REFLECTIONS

from an investor

Insights gathered from years of investing include thoughts on how to find the right investments, how to let investments work for you, risk management and the best temperament to have when investing.

by Hamish Douglass, Chairman and Chief Investment Officer

"Your goal as an investor should be simply to purchase, at a rational price, a part interest in an easily understandable business whose earnings are virtually certain to be materially higher five, 10 and 20 years from now. Over time, you will find only a few companies that meet these standards."

Warren Buffett

While Buffett might make investing sound easy, few people achieve outstanding investment records over the long term as he has. The following sets out some of my reflections gained over the years.

These 13 reflections are organised into four topics:

Finding the right investments, letting your investments work for you, risk, and the temperament to learn from mistakes. You can be assured that this list is not definitive. Each day has moments of learning.

REFLECTIONS FROM AN INVESTOR

Finding the right investments

1 STANDING ON THE SHOULDERS OF GIANTS

"If I have seen further than others, it is by standing on the shoulders of giants."
Sir Isaac Newton

At Magellan, we believe in benefiting from the knowledge imparted by the best. Our investment philosophy has been influenced by some of the legends of the investment world: Benjamin Graham (*The Intelligent Investor*, in which he highlighted the importance of thinking of stocks as businesses, the concept that the stock market is a voting machine in the short term and a weighing machine in the longer term, and incorporating a margin of safety); Phil Fisher (*Common Stocks and Uncommon Profits and Other Writings*, where he highlighted the importance of investing in quality companies with superior returns on capital) and Buffett and Charlie Munger who brought these concepts together.

From such insights, we have developed an investment philosophy that at its core is about investing in a concentrated portfolio of the world's best businesses purchased at attractive prices. The returns such a portfolio earns over time reflect the underlying returns on capital, growth prospects, competitive advantages and management capabilities of these outstanding businesses.

Our portfolio-construction process can be likened to a process for picking a sports team that can win a grand final. We find no appeal in picking a team of 'B-grade' players when we can scour the world for a team of 'A-grade' players. Unlike the coaches of many sporting teams, we have no salary cap to handicap us as we assemble fractional interests in the best team of outstanding companies at the most attractive prices.

If our investment returns have been better than others it is in large part due to the fact that we are standing on the shoulders of giants. Investing in a portfolio of outstanding businesses at appropriate prices produces superior outcomes and is more reliable over the longer term than any other investment approach we know. Critically, having a portfolio of outstanding companies is a huge advantage in times of adversity because it lowers the risk of large capital loss. As Buffett says: "To finish first you must first finish."

2 THE POWER OF NETWORK EFFECTS

The network effect describes the process whereby an additional user of a product or service makes that item more valuable to all users. Facebook's social network is a classic example of a two-sided network effect. On one side, each new user makes the network more valuable to other users as there are more friends for people to link up with. At the same time, more users on Facebook make the advertising network deeper and more valuable to advertisers.

Powerful network effects usually result in dominant companies that have exceptional returns on capital. Many of the investments we have made over the years have been in businesses that exhibited strong network effects. These investments include the Visa, Mastercard, PayPal and American Express payment networks, Facebook's social networks (Facebook and Instagram) and messenger platforms (Messenger and WhatsApp), the Google search business and YouTube business, Apple's and Android's app stores, Microsoft's Windows operating system and Office productivity suite, and eBay's marketplace. Other businesses in which we haven't made meaningful investments (to date) that exhibit strong network economics include credit-rating agencies, derivative exchanges and clearing houses, Amazon's marketplace, online travel agencies and the major Chinese technology platforms. We believe that autonomous driving software is likely to exhibit strong network effects as will the platforms for the sharing economy such as Airbnb and Uber.

An important lesson from investing in businesses that exhibit strong network economics is to be aware that they will usually attract the attention of regulators. We also note that there are many examples of businesses with powerful network effects where a competitor emerges with a business model that causes users of the product or service to leave existing networks. Classic examples where new competition has weakened a network include fixed-wire telephone networks (due to the emergence of mobile networks) and newspapers and television networks (due to competition from internet-enabled business models).

3 BEWARE OF MISTAKING COMPANIES WITH HIGH RETURNS ON CAPITAL OR MARKET LEADERSHIP FOR OUTSTANDING BUSINESSES

There are many businesses that earn high returns on capital or are market leaders that are not outstanding businesses. To be exceptional, a business must have two characteristics: it must earn superior returns on capital and have deep and durable competitive advantages (or an 'economic moat') that protect excess returns on capital over time. The following are examples of sustained competitive advantages.

- It is expensive for consumers to depart from the incumbent provider because of high switching costs, inconvenience or regulatory restrictions.
- The leading market participant has material economies of scale that give it significant cost advantages over competitors.
- The business has a strong and unique brand or is protected by long-term intellectual property rights such as copyright, patents, exclusive licences or trademarks.

"To be exceptional, a business must have two characteristics: it must earn superior returns on capital and have deep and durable competitive advantages..."

We have learnt important lessons from investing in businesses that exhibited high returns on capital or were market leaders but lacked long-term competitive advantages. Examples of such investments include Nutrisystem (a US meal delivery business for people seeking to lose weight), and US apparel retailer Abercrombie & Fitch. We now appreciate that few retailers have sustainable competitive advantages. The vast majority are low-quality businesses.

4 DON'T RELY ON THE REAR-VIEW MIRROR

"If past history was all there was to the game the richest people would be librarians."

"In the business world, the rear-view mirror is always clearer than the windshield."

Warren Buffett

We naturally spend a lot of the time analysing the past to identify investment opportunities. While this is a normal approach to take, it is dangerous to assume that the past is a reliable predictor of the future. Capitalism's creative and destructive forces are forever reshaping industries by growing new businesses and destroying dominant firms. To realise this, you only have to look at a list of the top 50 companies in the world 20 years ago and see how many have struggled since. We should all heed the advice of the great ice hockey player Wayne Gretzky who said: "Skate to where the puck is going, not where it has been."

Within our investment universe, for example, we question whether or not the best retail banking franchises and the best consumer brands will remain as dominant over the next five to ten years. We believe it is likely that technology and new media and retail platforms will weaken the competitive advantages of many banks and consumer brands in coming years. Businesses in this space might well earn reasonable profits but they are unlikely to be as dazzling as they once were.

It is frightening that an industry has developed—the 'smart beta' industry—that is based on rear-view investing or optimising factors that worked in the past. Anything can work until it doesn't. Our job as investors is to assess where the puck is headed.

5 YOUR BEST IDEAS ARE OFTEN MORE OBVIOUS THAN YOU THINK

There is a finite number of outstanding companies in the world. The vast majority of these companies are well-known 'blue chip' investments. Many people think that you can only earn superior returns by uncovering hidden gems.

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In our experience, the best long-term investments are often hiding in plain sight. They are usually market-leading firms that have superior returns on capital, excellent long-term growth prospects and wide economic moats.

We have a defined pool of the market-leading businesses that earn attractive returns on capital and that possess deep competitive advantages. We try not to stray outside this group. Charlie Munger reminded everyone at the 2008 annual meeting of Berkshire Hathaway of the limited number of great companies when he said:

"Most big businesses eventually fall into mediocrity or worse. So it is a tough game out there."

We find that in assessing a new investment opportunity it is often better to buy more of what you already understand than buy the 26th next best investment idea. We have frequently revisited old investment ideas and reinvested in them.

6 BE CAREFUL OF STOCKS TRADING AT LOW MULTIPLES OF EARNINGS OR THOSE THAT OFFER HIGH DIVIDEND YIELDS

It is interesting to assess why the market often fails to sufficiently differentiate between companies with vastly superior long-term prospects and those with more mediocre prospects. We suspect it is due to a combination of too much focus on short-term returns and the use of simplified investment metrics such as prevailing dividend yields or price-earnings multiples. These valuation measures, however, tell you little about the future growth in earnings, what incremental return on capital a business will earn over time, or the sustainability of a business's competitive advantages. Businesses with low price-earnings multiples or high dividend yields are often ones with unattractive prospects rather than opportunities that will deliver superior returns.

> **"...turnaround situations rarely deliver superior investment returns and they are best avoided."**

Occasionally, we find an opportunity to invest in an outstanding business at very favourable valuations and we have had the conviction to buy a meaningful amount; our decision to invest in Microsoft in 2013 is an example of this. We have also made mistakes in being attracted to businesses with low price-earnings multiples, such as our investment in 2015 in IBM, which had deteriorating business prospects.

7 AVOID TURNAROUNDS

"Both our operating and investment experience cause us to conclude that turnarounds seldom turn."
Warren Buffett

It is our experience that turnaround situations rarely deliver superior investment returns and they are best avoided. When a company gets into difficulty, typically two things happen: either the situation facing the company deteriorates further or it takes longer than expected for the turnaround to be executed. Time is the enemy in these situations—you will get little reward for being eventually correct.

We are very conscious that many investors have caught 'falling swords' by making contrarian investment decisions on the basis that it must be a good time to buy when others are panicking. In our experience many investments in turnaround situations deliver sub-par investment returns.

Let your investments work for you

8 THE MAGIC OF COMPOUND INTEREST

"Compound interest is the greatest mathematical discovery of all time."
Albert Einstein

"Money makes money. And the money that money makes, makes more money."
Benjamin Franklin

If we had to pick what were the most important factors driving our investment returns over the past 12 years, the answer would be our long-term investment time frame and our willingness to let the magic of compound interest do the heavy lifting. We have held long-term investments in many companies that have favourable characteristics for compounding capital at attractive rates.

> **"...our best investment returns have resulted from situations where we have...let compounding work its magic."**

These characteristics include favourable growth prospects, high returns on capital, and deep and sustainable competitive advantages. Post the initial investment, we have avoided the temptation of playing a short-term game of gin rummy by discarding investments frequently and seeking to find opportunities that might deliver higher short-term returns. An investment that can deliver a 15% return per annum for 10 years is usually far superior to an investment that can deliver a one-off 50% return over a short period. An investment that can deliver a 15% per annum return will multiply your money by four times in 10 years. In many cases, our best investment returns have resulted from situations where we have simply done nothing but let compounding work its magic. The nature of compound interest is that it takes time. There are few ways to compound your money quickly. This is why the turnover of stocks in our portfolio is limited. Our investment style of patience and compounding is not well suited to many investment professionals as it is hard to feel you are adding value when for 360 days in a year you decide to do nothing. On average, we have made around four key new investment decisions per year. Our team is constantly assessing opportunities but the nature of our approach is that we make decisions infrequently. In our experience, investors don't get rewarded for activity. They get rewarded for patience.

Risk

9 IMPORTANCE OF PORTFOLIO CONSTRUCTION

We believe that prudent portfolio construction is critical for reducing risk. Many people assume that prudent portfolio construction equates to holding a widely diversified portfolio. In our opinion, holding a well-diversified portfolio only ensures that an investor's portfolio will produce returns that are similar to the market's return. We do not believe in holding a widely diversified portfolio. Core to our portfolio-construction process are the following.

- We incorporate a margin of safety by not holding, at least knowingly, overvalued securities.
- We hold a meaningful amount of investments in companies that should perform strongly in an economic downturn.
- We minimise aggregation risk; i.e. the risk attached to similar economic, competitive or regulatory forces. We put defined aggregation risk limits on key risks to which our portfolios are exposed.
- We limit our maximum position size in any one stock.

"It is inevitable that we will make mistakes. Even our best ideas can be wrong."

It is inevitable that we will make mistakes. Even our best ideas can be wrong. Examples of where we were wrong with one of our 'best' (not such a great term in hindsight) ideas include the investment in the UK retailer Tesco and more recently the investment in Kraft Heinz. While it was disappointing to make such mistakes, the good news is that we had not aggregated the risk with similar investments so the overall impact on the portfolio from these mistakes was modest. The lessons here are do not put all your eggs in one basket and avoid the temptation to buy more and more stocks that match your 'favourite idea'.

10 BEWARE OF BUSINESSES WHERE THE COMPETITIVE ADVANTAGE IS DEPENDENT UPON GOVERNMENT SUBSIDIES OR VULNERABLE TO GOVERNMENT POLICY

In 2007, we made an investment in SLM Corp, which at the time was the leading private sector provider of government-guaranteed and non-government-guaranteed student loans in the US. SLM's business model depended upon the US Department of Education because it paid the private sector subsidies to originate and service government-guaranteed student loans. We were fortunate (lucky would be a better description) that we sold the investment in October 2008, immediately after the collapse of Lehman Brothers, due to our assessment that the company might lose access to capital markets to fund private loans. Not long after we sold our holding in SLM, the Obama Administration announced that it would no longer pay subsidies to the private sector to originate government-guaranteed student loans. This decision killed a core part of SLM's business model. It taught us to avoid investments where the core competitive advantage is vulnerable to government decisions.

11 KNOW WHAT YOU DON'T KNOW

"Real knowledge is to know the extent of one's ignorance."
Confucius

It is easy in investing to have confidence in what you know, or think you know, about an investment. After completing due diligence on an investment opportunity, the most important things to assess are what you don't know about an investment and whether or not this missing knowledge creates material uncertainty. Investors should always ask themselves: What is it about this investment that I do not know? This state of mind does not come naturally as confirmation bias leads people to information that confirms existing conclusions. To overcome this natural tendency, we try to invert the investment case and ask ourselves why we are wrong. This better equips us to look for what we don't know about an investment.

"It is critical that investors know the limitations of their knowledge or what is knowable."

We have developed a risk-assessment framework that sets out the things that could enhance or harm our assessment of a business. We try to assess the impact on the investment if any of these events were to occur. We then try to estimate the probability as to whether or not they might. It has been rare that we have made mistakes because we had not thought an event might occur. Usually we have not properly assessed the probability of an event taking place.

It is critical that investors know the limitations of their knowledge or what is knowable. Buffett describes this as knowing your "circle of competence". There are many things in investing that are unknowable and we believe investments are best avoided if there are too many unknowns. We believe that many large banks (particularly with sizeable investment banking arms) are simply too complex to understand and are outside our circle of competence.

"There are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know."
Donald Rumsfeld, former US Secretary of Defense

The temperament to learn from mistakes

12 DON'T BECOME EMOTIONAL

"An investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behaviour from the super-contagious emotions that swirl about the marketplace."
Warren Buffett

The market often provides us with excellent investment opportunities to buy or sell at prices significantly different from our assessment of the intrinsic value of underlying businesses. In chapter eight of *The Intelligent Investor*, Graham introduced the concept of 'Mr Market'. Mr Market is an obliging business partner who every day is prepared to tell you what your interest in a business is worth and on that basis is prepared to buy your interest or sell you an additional interest. Sometimes, he quotes you reasonable prices based on the business prospects and developments as you know them. Often, Mr Market is unpredictable and temperamental and quotes you ridiculously high or low prices. Additionally, Graham wrote: "Price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times, he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."

It is important that investors do not become emotional about movements in share prices. The unpredictable nature of the share market and wide fluctuation in prices are there to serve an investor. Buffett has famously been quoted as saying that you should be greedy when others are fearful and fearful when others are greedy.

We think it is critical that investors do not become emotionally attached to a company or its management. A company does not care who you are or whether or not you are a shareholder. The nature of the share market is if you don't buy the shares on offer for trade then someone else will. It is difficult to be emotionally detached after you have spent considerable time getting to know management and feel that you have a trusted relationship. This emotional connection can affect your decision to sell your shareholding.

13 DON'T MAKE THE SAME MISTAKE TWICE

"Those who cannot remember the past are condemned to repeat it."
George Santayana, Professor of Philosophy

It is inevitable that as an investor you will make mistakes.

There are three key principles we follow when we make a mistake:

- Correct the mistake. In most instances, a decision to sell the investment is the most appropriate course of action when we have made a mistake. Wishing for our money back is usually another mistake.
- Don't repeat the same mistake.
- Learn from the mistake.

To try to ensure we do not repeat a mistake, we:

- Own the mistake. We do not attempt to avoid the blame. (You will never learn from a mistake unless you take ownership.)
- Acknowledge the mistake publicly. I do this within our investment team and publicly with our clients.
- Write down what went wrong and revisit our mistakes. (You will never learn from your mistakes if you pretend they didn't happen.)

People who acknowledge and learn from their mistakes will make fewer mistakes and will become better investors. ▲

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