March 9, 2015

Long Term Investing

During the month of February we were lucky enough to get our hands on an investment book called *100 to 1 In the Stock Market: A Distinguished Security Analyst Tells How to Make more of Your Investment Opportunities*.[1] Since the book had been out of print since the early 1970s and a well-capitalized, smart cadre of investment professionals took a cult liking to it, prices on secondary markets soared. As little as three months ago, copies were exchanging hands at over $600 on Amazon. This January, the publisher authorized a limited release of new copies for $40 each. We quickly pounced on the opportunity and could not be happier that we did.

A slight digression: The process through which we ended up buying this book is not too dissimilar from how we invest in stocks. We do not simply research cheap companies which satisfy our criterion. Rather, we research many companies, with an emphasis on those that have quantitatively clear business quality; a sustainable competitive advantage if you will. Many quality businesses trade at prices and valuations that we would never pay. Yet in performing our extensive research, we build the knowledgebase necessary to pounce on an opportunity if and when it may present itself. We believe it is far better to be prepared and ready for a situation than to simply react to it. With a double-dose of patience and discipline, opportunities inevitably present themselves.

100 to 1 was written by Thomas William Phelps, a man whose career in investments started on the eve of the Great Depression. Phelps wisdom accrued through years of writing and editing for the Wall Street Journal and Barron's, working in the finance departments of du Pont and Socony Mobil Oil, and at several investment firms through the years.

One of the foremost lessons to take out of this book is the need for patience and discipline in the stock market. This is a point we will continue to emphasize. Markets gyrate. Nothing aside for fraud travels in a straight line. Growth, in particular, is lumpy over time. Howard Marks has offered this quote from Rudiger Dornbusch which carries much wisdom: "In economics things take longer to happen than you think they will, and then they happen faster than you thought they could."[2]

However, in finding 100 to 1 stocks, there is no avoidance of the elements of time and patience. It takes 35 years compounding at 14% annually, 30 years at 16.6%, 25 years at 20%, 20 years at 26% and 15

[1] At the time of this writing, 100 to 1 (paperback) is listed as 'In Stock' at the following web **link**

[2] http://www.oaktreecapital.com/memo.aspx

years at 36%. To earn these returns requires extremely persistent increases in the intrinsic value a company. More realistically, as Phelps outlines, it requires a combination of persistent increases in intrinsic value alongside the market's rerating of the company's prospects. By this, we mean the multiple the market is willing to pay for the company's earnings must increase alongside its intrinsic value. This is something we have talked of frequently—the two sources of return in a stock.[3],[4] On the one hand you have the company's cash flow yield and on the other you have the multiple the market is willing to pay. Both sides are dynamic: the cash flow yield and the multiple both can rise and fall. However, those companies that make it to 100 to 1 will by nature have to increase both consistently.

A second lesson is how often history repeats itself. There are certain constituencies with loud voices in the financial community whose volume simply does not fade across the decades. These groups, in no particular order are: the dollar doomers, the peak-Americanists, the valuation alarmists, the inflationistas, the Gold bugs, etc. There are however two steady constants: if your timeframe is long enough, equity markets in aggregate will go up; and, across all timeframes there are outstanding companies who prosper in markets good and bad. In perusing the Amazon reviews of *100 to 1*, there are a few negative reviews that bemoan the lack of a clear-cut recipe to finding such stocks. Such reviews are amusing and reminiscent of the proverb: "Give a man a fish and you feed him for a day; teach a man to fish and you feed him for a lifetime." The key takeaway from the book is the proper mindset that should be adopted in thinking about the stock market. It is no wonder that many of the most powerful concepts from Warren Buffett and Charlie Munger seem to have their origin in this book. Some of these concepts range from the idea of buying only stocks that you would be content to own were the market closed for 10 years, to Munger's "tell me where I'm going to die, so I won't go there." It is also no wonder that many Berkshire observers note and study how "in the early 1970s, Berkshire slowly but very significantly changed its business strategy."[5]

The optimism inherent to Buffett's investment philosophy and the very idea of "Buy American" have their distinct origins in this book. We would urge everyone we know, whether client or fellow investor to read this book and grasp some of the profound lessons on the long-term power of compound interest and patience. These past few years in the markets have seen a rapid rise in asset prices. It is simply

[3] The prelude to our 2013 Outlook contains an explanation on the role of a change in the market's multiple on long-term return: http://www.rgaia.com/wp-content/uploads/2013/08/December-2012-Investment-Commentary.pdf

[4] Our description of "actively passive" investing highlights some of the principles of long-term investing that attract us to the *100 to 1* philosophy http://www.rgaia.com/october-2013-investment-commentary-our-actively-passive-investment-strategy/

[5] http://fortune.com/2015/02/28/berkshire-after-50-years/

impossible for this rate of ascent to continue in perpetuity, but it is equally important to remember that as they say, "no one rings a bell at the top." No top is "the" top. Great companies do great things regardless of market highs and lows, because they are incented and driven to do so. To that end, we are constantly aware of the bigger risks facing the economy and the stock market, but focus the vast majority of our research on understanding the actual drivers of the businesses in which we invest.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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