LOH-GRONAGER PARTNERS

WHAT MAKES A SUCCESFUL VALUE INVESTOR?

PART II – THINKING LIKE A BUSINESS OWNER

In this, Part II of our Multi-Part Series (published monthly), we are going to evaluate what it takes to embrace the 'ownership mentality'. This is essential when it comes to treating the partial ownership of a business (e.g. a share in it) with the same seriousness as if we were to be buying/owning the entire business. Once we have mastered this, we are one step closer to answering the question:

What makes a successful value investor?

Perhaps the easiest concept to understand but the hardest to implement in your investment strategy is to put into practice what Benjamin Graham, the father of value investing, wrote at the very end of The Intelligent Investor: 'Investing is most intelligent when it is most business like.' Buffett has said that these worlds are the nine most important words ever written about investing and paraphrased them himself when he says: 'I am a better investor because I am a businessman, and a better businessman because I am no investor.'

But what do they really mean? Many investors point to these two sentences as establishing a fundamental corner stone of value investing, that a stock should not be looked at as a piece of paper or numbers on a screen but treated as a fractional ownership interest in the underlying business. However, this interpretation is too simple and like many things when it comes to investing you have to dig a little deeper to find the real gold. Graham, I believe was alluding to the manner with which an investor conducts his affairs, in that the very act of buying a fractional ownership interest in an underlying business is an act of entrepreneurship and should be treated in all respects as one would any business venture.

When most investors want to know how a business is doing, they look at the stock price. What Graham is saying is that if you think like a business owner, you focus your attention on the underlying business and not on the stock price. There is a clear distinction between knowing a business and investing based on its fundamentals (including its products and services, inventories, working capital needs, capital reinvestment needs (e.g. property plant & equipment), raw materials expenses, and labour relations) and buying/selling pieces of paper that change in price second by second. Either you are an investor, or you are a speculator and if you are the latter remember what Mark Twain wrote (yes, I know this is the second publication in which I mention him, and I still maintain I never liked his book, Huckelberry Finn, but I seemingly can't get away from the guy!):

'There are two times in a man's life when he should not speculate: when he can't afford it, and when he can.'

Buffett who is the most well recognised of Graham's disciples, fully absorbed this concept. He considers it the height of foolishness to view the constantly changing prices as far removed from the company's financial statements. However, adding or removing positions based solely on stock price movements that apparently better reflect the value of the underlying business than the changes in the balance sheet or income statements is equally foolish. For him, there is no difference between owning one share of the business and the entire business. The mentality of operating like a business owner or entrepreneur applies equally to both.

Buffett likes to give the example of Berkshire's partial as opposed to full ownership of both Coke and Gillette to demonstrate this in his annual letters to shareholders:

'We think of Berkshire as being a non-managing partner in two extraordinary businesses, in which we measure our success by the long-term progress of the companies rather than by the month-to-month movements of their stocks. In fact, we would not care in the least if several years went by in which there was no trading, or quotation of prices, in the stocks of those companies. If we have good long-term expectations, short-term price changes are meaningless for us except to the extent they offer us an opportunity to increase our ownership at an attractive price.'

Many investors, including myself, believe that you never really understand a business until you own it, until there is real money on the line. To see yourself as an owner of the business is a psychological concept, as once you have capital at risk you will be doubly motivated to track and learn everything you possibly can about the business and to continually ensure that it remains a sound investment. This is why as opposed to having a 'paper' watchlist where you monitor potential investments only on 'paper' I believe that it makes sense to buy even just one share of the business to start with. This will put you into the right psychological space and induce the ownership mentality. This will motivate you further to ensure whether or not the business is worthy of a full position in your portfolio.

When you start looking at a business with an owner's mindset your perspective completely changes. This is in part due to the 'endowment effect' which we will discuss in depth in another publication, but essentially it means that once you 'own something' you attribute a higher value to it than you would if you did not own it. It is human nature to care more for things that are ours than things that are not. This is why when we are an owner of the business we are invigorated and energised to make the commitment required to understand all aspects of it and to constantly evaluate new information to ensure that it remains a good investment.

In general, most investors make buy and sell decisions after evaluating the current price of a share of the business versus their perceived value of that share in the business. They buy when they believe the expected return is more than compensated for by the risks involved and conversely sell when this is no longer the case. Over time investors believe that the share price will come to reflect the fundamentals both good or bad of the underlying the business.

There are three ways that an investor can profit from the ownership of a stock:

- Firstly, from an increase in the earnings of the underlying business, which will eventually be reflected in a higher share price through retained earnings, share buy-backs, increased investment or increased dividends.

- Secondly, from an increased multiple that investors are willing to pay for the business e.g. the business goes from a 12x P/E multiple to 18x P/E.

- Thirdly, through a narrowing of the discount between the underlying businesses value and the current share price.

Only through careful analysis of the business that comes through embracing an ownership mentality can we predict any of these outcomes with confidence.

With this in mind, when I analyse a business, I look at it as if I were going to buy the entire business, not a portion of it. There are two related questions that I like to pose to myself:

1. If I inherited the entire business today, would I keep it or sell it?

2. If I had exactly the same amount of money as it would cost to buy the entire business, would I buy this business or a different one?

When you look at the make-up of the Forbes 400 or any rich list for that matter, the vast majority are entrepreneurial business owners. There would have been countless times during their respective journeys where they would have been approached by a buyer or made offers to cash out, but they refused. Usually, because they knew they were onto a good thing and had 100% confidence that the business would only become more successful and valuable over time. This is what it means to properly understand a business, to be willing to have all your eggs in one basket and even if someone offers you slightly more than what the business is worth today, the confidence to turn them down out of certainty that tomorrow it will be worth far more.

An ownership mindset is especially valuable when it comes to selling positions in your portfolio. No unlisted business owner knows the true value of their business on a second-by-second basis and this doesn't seem to bother them. They know when it is doing well and when it is doing less well and the 'hypothetical fluctuations' in value do not drive their day-to-day decision making. In the stock market because we can see the share price or market value change constantly, this pulls at every fibre of our being calling for 'action'. If it goes up in value, euphoria and we feel rich, down and we feel poor and depressed. The unlisted business owner likely has close to 100% of his net worth in his business, yet he sleeps soundly at night as he thoroughly understands the business and its trajectory. It is this degree of comfort that we should have with each of our portfolio holdings. It is my belief, that only by being this comfortable with our investments can we have the faith required to add to our positions when they fall and ride them to ever higher highs over the long-term. This is how the real money is made in markets.

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
LOH-GRONAGER PARTNERS

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