Sic Parvis Magna: Great Things from Small Beginnings

One of our favourite pieces of wisdom from Charlie Munger is his so-called first rule of compounding: "never interrupt it unnecessarily."

Would you get out of bed for a daily return of 0.073%? It does not sound like it is worth the effort, but a daily return of 0.073% over roughly 250 trading days in a year equates to an annual return of 20%. An annual return of 20% leads to some remarkable outcomes over time:

Year	0	5	10	15	20	25	30
Investment Value	100,000	248,832	619,174	1,540,702	3,833,760	9,539,622	23,737,631
Multiple on Original Investment (x)		2.5	6.2	15.4	38.3	95.4	237.4

While most people would agree turning $100,000 into $250,000 (2.5x the original investment) is a good outcome over five years, note the value in years 10 (6.2x the original investment), 20 (38.3x) and 30 (237.4x). The math is heavily back-end loaded – in fact, nearly 60% of the ultimate value of $23.7mn is generated *after* year 25.

Everyone seems to intuitively agree that compounding delivers wonderful results over time, but very few seem to take heed that one of the main ingredients to this kind of outcome is the patience to let the compounding effect take hold. Instead, the temptation to 'do something' overrides Munger's first rule. The result is performance chasing – trying to own what is working right now.

Writing in *The Big Secret for the Small Investor*, Joel Greenblatt – himself a star in the firmament of successful long-term investing – relates the following story based on a Morningstar study covering the decade ended 31 December 2009:

> *The best performing stock mutual fund of the last decade earned more than 18 percent annually. [...] This is particularly impressive since the market as measured by the S&P 500 was actually down close to 1 percent per year between 2000 and 2009.*
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> *Yet, the average investor in this same fund managed to lose 11 percent per year over those ten years. How?*
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> *Pretty much after every period the fund did well, investors piled in. After every period the fund did poorly, investors ran for the exits. The average investor managed to lose money in the best-performing fund purely by buying and selling at just the wrong times!*

This anecdote should give every investor a moment of pause. Turning a positive 18% compound return into an 11% per year dollar-weighted loss over a decade speaks to the fundamental contradiction at the heart of successful long-term investing: it requires contrarian action, the ability to weather volatility, and the wherewithal to stick with an investment strategy.

The problem, of course, is that our collective ingrained loss-aversion response wants every fibre of our being to put a stop to the psychological pain and anguish of short-term volatility and drawdowns by selling out. More often than not, such moments present good opportunities to allocate capital. (A helpful way to frame the conundrum: lower prices today equate to higher returns in future.)

Our Goal: Long-Term Compounding

Ultimately, our goal is to compound our clients' wealth over long periods of time. By being rigorous as to the quality of businesses we own, we hope to reduce the fundamental risk of achieving this outcome. It also explains why we are so focused on the returns on capital generated by the businesses we own (as opposed to the rate of year-over-year growth). Munger again:

> *Over the long term, it is hard for a stock to earn a much better return than the business which underlies it earns. If the business earns six percent on capital over forty years and you hold it for forty years, you are not going to make much different than a six percent return – even if you originally buy it at a huge discount. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, even if you pay an expensive looking price, you will end up with one hell of a result.*

What is critical for our investors to understand is that we will not compromise our quality-focused process or philosophy to try and win the horse race of annual performance. Long-term compounding is much harder to achieve if one tries to do so in a series of 12-month sprints, where the goal is simply to be 'ahead of the game' over every individual measured period.

If this sounds like we are waving the white flag on performance, the truth is much the opposite. We do not expect our investors to ignore our results over the medium-to-long term; as an active manager, we *want* to outperform the market over time. To do so, we need to perform the bottom-up analysis and purchase high quality businesses at prices that include a margin of safety, and our commitment to our investors is to stick to our philosophy and process to deliver on these goals. Our point is simply that we are trying to compound your capital over the long term, not 'win' in every individual period. There is a graveyard of investment managers who have attempted to do the latter.

Consider the analogy of comparing long-term investing to the Tour de France – one of the ultimate tests of sustained performance – favoured by British investing legend Terry Smith.

The Tour consists of three types of stages: the flat or rolling stages, the mountain stages, and time trials.

In a time trial, cyclists are set off individually whilst wearing skin-tight clothing on an aerodynamically optimised bicycle. As this stage is a straight-up test of unassisted riding ability and power output, it is usually won by relatively larger riders with an ability to deliver a high power output for a sustained period of time. The time trial – being a competition against the clock – is sometimes referred to as the 'race of truth,' as it relies solely on the cyclist's ability to master the elements.

Conversely, the flat or rolling stages require a different strategy. The race generally sees the whole peloton riding a stage to the finish line as a group. Riders reduce the amount of effort required by slipstreaming in the peloton. In fact, each rider can save up to 30% of energy by cycling behind other riders who are going out front. (For comparison, think about what happens when you put your hand out the window of a car going 50km/h; reducing that kind of wind resistance is the point of riding in the peloton.) The designated sprinter for each team – who is hopefully still fresh from being able to slipstream in the peloton – is usually set loose close to the finish line in order to win a sprint victory.

The mountain stages are normally won by climbers, who tend to be much smaller and lighter cyclists that optimise their power-to-weight output to keep up their speed for longer as they work their way uphill. In these stages, it is all about endurance when fighting the forces of gravity.

The point is that sprinters have a very different body type than time trial specialists, and a cyclist who is a successful sprinter is unlikely to win a time trial (and vice versa.) Good climbers are generally smaller in stature, and generally do not excel at sprinting. In short, there is no single rider with the physical attributes required to excel in all three stages.

Interestingly enough, the Tour de France has been won on eight occasions by riders who have never won a single individual stage. In their case, the secret was to be excellent at one of the disciplines, and good enough at the others that they remained competitive throughout the entire Tour. The key to their long-term success was consistency.

The lesson from this analogy for investors is obvious. Many investors look for an investment strategy that can outperform in every conceivable set of market conditions; the historical evidence emphatically confirms that this is impossible. Trying to actively position to outperform month-by-month, quarter-by-quarter and even year-by-year is ultimately a fools' errand, likely to lead to the type of return profile discussed by Greenblatt as one attempts to pick the 'momentum' stock, sector or strategy that is working in the moment.

When it comes to successful long-term investing, it pays to try and win the Tour, not every individual stage. We think our quality-focused process will deliver this outcome over time. The consistent aggregation of incremental gains – in other words, compounding through time – will deliver the 'great things from small beginnings' that Sir Francis Drake had on his family coat of arms. *Sic parvis magna*, indeed.