Focused Business Investing

Starlight Capital

For those of you who have heard me speak before, you know that I am a disciple of Warren Buffett and his approach to investing. Over the last decade and a half, I've been exposed to the teachings of other investment professionals and I've managed through some very trying market cycles and events. These experiences have been additive to my investment knowledge and while my process has evolved over the years, the core remains distinctly Buffett.

One of the many books I have read about Buffett is The Snowball, written by Alice Schroeder. In this book, Alice recounts an exchange that took place the first time that Warren Buffett and Bill Gates met:

> *When Warren Buffett and Bill Gates first met, their dinner host, Gates' mother, asked all seated at the table to identify what they felt was the single biggest factor in their success in life. Buffett and Gates gave the same one-word answer. Focus.*

When I read that passage, it resonated with me. In that simple, one-word answer, I recognized the secret to being successful in most endeavours, including investing. It's the ability to focus our energy and attention on key value drivers and success factors in order to generate the results we are looking for in the most efficient manner. **Focus.**

I have managed real estate, infrastructure and global equity portfolios, and all of them have been managed according to the same investment philosophy and process. This paper will attempt to distill all of that into three words that outline my investment approach. **Focused business investing.**

In the simplest terms, focused business investing is "investing in a focused manner, in high-quality businesses." I chose each word carefully to ensure that it captured the essence of what I have learned over the years in managing a number of investment portfolios.

Focus

For me, focus refers to a couple of things: high-quality companies and concentrated portfolios.

High-quality companies. The MSCI World Index contains over 1,600 companies, all domiciled in developed countries. Fortunately for me, I'm not required to have an opinion on all 1,600+ companies because most of them do NOT meet my quality hurdle. Many of them are commodity businesses and by that I mean, the goods and/or services they provide are undifferentiated from those offered by their competitors. As such, they are left to compete on price and are incapable of consistently generating strong returns on capital.

One of the easiest ways to identify a commodity business is to examine the manner in which you consume its goods and services. "I've got to put gas in the tank," "I'm going to be late for my flight" or "I'm going grocery shopping" are common phrases that we have all likely used at some point. However, the absence of a brand name – for example, Shell Oil Company, Air Canada or Loblaws Companies Limited – is a good indication that the industry, or these companies, offer commoditized goods and services with little differentiation from their competitors' offerings.

Now contrast that with "Google it," "I bought the new Jordans" or "I'll have a rum and Coke" and you begin to see the contrast to businesses that have "franchises" that allow them to compete on something other than price. These businesses (Alphabet Inc., Nike Inc. and The Coca-Cola Company) are all world-class businesses that generate strong returns on capital and have rewarded investors with outperformance for decades. In the process, they have become household names, and the goods and services they provide have become ubiquitous in our daily lives.

I tend to focus my attention on those businesses with franchise value as evidenced by their pricing power, differentiated service or product, and superior long-term returns on capital.

Concentrated portfolios. I also tend to concentrate or focus my portfolio into approximately 25 to 35 companies at any one time. There are only so many truly high-quality businesses to invest in. Most of them are very well known and consequently they are often expensive – more on this later. I don't believe in putting money into my 80th best idea when I can allocate more capital into one of my 10 or 20 best ideas. In addition, how much does anyone really follow the 80th position in a fund, especially if the weighting is insignificant? Instead, I think it makes more sense to focus on a select group of high-quality businesses and concentrate the portfolio in those names.

Some might look at a concentrated portfolio and deem it to be a risky strategy. I feel that it is less risky to run a portfolio of 30 high-quality companies that have been well researched and are thoroughly understood, versus a portfolio of 100 mediocre companies, some of which are not fully researched or well understood. I've never comprehended the indexer tendency to underweight poor businesses or businesses with bleak prospects. All investors have limited time and energy, and it seems to me that successful investors will maximize their personal "return on effort" by focusing on high-probability-of-success operations. That is what I try to accomplish by focusing on high-quality companies and concentrating my portfolio.

Business

The Business itself is what we are investing in, so I'll spend a disproportionate amount of time discussing what makes a high-quality business and why this is so important to my investment process. To me, a high-quality business is one that generates 1) strong recurring free cash flow from 2) a collection of irreplaceable assets, capitalized with 3) low amounts of debt and lead by 4) a management team that behaves like owners and treats you like partners.

Recurring free cash flow. There is an old saying that "cash is king." Well if cash is king, then cash flow is divine because it literally gives a business life. I only invest in businesses with strong, recurring POSITIVE free cash flow. Any business that does not generate positive free cash flow over the long term is just a collection of liquidating assets that will eventually hit the wall and collapse. You cannot invest in those businesses; you can only trade them. I try to avoid those types of situations.

Charlie Munger has been Warren Buffett's partner at Berkshire Hathaway for decades. He likes to say that most "wonderful businesses" generate more free cash flow internally than is needed to fund the business. That allows the management team to return it to the people it belongs to: the shareholders. As a result, many high-quality businesses have a track record of paying rising dividends and/or buying back considerable amounts of their stock.

While appreciated, dividends are not essential to my investment process. Several companies I have owned over the years do NOT pay dividends or buy back stock. Often it is because they have opportunities to deploy capital at high rates of return. In those rare cases, I am happy for a rational management team to retain and profitably deploy capital. From all others, we prefer cash!

Irreplaceable assets can be tangible or intangible and are easily spotted in many franchise businesses. Union Pacific Corporation (UNP) is one of the seven large, Class 1 railroads in North America. I will go out on a limb and say that there will NEVER be another large Class 1 railroad built in North America, making UNP's tracks and rights of way an irreplaceable asset. As UNP invests more into this network to make it more efficient over shorter distances, UNP will displace more truck traffic and increase the value of this network.

Ditto for The Coca-Cola Company's (Coke) brand, an intangible asset but no less irreplaceable. I'm confident that even with $200 billion and access to the best management team on the planet, it would not be possible to overtake Coke's dominant position in the carbonated beverage market. Coke's business is shockingly simple – they don't even put the syrup in the soda water; the bottlers do! It is the brand, and the billions of dollars of investment over decades to build the brand, that is Coke's irreplaceable asset. When is the last time you walked into a bar and asked for a rum and Pepsi?

Debt is something I like my companies to avoid. It's not because I fear these businesses will go bankrupt. It's because I want fewer claims between me and the cash flow the business generates. Debt generally comes with debt service costs, usually interest expense. This must be serviced before free cash flow can be paid out to shareholders. During a cyclical downturn, when revenues and cash flow decline, debt service generally remains fixed and eats up a larger percentage of cash flow, leaving less for shareholders. There's no hard and fast leverage limit; it depends on the volatility of the cash flow the business generates and the duration of the assets capitalized. But less is generally better.

Management teams that behave like owners and treat you like partners are a rare and valuable resource which we greatly covet. Everyone wants to invest in companies run by strong management teams but what does that actually mean? To me, a strong management team is one that generates consistently high returns on capital. They behave like owners because hopefully they are owners of their business' shares, purchased with their salaries and bonuses. And they treat you like partners by providing you with sufficient information to accurately assess the value and condition of the business. Management is crucial since they decide which assets to own, how to capitalize them and what to do with the resulting free cash flow. Investing in a business run by a weak management team is an invitation to destroy capital.

Investing

Investing is what everyone claims to do; however, much of the advice that is provided by “experts” is really trading advice. Positioning for datapoints, playing an event and rotating into a sector are all common examples of trading – not investing – behaviours. In my experience, investing is a longer-term operation, focused on the quality and returns of a business across a cycle. Accordingly, I tend to build portfolios that feature lower turnover with fewer positions and larger weights.

Many times I’ve heard people say that buy and hold is dead or no longer works. I usually correct them by pointing out that buy and hold has NEVER worked. Simply buying good businesses and expecting to get extraordinary results is destined to disappoint. Investors must always ensure that they are getting enough return for the risk incurred. Overpaying for great businesses is only slightly better than overpaying for mediocre ones. All businesses have operating and financial risk and ignoring this to invest in a business when it offers low returns is an invitation for excess volatility and suboptimal results.

If you read an older edition of “Buffettology,” you will learn that some of Warren Buffett’s favourite companies included The Bear Stearns Companies Inc., Circuit City Stores Inc., Federal Home Loan Mortgage Corporation (Freddie Mac), Federal National Mortgage Association (Fannie Mae), MBIA, Inc. and Merrill Lynch & Co. A buy-and-hold portfolio containing those companies would have yielded a very unpleasant experience over the last 15 years. Even great businesses can run into trouble in a truly adverse environment. A wise investor is alert to the potential for a great business to deteriorate in the face of unanticipated stress – like a global recession, second only to the Great Depression, caused by the bursting of a global financial bubble.

Another reason buy and hold is perilous stems from the fact that there are only three sources of return for any equity security – yield, growth and trading multiple. Investors often know the yield of a security but ignore the sustainability of that yield. Or they are seduced by the promise of growth and ignore the probability and/or riskiness of generating that growth. Or they may simply fail to notice that the market has already priced in the growth they are anticipating. Whatever the oversight, failing to respect all three sources of return usually results in investors being disappointed with their return.

Benjamin Graham, the father of modern security analysis and mentor to Warren Buffett, is often quoted as saying, “In the short run, the stock market is a voting machine (popularity contest), but in the long run it is a weighing machine.” In the long run, the stock market weighs the value created by a business as a function of the risk incurred to generate that value. If the goal of your portfolio is to generate meaningful alpha, why not build that portfolio out of companies that have historically created more shareholder value? I believe this is best accomplished by purchasing high qualities businesses as defined here.

In summary…

Focused business investing attempts to build a concentrated portfolio of high-quality businesses that will generate superior risk-adjusted returns over the long term. The focus is on companies with strong, recurring free cash flow from irreplaceable assets, capitalized with low levels of debt and run by management teams that behave like true stewards of investor capital. However, this must be done only when these companies are priced to deliver sufficient return for the risk incurred.

Executed with discipline, this strategy has served our unitholders well for the last decade. I’m confident it will continue to do so in the decades to come. We are passionate about investing and excited to deliver on the promise that is Starlight Capital. We invite you to partner with us for the long term as we build this business.

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