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Giant Steps towards managing investment adversity

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A multidisciplinary perspective to investing

Many approaches to share investing overlap or disjoin according to underlying principles, be they quality, value, growth, thematic, behavioural, or some combination. A multidisciplinary perspective enables a broad scrutiny of investment decisions and also serves as a wellspring for inspiration and creativity, akin to Charlie Munger's 'latticework of mental models'. Otherwise, the daily pursuit of value for investors is littered with distraction, vignette, portfolio construction gimmicks, and financial models that stand for nothing.

Like many others, we seek insight through 'equity factors' and statistical analyses, primarily in relation to risk control. We don't, however, seek the 'investment truth' in these things. It's vital to discern causality from coincidence and narration from science, particularly when a story coalesces around hard-looking numbers. Testing historical data or even having a great live track record is dangerous primarily when a mistaken belief of completeness or inevitability is attached. While a good econometrician will always relish new and interesting data points to improve a financial model, it is small consolation to investors (like you) who may have inadvertently signed up to a 'crash-and-burn' teachable moment.

Bad returns at bad times are just bad for investors

More return with less risk is the best achievable outcome for investors, and those who forfeit that objective should feel a twinge of guilt. Beside the false inevitability of joining more risk with more return, from a total portfolio perspective, riding junky, highly geared, cheap 'value' companies on the way down is its own kind of punishment, not compensated by any commensurate rise on the way back up. Bad returns at bad times are just bad for investors.

"[Benjamin Graham's] … vantage point was from the perspective of eternity and calamity – timelessness and a worst-case scenario to arrive at a margin of safety." Christopher M. Begg

Begg's perspective of eternity and calamity is tantalisingly close to our abstract views on quality and value. We first briefly take a step back to frame the more general trade-offs in share investing.

"Intelligent people make decisions based on opportunity costs." Charlie Munger

Risk and time are the price of admission

Successful share investing usually requires investors to forego their capital for an extended period of time. The question is: how do investors trade this opportunity cost most wisely? As **risk** and **time** are the price of admission, what are the appropriate rewards to seek for bearing these costs, or else avoiding them altogether?

The relevant risks are two-fold: instability of your capital and the potential for the permanent loss of capital. While share investors **can afford** a certain amount of return instability (as is expected with share investing), they **can't afford** the permanent loss of their capital. We therefore orient our process to rest on sure fundamental footings. The exit strategy from investments is the cash flows generated by the businesses, not the hope or expectation that the share market (or central banks!) will bail us out in one form or another.

The concept of time is more nuanced and encompassing, more given to abstraction and imagination. While we experience time sequentially, we routinely abstract from it to consider events that are distinct to the current set. This is a very useful thing to do, not least because it helps guard against real dangers that have no immediate precursor.

"All a musician can do is to get closer to the sources of nature, and so feel that he is in communion with the natural laws." John Coltrane

Eternity and calamity

Calamity, while usually absent, is the event that needs be accounted for in the fullness of time, to avoid courting disaster. 'Quality' should be the constant of a profitable business franchise, unconditional on any particular events occurring or not occurring – but don't conflate quality with growth as some do. Unprofitable growth is the definition of value destruction, while a profitable but static or even shrinking business only requires non-reinvestment to achieve nearly perfect investment results, potentially more reliably. And don't conflate quality with business cycles, as there's no such thing as conditional quality.

The steady characteristic of quality is paradoxically only visible through time, and so one point in time tells us nothing very meaningful about quality.

What we commonly refer to as value is the recognition that a business may be trading close to its worst-case scenario. It may be experiencing its own version of calamity in its performance, market perception, business cycle, or some combination. Collapsing the dimension of time enables us to reconcile our investments against the certainty of eventual calamity and to act upon it when it does occur, enhancing the prospect of improving conditions having representation in our portfolio.

The relationship between quality and value is only that they should be mutually consistent, and the timeless perspective helps make that more clear. One company's version of calamity may look very different to another's. In fact, its calamity may look nearly the same as its own best-case scenario, if it has an inherent robustness to varying conditions. Consider the industries of beer, chewing gum, or canned soup, and all the possible future events that will **not** materially impact their 'demand-side outlook'. Given that's the case, it's no surprise that some companies look cheap or expensive based on current superficial considerations, only to switch places upon a fuller examination of what may happen.

Viewing quality as a 'flavour-of-the-month'

Some market observers like to point out that quality, when viewed as a factor, is like all other factors in that it can become the 'flavour-of-the-month', overvalued, and potentially painful to investors when inflated prices and valuations subside. We agree with this basic observation but feel it overlooks an important point.

While all segments of the market can experience over-valuation, high quality companies should not experience the same severity in the reduction of their underlying cash flows when adversity eventually does arrive. Recall that large portions of the market or economy may essentially disappear under relatively modest economic pressure, following any number of plausible events. Or they may be particularly prone to over-investment relative to the (un)steadiness of future demand (think 2000's dot-com boom and eventual bust), severely impacting their profitability. Our view of quality focusses on the eventual delivery of reliable cash flows. The multi-decade recovery of the Nifty Fifty (1960's and 1970's 'must own' businesses that investors were told they could buy and hold forever) offers a kind of testament to that fact.

This consideration has bearing on the appropriateness of a share portfolio that can occupy a steady 'home' within your diversified portfolio. While value-oriented or opportunistic strategies may have their place, the deliberate move from cash into riskier assets should include a proper inventory of both the trade-offs and opportunities available along the way.

We see quality as the first logical stop for consideration, especially where it is positioned to deliver relatively low risk and a strong risk/return trade-off.

Investors should not be lulled into a false sense of comfortable helplessness

Adhering to a few time-tested investing precepts turns the advantage away from the share market and back to the investor, without cause to bother with the disconnected portfolio construction gimmicks that have more recently caught favour. We do not believe that investors should be lulled into a false sense of comfortable helplessness, placing their fortunes on overly passive/index-like or formulaic solutions that have only a tenuous connection to the discipline of investing, if only because of the potential dangers involved.

Conclusion

The last few years have been particularly kind to our style of investing. While it is an easy time to draw attention to the benefits of our approach, it is also an opportune time to consider the total portfolio implications that tie together the more general risks and opportunities of share investing in a meaningful way. **i**

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