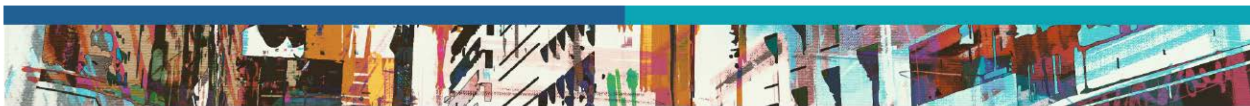

PORTFOLIO UPDATE

Jason Del Vicario, CFA®

Lately we have been encountering some investment propositions that, in our view, face binary outcomes. Using a coin flip analogy, a binary outcome looks like this: tails we win, heads we lose. But it doesn't have to be this way; sticking with the coin analogy we prefer tails we win, heads we win/lose a little.

> Risk to us is:
> 1) the risk of permanent loss of capital or
> 2) the risk of inadequate return.
> *- Charlie Munger*

Per the quote above, it's more fun to discuss how to avoid the risk of inadequate return because it naturally leads us to discussing how to select businesses that could outperform. However, it is vitally important to discuss how to avoid or minimize the first risk: permanent loss of capital. At the risk of stating the obvious, permanent loss of capital = -100% ROR. It won't matter how many wonderful businesses an investor identifies if the bulk of their capital is periodically 'blown up.'

At Hillside we try to avoid such outcomes in the following ways:

1. **Diversification:** We are firm believers in running a concentrated portfolio and note that 15-25 positions provide adequate diversification benefit; but twenty positions isn't the same as one or two!

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2. **Business analytics:** We take pains to avoid businesses sporting a 'tails we win, heads we lose' proposition. Businesses with diverse and stable customer bases combined with a high percentage of recurring revenues are favoured while businesses with narrow customer bases selling infrequent durable goods are avoided.
3. **Position sizing:** We will 'punish' companies that sell durable goods by limiting our exposure to 1% per position or 15% in aggregate for a group of businesses that share this less desirable characteristic. Along the same lines, we may also require a higher forward return (and thus a lower acquisition price) as compensation for the higher risk profile.
4. **Business financials:** It is very difficult to go bankrupt without debt. The very best business models do not require debt to maintain or grow their operations. But for rare exceptions, the long-term focused investor should demand and covet strong balance sheets.
5. **Focus on incentives:** It's one thing to swing for the fences with other people's money; it's a very different matter with one's own financial means. We tend to find that founder run/owned businesses tend to operate more conservatively and with a longer-term view in mind which aligns well with our interests.

For the rawest example of a binary outcome, consider the plight of the resource exploration company. Imagine a company that raises money (by selling shares) and buys the mineral rights to a plot of land believed to contain a desirable resource. The company then spends the money exploring to see if the land in fact contains the resource and if it can be economically extracted. The result here is simple: the mineral is either found or not, and if not found, the likely scenario for equity holders is permanent loss of capital aka -100% ROR.

However, binary outcomes are not usually this black and white. Consider the luxury watch market. The luxury watch market is dominated by Rolex; they represent ~30% of all luxury watch sales. Rolex is a foundation owned business and doesn't retail its own watches (well, not quite true as we'll see in a bit). Luxury watch dealers thus covet Rolex allocations and are heavily dependent on being in the good graces of Rolex. Rolex comprises 50-90% of the sales revenues for the dealers we analyzed. What happens if Rolex decides a given dealer has broken their rules and ceases to deliver product to sell? What happens if Rolex decides to start retailing watches themselves and cutting out dealers? These are nightmare scenarios for dealers and one which is tricky for us to evaluate. On the one hand many of the dealers have been retailing Rolexes for 50-100 years and Rolex claims they have no interest in retailing their own watches. On the other there clearly exists a heavy dependence on a supplier the dealers do not control and Rolex recently acquired Bucherer, a leading Rolex dealer. Such quandaries may lead us to simply kill the idea and move onto the next or we may invest while paying particular attention to the disciplines (especially position sizing) noted above.

Warren Buffett once quipped that the stock market is a 'no-called-strike game.' He means that investors are not penalized for letting opportunities pass them by without taking action. In our view, investors will be best served passing on binary outcome investment options.

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