Nothing endures but change.
Heraclitus

Dear Investor:

This month’s letter is about impermanence, and its implications to stock selection and risk management. Buddhism defines impermanence as “the notion that all of conditioned existence, without exception, is transient or in a constant state of flux.” The Buddha taught that, because conditioned phenomena are impermanent, attachment to them becomes the cause for future suffering. His teachings are as enlightening to investing as they are for life in general.

The footprint of impermanence is prominent in the history of the S&P 500 index, which was originally formulated in 1957. Notably, four of the top ten S&P constituents today (Apple, Microsoft, Google, and Walmart) weren’t even in existence then. At its inception, the index was dominated by oil producers, railroads, and utilities, while today more than half of its weight is concentrated in technology, financials, and health care. The index continues to include about five hundred stocks, but over one thousand names were replaced over the years.

As devoted long-term investors in outstanding companies, we’ve come to recognize that any investment theme, no matter how compelling, will eventually weaken. Even when fundamentals don’t deteriorate, a seemingly attractive investment can underperform simply by peaking in popularity. For this reason, we are not dogmatic about our pursuit of attractive attributes, but focus instead on how the companies we consider outstanding might change relative to expectations, and for how long our variant view might persist. While our focus is on longer term trends, we do not believe in staying wrong for long when change fails to go our way. That said, the ability to endure in the face of change is one of the key traits of an outstanding company.

In 1994, Wharton professor Jeremy Siegel published the best seller Stocks for the Long Run, which went on to become known as “the buy-and-hold bible,” due to its empirically driven conclusion that stocks go up over time. With the benefit of the dot-com bubble in hindsight, Siegel then published The Future for Investors in 2005, where he focused more on the notion of impermanence. Like the Buddha, Professor Siegel emphasized that nothing lasts forever. But unlike the Buddha, who preached the acceptance of this impermanence as true wisdom, Siegel advocated sticking with a specific type of “tried and true” stock for the long term.

The ideal stock, according to Professor Siegel, is one that benefits from a strong brand name, products that don’t change over time, high cash flow and dividend yields, and an earnings multiple that is not much higher than the market’s. He offered Hershey’s,
Heinz, and Coca Cola as prime examples of the type of stocks an investor should hold for the long run. Ironically, Siegel called these stocks Corporate El Dorados, in honor of the mythical, lost city of gold that was never found.

We agree with the attractiveness of the attributes that Professor Siegel highlights, and while we do not assume anything to be permanent, we can see why they will persist. In the end, whether one likes to invest in established companies, emerging growth, or distressed situations, it is less about the attributes themselves, and more about how they change in time, and relative to expectations.

One of the most valuable concepts in The Future for Investors is what Professor Siegel called the ‘Growth Trap’. He defines it as the fallacy of assuming that just because an industry or company is growing rapidly, it represents a good investment. To avoid falling for this trap, Professor Siegel recommends industries and companies that are less popular for their growth, or even those that have bad reputations, and for which expectations stay stubbornly low. An outstanding company in an improving industry that is still considered toxic has been, and should remain, a formula for outsized returns. Nursing homes, trucking, and utilities are examples of such industries. They are not generally perceived as great, but all contain formidable companies with repeatable and highly profitable growth models that benefit from underappreciated secular trends.

While out-of-favor industries can be fertile ground for finding value, we do not shy away from industries and companies that are in favor if we believe their ability to sustain outsized returns is still underappreciated. Such stocks are often perceived as expensive, putting them out of reach of most value investors, even when in reality they might be bargains. We believe investors are systematically biased towards thinking in short-term, linear increments, and so they often underestimate the value that outsized compounding delivers in time. Perhaps because of the popularity of the notion that strength can't last forever, the value of the strongest and most enduring trends is frequently underappreciated by investors.

In conclusion, because everything is impermanent, we must remain on alert and flexible in coping with the changes that the future has in store. We cannot choose this future, and neither is it in our interest to fight it as investors. While we strive to position ourselves to benefit from longer-term trends, we are neither oblivious to cycles nor to the teachings of the Buddha.

Best regards,

Victori Capital