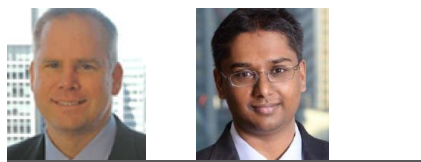

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Giant Steps

"[Benjamin Graham's] Spinozian 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

We would like to thank Christopher Begg for his encouragement to bring a multidisciplinary perspective to investing. We routinely seek out the best ideas in investing and so were not surprised to land on the pages of a true Graham and Dodd disciple, linking the best of investment thinking through time to the present. In addition to his excellent East Coast Asset Management letters, we would recommend his suggested reading list, compiled for the benefit of his students at Columbia Business School.

A multidisciplinary mindset can foster a certain consistency of thought that is robust to a broad array of challenges. It can support a wide range of scrutiny or sanity checks, as well as serve as a wellspring of inspiration and creativity – akin to Charlie Munger's lattice of mental models. Properly considered, the many approaches to equity investing either overlap or disjoin according to underlying principles, be it quality, value, growth, capital cycle, thematic, asset conversion, behavioural, or some combination. Otherwise, as we can all appreciate, the pursuit of shareholder value is littered with distraction, vignette, false hope, false choice, false precision, portfolio construction gimmicks, and models that stand for nothing.

Speaking of which, we also identify with those who seek insight through equity factor construction and regression analyses, particularly as it pertains to risk control. We don't, however, seek the 'investment truth' in these things. We are careful to discern causality from coincidence and narration from science, particularly when a story coalesces around hard-looking numbers. We are not going to pursue something just because it's "in the data" because not everything important about the future is "in the data."

"You see, but you do not observe. The distinction is clear." – Sherlock Holmes, A Scandal in Bohemia

Regression analyses, historical back tests, and even great live track records are dangerous primarily when a mistaken belief of completeness or inevitability is attached to them, which may or may not match the intent of their constructors. While a good econometrician will always relish new and interesting data to improve his or her old model or set of factors, that's small consolation to investors who may have inadvertently signed up to a crash-and-burn teachable moment in the interim. We believe that it will always be true that 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 the junky, leveraged, cheap "value" 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.

The invocation of eternity and calamity is tantalisingly close to our own abstract views on quality and value. By that we mean their *raisons d'etre* as valid approaches to investing, not their highest r-squared representations, and so we abstain from including any formulas in this letter. We first briefly take a step back to frame the more general trade-offs in equity investing.

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

Successful equity 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 avoid paying them altogether?

We see the relevant risks as two-fold: volatility and the potential for the permanent loss of capital. One of these risks is tolerable (volatility), while the other is intolerable (the permanent loss of capital). Fortunately, they can be addressed according to their severity and negative investor utility. Our investors **can afford** a certain amount of return volatility, so we trade this tolerance for something that is more valuable to them, namely the prospect of substantial and continuing real capital appreciation where we can identify it.

Our investors **can't afford** the permanent loss of their capital. We therefore orient our

process to rest on sure fundamental footings. The "exit strategy" from our investments is the cash flows generated by the businesses we invest in, not the hope or expectation that the market will bail us out in one form or another based on a behaviour observed in the past and assumed to repeat in the future. We pay particular attention to the assumptions implicit to the future arrival of our companies' cash flows, seeking to minimise the very risks we assume by investing in equities.

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 quite distinct to the current set, in no particular order, or in an order that is not related to the present sequence. This is a very useful thing to do not least because it enables us to guard against real dangers that have no immediate or obvious 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

We understand that eternity is the perspective through which all temporal illusions reveal their fallacy. Calamity, while usually absent, is the event that needs be accounted for in the fullness of time, or else one invites disaster.

Along these lines, *quality* for us is the time-invariance or event-invariance of a profitable business franchise, unconditional on any particular events occurring or not occurring. We do not 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 (see See's Candies example). Nor do we conflate quality with capital cycles, as we view the notion of conditional quality to be oxymoronic, at least in its ideal form. While unchanging, the steadiness that is the quintessential 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 terms of its fundamental performance, market perception, capital cycle, or all of the above. Collapsing the dimension of time enables us to reconcile our investments against the certainty of eventual calamity, as well as to recognise and 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 its own best-case scenario, if it has an inherent robustness to varying conditions and outcomes. Consider the industries of beer, chewing gum, or canned soup, and all the possible future events that will **not** materially impact their fundamental 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 or will happen, as in not everything will go perfectly.

The concept of the capital cycle is very interesting in this context. In our view, it offers both potential enhanced costs as well as benefits, similar to the way that anticipated growth does. The capital cycle is essentially the imposition of a likely shape or sequence of events in which capital formation follows excess profitability to its own excess, resulting in overcapacity and depressed profitability. To the extent this can be observed and anticipated, either on the way up or on the way down, it opens the door to excess returns to investors which are all the more pronounced because they are unforeseen. But it also adds another step to an investment process that can prove to be incorrect, at least in its detail, similar to anticipated growth. Investors need to guard against cases where small errors have large consequences in their portfolio, or at least maintain an appreciation for cases where considerable error has only negligible impact.

The true north of our concept of quality is the famous See's Candies example. Although untapped pricing power worked a particular kind of magic for See's, it is worth noting that this favourite investment of Buffett's and Munger's would have been all but missed by the more standard approaches to value, growth, and capital cycle investing. Taken as a pure example of quality, while seemingly expensive on earnings measures and having very modest growth prospects, See's registered so strongly on other "qualitative" considerations so as to have rendered any proximate valuation as almost irrelevant. For anyone interested, the well-documented example of See's stands out as an impressive "money machine," "license to print money," or "great business" in the words of Munger himself. To those accolades we would add our own somewhat nerdy "event-invariant profitability.

Like Warren and Charlie contemplating See's, and nearly missing it for its seemingly high price, investors should not hesitate to traverse the higher echelons of "expensiveness" when the right type of opportunity comes along.

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 for investors when inflated valuations subside. We agree with this basic observation, but as a matter of principle, we feel it overlooks an important point.

While all segments of the market can experience over-valuation and price corrections, high quality companies should not experience the same severity in the diminution of their underlying cash flows when adversity eventually does arrive. It is useful to recall that in other large portions of the market or economy, entire businesses and industries may essentially disappear under relatively modest macro-economic pressure, following any number of unfortunate but entirely plausible series of events. In the same vein, some sectors are particularly prone to capital over-investment relative to the (un)steadiness of future demand or changes in competitive landscape, severely impacting or destroying their profitability. Our particular view of quality, while idealised, is special in that it offers a final salvation to investors through the eventual delivery of reliable cash flows, come what may, and the multi-decade recovery of the Nifty Fifty offers a kind of testament to that fact.

This consideration has particular bearing on the appropriateness of core equity portfolios, or asset class portfolios that are meant to occupy a steady-state allocation within diversified portfolios. Value-oriented opportunistic strategies certainly have their place, but the deliberate move from cash into riskier assets should include a proper inventory of both the trade-offs and possibilities involved along the way. We see quality as the first logical stop for consideration, especially when it can be expected to deliver relatively low risk and relatively high Sharpe ratio.

Once our investors appreciate these concepts, they understand both the goal and the mode of our investment process. We believe that adhering to a few time-tested investing precepts turns the advantage away from the 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 or formulaic solutions that have only tenuous connections to the discipline of investing, if only because of the potential dangers involved.

Consider the difference between a low-volatility approach that, through chance, shares some desirable attributes with a fundamental strategy that has a capacity to gauge and trade off fundamental quality and value. Accordingly, it too may land on lower volatility, higher Sharpe ratio segments of the market as valuations permit. In the event that low-volatility becomes overly popular and expensive (not to implement, but in valuations), there is no direct mechanism for a price-volatility calculator to detect, accommodate, or avoid this danger of a permanent loss of capital. The fundamental approach, on the other hand (and not just any "fundamental" approach), requires no new paradigm shift to avoid this accident waiting to happen, adjusting itself as a matter of course. Solid fundamental approaches are self-organised against fundamental overvaluation and the permanent loss of capital. Price-volatility calculators are off in the breeze somewhere, computing the easiest thing in the world to compute: price volatility measures.

The last few years have been particularly kind to our style of quality-focused investing, both in our global and Australian equity portfolios, which is of course gratifying from a client-facing performance benchmark point of view. While it is an easy time to draw attention to the benefits of our approach, it is also an opportune time to promote the broader total portfolio implications that tie together the more general risks and opportunities of equity investing in a meaningful way. i

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