley led a team of excavators to uncover the many wonders of Ur, including a board game now regarded as the predecessor of modern-day backgammon (see picture below).



Amongst the findings were several solid white tetrahedral objects with lapis-lazuli inlays, believed to be one of the earliest sets of dice to be unearthed.

David Schwartz, the author of “Rolling the Bones: The History of Gambling,” notes that the likely precursors to these first dice were collections of knuckle bones, or astragali, from hooved animals uncovered at many archaeological digs around the world. Given their irregular shape, they bounce in unpredictable ways when tossed, surrendering their outcome to the drivers of chance and luck. These findings support the idea that people indulged urges in gambling since well before the dawn of western civilization.

Sociologist William Thomas points out that the human fascination with gambling exists because it recreates the pain and pleasure of conquests like finding food, participating in sport, or competing for mates with limited effort.

“In gambling the risk is imminent, the attentions strained, the emotions strong; and even where the element of skill is removed entirely, and the decision left to chance, an emotional reaction analogous to the feeling in genuine conflict is felt.” – “The Gaming Instinct,” – William I Thomas.

Renaissance-era physician Gerolamo Cardano wrote one of the pioneering works on the statistical principles of probability, “Liber de Ludo Aleae (Book on Games of Chance). In it, he considered the theory behind the outcomes in games of dice. Aside from being a noteworthy physician, Cardano authored numerous publications covering a variety of subjects in mathematics, astronomy, and physics. He was an outstanding scholar. Ironically, despite his efforts to understand the theory behind games of dice, Cardano himself was a gambling addict of sorts. By his admission, he gambled daily and regularly lost large sums of money.

Given this broad-based and innate instinct to gamble, it is less mysterious that so many people continue to participate in financial speculation, resulting in periods of pronounced booms and busts in markets.

Within a few years of Cardano’s passing unfolded the Dutch “Tulpenwoede” (tulip madness). While the price of tulip bulbs rose to astronomical levels, their cost of production and practical usefulness remained relatively unchanged. As speculation neared its peak, new florists continued to enter the market, with many leveraging their savings or assets to take part. The market finally crashed in February 1637, when offers for tulips in a Haarlem auction failed to receive any bids. The failed auction caused speculators, many of whom purchased tulips on margin, to become forced sellers.

“Tulpenwoede” is just one example of broad-based price speculation with disastrous consequences. Since then, canals (the 1790’s), railways (mid-1800’s), radio and transportation companies (1920’s), Dot-Com’s (late 1990’s) and, more recently, US and European housing (2000’s) have all experienced rocketing prices driven in large part by speculation. Sharp price declines and a significant number of “investors” losing their capital marks the tragic end to these bubbles.

“Nowhere does history indulge in repetitions so often or so uniformly as in Wall Street. When you read contemporary accounts of booms or panics, the one thing that strikes you most forcibly is how little stock speculation or stock speculators today differ from yesterday. The game does not change, and neither does human nature.” – Reminiscences of a Stock Operator, Edwin Lefevre.

Despite the many object lessons in the history of speculation, enough “investors” remain keen to participate in and exacerbate the formation of new asset bubbles.

“So we have a vast gambling culture, and people have made it respectable. Instead of betting on horses or prizefights, we can bet on the price of securities or the price of derivatives relating to securities, and we can bet on athletic contests. We have a huge amount of legalized gambling. And of course the public market, which operates every day with transactions, is an ideal casino. . . . And very respectable people get drawn into it. They see other people getting rich.” – Charlie Munger.

Charles Ellis alluded to such behaviour in his 1975 essay “The Loser’s Game.” In it, he outlines the work of electrical engineer Simon Ramo who studied the strategy behind tennis matches. He declared that it was not one game, but two. Professionals participate in one game; amateurs play in the other. He points out that the nature of the two games is markedly different. Professional tennis players are disciplined enough to hit the ball with well-aimed shots, limiting fundamental mistakes. They play consistently well through volleys until one player outmaneuvers his opponent by directing the ball just out of the other’s reach. In summary, professional players win points.

Amateurs, on the other hand, make more unforced errors, play shorter volleys and concede more points. When they do win, it is because their opponent made more errors.

Ramo’s conclusion was that a winning strategy in tennis is to avoid mistakes. Like Ellis, we find its analogy in investing to be instructive. We prefer to develop a plan that is conducive to the generation of positive returns as consistently as can be reasonably expected of fully invested equity strategies. We prefer not to gamble or rely on the market to dictate whether we have won or lost. To do so is to engage in the loser’s game.

Rather, we try to emulate Ted Williams, preferring to “wait for the fat pitch.” Williams would only consider taking swings at pitches in the part of the strike zone where he knew he had a greater probability of getting a hit. By waiting for the “fat pitch,” he was looking for points that he could win with a higher degree of confidence.

Our process is to invest in companies that we believe carry the best likelihood to return greater sums of money to our investors than is required for investment. Having this focus enables us to develop a checklist of identifiable characteristics that we want our portfolio companies to embody. Following this list, while time-consuming, promotes discipline and reduces the number of errors we make.

“Successful investing takes time, discipline and patience. No matter how great the talent or effort, some things just take time...”
– Warren Buffet

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We often try to relate shares in our portfolio to human nature or the natural sciences. Casinos and gaming companies are one such example.

Consulting our checklist, we appreciate the tangible and intangible assets these companies hold, many of which are hard to replicate. Legislative regulations raise the barrier for new entrants, making the likelihood of increased competition all the more tenuous. These, in turn, allow for higher operating margins and cash flow generation. We look at shareholders' experiences over time, making sure they have captured the benefits of these factors.

As some investors shy away from these companies, their quoted prices are more likely to understate their intrinsic value. At this point, we find these stocks within our strike zone and view them as higher-probability wins that are, ironically, more independent of hope, fate, and fortune for their success as investments.

We are aware of recent events in China as authorities have detained several Crown Resorts employees. The arrested employees are under investigation for the recruitment of high-roller Chinese gamblers to play at Crown's Australian casinos. Under Chinese law, advertising casinos and organising group tours for Chinese nationals to visit casinos overseas is illegal. Casinos located in Australia are reliant on high-rollers from China to boost revenues. The latest crackdown has undoubtedly cast a pall over such visits and local casinos' VIP segment revenues. It is unsurprising to find that Australian casino share prices have declined.

With the Chinese authorities continuing their investigations, it would be premature to draw broad conclusions on their eventual outcome or their impact beyond the immediate term. At the least, speculation on this point tends toward an uneducated guess, unforced error, or even a gamble.

We will wait until we can objectively reassess the fundamental drivers for these companies, including their capacity to adapt to new circumstances, with more concrete information. At that time, we will return to our checklists and carefully go through each item. Any potential actions we take will be a move to win points or recover from a poorly played shot in a long rally.

Despite it being in our very nature, we will not gamble.

*"The greatest advantage in gambling lies in not playing at all." –
"Liber de Ludo Aleae," – Gerolamo Cardano.*

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