Ambit Coffee Can Newsletter – Jan'18

Boredom is dangerous while investing in stocks and managing companies

Many people who work on assembly lines in a manufacturing process may find themselves bored by the repetitive nature of their work. This can be a very dangerous situation. Mistakes on an assembly line or with some sort of heavy machinery, caused by boredom, can be costly not only to the health of the workers, but also to the company. This is commonly observed in several cases, much beyond assembly lines, two of which relate to equity investments which we discuss in this newsletter.

Avoid investing in companies whose promoters lack focus on their core operations and hence could commit mistakes caused by 'boredom'

In his 1996 annual letter to shareholders, Warrant Buffett wrote, "Loss of focus is what most worries Charlie [Munger] and me when we contemplate investing in businesses that in general look outstanding. All too often, we have seen value stagnate in the presence of hubris or of boredom that caused the attention of managers to wander."

In their 2011 book, 'Great by Choice', authors Jim Collins and Morten Hansen gave the example of two people walking from San Diego, California to the tip of Maine, a journey of 3,000 miles. The first person walks assiduously at a steady pace of 20 miles per day with focus and discipline, irrespective of good or bad terrain or weather conditions; the second person walks large distances on good days and waits in his tent on days with bad weather – figuring that he would make up for the slack on good days. Eventually, the second walker tires himself out by the time he reaches Kansas City while the first walker, maintaining his strict discipline, has already reached Maine by then.

Collins and Hansen use this example to describe John Brown, the CEO of Stryker Corporation, a Fortune-500 medical technologies firm. Brown had understood that the discipline of consistent performance required both parts of a 20-mile march: "a lower bound and an upper bound, a hurdle that you jump over and a ceiling that you will not rise above – the ambition to achieve and the self-control to hold back." Describing what it takes to be a '20-Mile March' company, the authors wrote "20-Mile March requires hitting specified performance markers with great consistency over a long period of time. It requires two distinct types of discomfort, delivering high performance in difficult times and holding back in good times." This steady pace comes only with tremendous focus on your core business and refraining from betting massive amounts of time and resource on unrelated diversification.

Focusing on the core business is directly linked to efficient capital allocation because as soon as the management's focus diverts from its core, it inevitably leads to faulty capital allocation in unrelated diversifications. This seemingly maniacal focus also helps investors to assess whether the promoter group has other listed/unlisted business entities outside the company in question because existence of many such interests may lead to a dilution in focus. Similarly within the company in question, the business interests should be focused; several businesses within the company which are unrelated to the core activity, either product-wise or geography-wise may act to both dilute management bandwidth and lead to sub-optimal capital allocation.

Boredom in stock market investing

"Go to a continuous-process factory sometime — a chemical plant, a cookie manufacturer, a place that makes toothpaste. If you find anything interesting, you've found something wrong. Investing is a continuous process too. It isn't supposed to be interesting. If you go to the stock market because you want excitement, then sooner or later you will lose." said Charles Ellis, an American Investment Consultant and founder of Greenwich Associates, in an interview with The Wall Street Journal in June 2001.

In stock market investing, people often jeopardize their own portfolio performance out of sheer boredom. Why else put money into a stock where the underlying business never existed 2 years ago and might not exist 3 years from now? Why bother chasing hyped companies that trade at absurd valuations despite uncertain fundamental prospects? Because people are bored! It is no different from going to a casino. It seems exciting even though you lose your money in the process. And just like a casino, these bets pay off often enough to keep people coming back seeking such excitement.

Too many people trade too much, too often and do not reap the benefits of long-term investing and sensible asset allocation. Repeated trading and modification in investments usually lead to lower returns and higher transaction costs (which are a source of income for brokers and most financial advisors). Buying and selling of your investments may be fun, but if you want to benefit from long-term wealth creation, patience is the key.

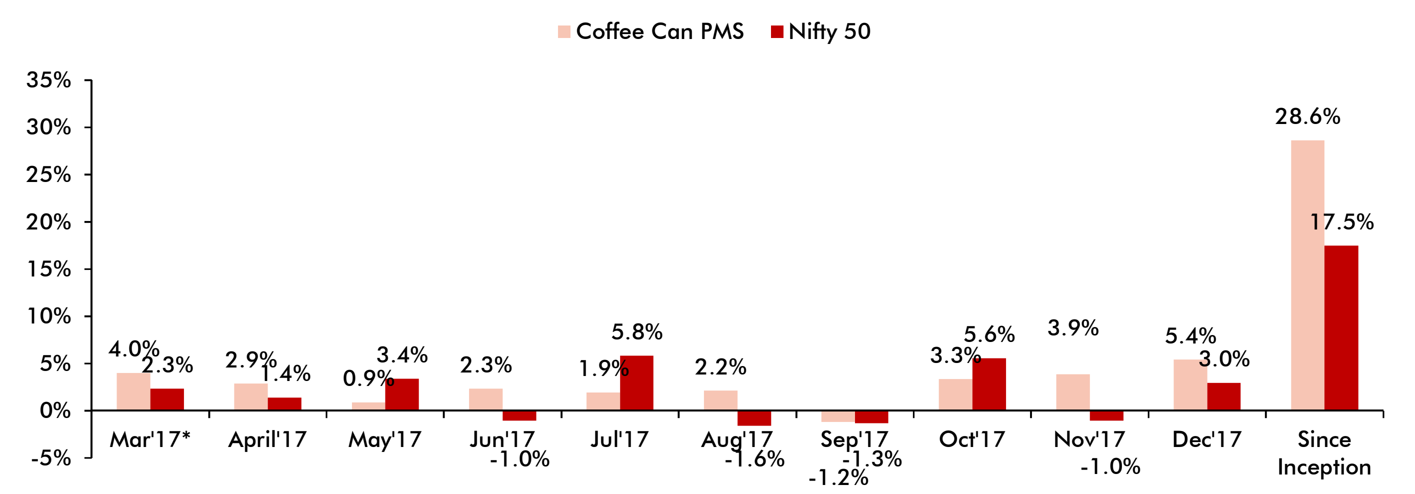
Patient investing (i.e., negligible churn) in stocks which are expected to remain focused on their core business and sustain their fundamental strengths over more than a decade, helps a fund manager resist the temptation to buy/sell in the short term. This approach reduces transaction costs which add to the overall portfolio performance over the long term. We illustrate this with an example. Assume that you invest US$100mn in a hypothetical portfolio on 30 June, 2006. Assume further that you churn this portfolio by 50% per annum (implying that a typical position is held for two years) and this portfolio compounds at the rate of Sensex Index. Assuming a total price impact cost and brokerage cost of 100bps for every trade done over a ten-year period, this portfolio would generate CAGR returns of 13.3%. Left untouched, however, the same portfolio would have generated CAGR returns of 14.5%. This implies that around 9% of the final corpus (around US$35mn in value terms) is lost to churn over the ten-year period. Thus, a US$100mn portfolio that would have grown to US$382mn over the ten-year period (30 June, 2006 - 30 June, 2016) in effect grows to US$347mn due to high churn. The shortfall in the returns is obviously the returns that the broking community earns for helping the investor churn his portfolio.

Performance update – Ambit's Coffee Can PMS

Ambit's Coffee Can Philosophy of investing attempts to overcome the dangers associated with boredom on both the aspects highlighted above. It seeks focus and discipline in companies, which help them overcome disruptive evolution as they scale up their business over time (for at least more than a decade into the future). **Also, there has been no change in the list of stock holdings (i.e., zero churn) in the portfolio since inception of the PMS.** Going forward, given the longevity of fundamentals that we seek in our portfolio companies, we don't see Ambit's Coffee Can PMS churning more than one stock per year on average (i.e., no more than 5-10% expected average churn in the portfolio in future). We like this quote from Warren Buffett – *"If you aren't thinking about owning a stock for 10 years, don't even think about owning it for 10 minutes"*

The exhibit below shows the performance of Ambit's Coffee Can PMS since inception (6 March 2017). The portfolio consists of 11 stocks of high quality companies, spread across Financials (2 stocks), Home Building Materials (3 stocks), Consumer Discretionary (3 stocks) and Consumer Staples (3 stocks).

Ambit's Coffee Can PMS performance update (as on 31st December 2017)



*Source: Ambit Capital, Bloomberg. *Date of inception= 6th March 2017; All returns are absolute returns net of fees and expenses*

Regards,

Rakshit Ranjan, CFA

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