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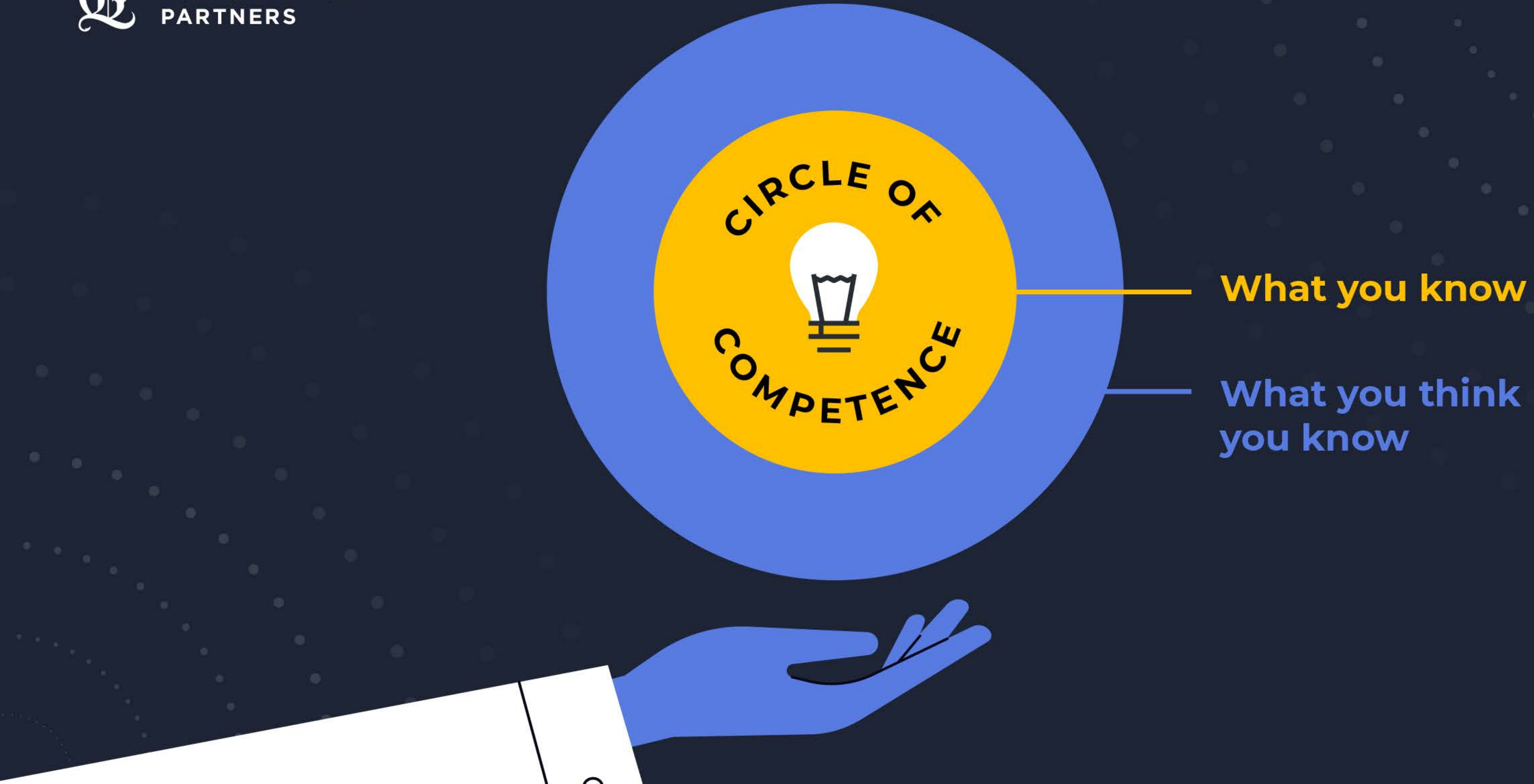

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WHAT MAKES A SUCCESFUL VALUE INVESTOR?

PART I – CIRCLE OF COMPETENCE

In this, Part I of our Multi-Part Series (published monthly), we are going to explore one of the simplest yet most frequently misunderstood concepts that is essential to grasp, if we are to satisfactorily answer the question:

What makes a successful value investor?

That concept, is an investors circle of competence. On this subject the author of one of my least favourite childhood books (Huckelberry Finn – Don't kid yourself I know you didn't enjoy it in school either!) wrote:

'It ain't so much the things that people don't know that makes trouble in this world, as it is the things that people know that just ain't so.'

The concept of only investing in businesses that you understand i.e. that sit within your circle of competence is seemingly straightforward to grasp, as it makes intuitive sense to only buy things that you understand. In my view, the complexity comes with the much harder task of defining: What is my circle of competence? What does it encompass? Where are its boundaries? How can you prove that you really understand a sector/business? Perhaps most importantly how do you maintain your conviction that you are right, and the market is wrong when the businesses stock price falls by 50%?

I define my circle of competence as the sum of all the knowledge that I have accumulated over the course of my lifetime, or as we like to repeat often here at Loh-Gronager Partners (LG Partners), taking inspiration from Charlie Munger, 'all knowledge is cumulative.' Thus, the boundaries of an investors circle of competence are constantly changing as they learn and experience more. In the investing game experience counts.

With regards to investing in businesses, the language of business is accounting so this is an essential element in any investor's toolbox, as it allows for the ability to read and analyse a company's financial statements. From these and other sources we use our own fundamental analysis to forecast the company's economic prospects into the future, discount them back to their present value today and we are left with our assessment of the businesses intrinsic value. To do so, we need to have a thorough understanding of the company, how it makes money, how it will grow in the future, what are its competitive advantages that will ensure its success. In an investing sense, it is in answering these fundamental business questions when analysing investments that expands an investors circle of competence.

When I find a company that I think is interesting, the first question that I ask myself is, is this company operating a business that is already within my circle of competence? In fact, this is question number 1 on the LG Partners investment checklist of ~250 questions! I.e. have I invested in or thoroughly analysed a similar business in this sector before? If the answer is yes, then I need to establish either why I did not invest in the previous business or what the result was (favourable/unfavourable) from the previous investment and why? If the answer is no, this is a red flag, this does not mean you should not continue studying the business, but it does mean that you have to acknowledge that you are now not on firm ground and must proceed with your research/analysis with added caution. This process, however, will allow you to expand your circle of competence over time and build 'muscle memory' when it comes to analysing new investments.

The most successful investors have a strong intellectual curiosity about business and why things work the way they do. They can't help but ask question after question to try to understand why a business operates the way that it does. It is this thirst for knowledge, through reading newspapers, trade and industry journals, investor forums, books and annual reports. With all of this information passing through our investment filters, it aids us in the investment process in terms of idea generation as well as the building of 'muscle memory' when it comes to new business analysis and evaluation.

Even if the sector is not within your circle of competence let alone the business, if your instincts are telling you that this is an opportunity worth pursuing then this is an opportunity to become an expert in this business and sector through thorough and independent research. All businesses are the same, in that they attempt to sell a product or service at a higher price than the marginal cost of production. If you can simplify the business down to its most basic components to see if it has a durable competitive advantage for long-term success while ensuring that it is operating in an industry that is providing more tailwinds than headwinds, you may have found a good potential investment.

It is important to remember as an investor that you do not need to know everything nor have an opinion on everything. It is absolutely fine to take a pass on a stock/sector that you are not comfortable with. In fact, this may be an essential part of your investment process to narrow down your investable universe. It is fine to say 'I don't know', Buffett famously has a tray on his desk marked 'Too Hard', and for me most businesses that I look at ultimately end up in my 'Too Hard' pile.

When it comes to risking your capital, you must only invest in things that you truly understand. This is what builds your margin of safety and means that even if you are wrong you will not lose all of your capital. Remember: Rule Number 1. Don't lose money and Rule Number 2. Don't forget Rule Number 1.

Every investors' circle of competence will inevitably be small to start off with, but constant learning and evaluating potential opportunities will help it to expand in both breadth and depth. Succeeding as an investor does not depend on how much you know, it depends on whether what you know is right or wrong. When you know that, you will also know whether or not you are operating inside or outside of your circle of competence. To ask the question 'Is this investment within my circle of competence' is to answer it.

Every day there are new companies in the news, companies hitting new all-time highs, companies entering bankruptcy, companies IPO'ing...the action and noise is ceaseless. If you allow it to, this can overwhelm the senses of any investor. It is actually advantageous to let the vast majority of this information and action pass you by, inaction should be your basic tendency. Too many investors concern themselves with trying to widen their circle of competence too quickly, but I think in investing you are better having knowledge that's an inch wide and a mile deep than a mile wide and an inch deep. For all investors there is a subset or type of company or sector that we find the most interesting and that for me is the best place to start building your circle of competence. As it is the curiosity about the sector/type of business that will allow you not only to ask the right questions, but also to motivate you to keep digging until you find satisfactory answers. All the time growing the circle.

I'll leave the final words on the subject to Buffett, as always he summarises the topic better than anyone else:

'Just keep accumulating knowledge. That's one of the beauties of the business that Charlie and I are in, is that everything is cumulative. The stuff I learned when I was 20 is useful today. Not in necessarily the same way and not necessarily every day. But it's useful. So, you're building a database in your mind that is going to pay off over time.'

I trust you have enjoyed our journey together so far however, if our paths diverge from here, then as the investing legend, Charlie Munger says, 'In the investment business, all knowledge is cumulative' and in this spirit, we wish you continued success on your journey!

Yours sincerely

Ardal Loh-Gronager
Managing Partner
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