JRW FINANCIAL LLC

INVESTMENT COMMENTARY – AUGUST 2015

The Business of Investing

"*Investing is most intelligent when it is most businesslike.*" – Benjamin Graham

Whew! Well, this has been interesting. The U.S. stock market has not seen volatility like the kind we have had recently since at least 2011, if not all the way back to the financial collapse in 2008. I advise continuously to avoid the day to day market noise, as it is just that: noise. However, declines to the extent we saw in the last weeks of trading, coupled with the sharp snapback of prices, cause even the most casual observer to stand up, take notice, and check their 401k balances.

I've written before about my fascination with the psychological aspects of investing known as behavioral finance. Humans are wired to act irrationally, particularly with respect to investing. We are paralyzed by the fear of loss when we see our holdings decline in price, and we seem to forget all about our fundamental investment theses or our process of being long-term investors. Irrational actions lead to underperformance.

I harken back to Warren Buffett's counsel: it's much better from a long-term investment perspective to be ***fearful when others are greedy and greedy when others are fearful***. In theory that makes perfect sense, but as with much of theory, putting it into practice proves very difficult. Still, with the amount of sudden fear in the market recently, and with little evidence to suggest a change in economic or financial conditions of a magnitude representative of a collapse in prices, it has been truly a time to show patience and discipline in the face of fear. As long-term investors, we have to understand that markets will go down, sometimes significantly, while we are invested. Rather than attempt to play an ill-fated game of market timing, however, we should look at declines as opportunities to buy increased stakes or new positions in best of breed businesses. At the very least, if you are not planning to sell stocks in up or flat market conditions, declines in price, though severe, should not cause you to change your outlook or process.

In reviewing the JRW Core Equity portfolio closely amidst the market turmoil, I found exactly zero positions I felt needed to be trimmed or sold on the basis of price declines. I believe in the businesses we own in the portfolio and I believe in their ability to compound future returns on invested capital. Further I believe our returns on investment will follow the trajectories of these businesses and that we are positioned well long-term. A down day, week, month, or even year does not an investment process make. We are sticking to our guns and maintaining our exposure in the portfolio. And as always, we are on the lookout for more best of breed businesses trading at reasonable discounts to our estimate of per share business value. I imagine that I will find a few interesting opportunities amidst the turmoil.

In last month's commentary, I gave some information as to the benefits of having a long-term perspective on our investing operations. Part and parcel of this long-term approach is our insistence on viewing equity investments as ownership interests in the businesses behind the stock certificates.

If I had to describe the type of investing we do, I would say we are fundamentals-driven, value-oriented, businesslike investors. That is the lens through which we see the market and the businesses behind the stocks that comprise the market.

We are fundamentals-driven because we focus on the underlying fundamental financial metrics of the business to determine whether we have a good investment opportunity. We focus on fundamentals as opposed to technical analysis, macroeconomics, or geopolitical events. We do not try to time the market, nor make prognostications as to the future.

We are value-oriented because we want to purchase assets for less than they are worth ideally. We understand that even best of breed businesses are bad investments at certain inflated prices. If all else is equal, however, we take the modern Buffett/Munger approach to value: we find it better to purchase wonderful businesses at fair prices than to purchase so-so businesses at substantial discounts.

Perhaps the most important element of our investing, and the one we believe drives the majority of our long-term returns, is the businesslike nature of our approach. Our portfolio is comprised of common stocks representing ownership interests in strong businesses. We determine investment success by the ability of the businesses we own to increase in per share business value over the life of our ownership. Whereas technical traders focus on the movements and patterns of stock price, we focus on the fundamentals of business performance. We strive to know as much about a business as we can in order to be comfortable owning our shares. We are interested in the management teams with whose interest we align when we purchase shares of the companies they run. And we look out to the future to envision clearly based on current business performance whether the business will be better positioned, stronger, and consistently earning high returns on capital over that period.

We do not trade stocks and we do not make macroeconomic forecasts. We search the global marketplace for ownership interests in competitively advantaged businesses with long runways for future compounding of per share business value. We analyze businesses for their ability to generate significant returns on invested capital and their opportunities for future reinvestment and growth. Although limited from doing so by the size of our capital base, we treat each investment as if we were going to purchase the entire company with no desire to sell in the future. This simple lens provides the impetus to maintain our discipline with respect to business quality, probability of future compounding, and valuation.

Our portfolio is formally the JRW Core Equity portfolio. To facilitate my businesslike thinking about investing, I think of our portfolio as a financial holding company which owns portions of subsidiary businesses. Without question, this endeavor seeks to emulate Mr. Buffett and Berkshire Hathaway, to the extent anyone can actually purport to do so. Berkshire is a conglomerate made up of wholly-owned subsidiaries and minority equity investments. Mr. Buffett allocates the cash generated by subsidiary businesses and the dividend income generated by equity investments into future investment opportunities.

I view our portfolio in a similar way. I find that this perspective allows me to focus on the businesslike nature of the investing we do. I view my own role, aside from being a partner alongside my clients, as Chief Capital Allocator of our portfolio, akin to Mr. Buffett's role in Berkshire. It is my responsibility to allocate capital to the businesses that offer the highest probability internal rates of return over the long-term with little to no risk of permanent capital loss.

I believe strongly in concentrating capital into the best of the competitively advantaged businesses we research when Mr. Market offers ownership shares at reasonable market prices relative to per share business value. To that end, twenty-five subsidiary businesses has been the upper limit on the number of businesses we will own. My preference is to own more significant stakes in a smaller number of the best businesses I can find.

Circle of competence is an important theory when investing in businesses. I know for certain there are things I do not and cannot know. Investing in a business that is difficult to understand or that operates in an industry beyond my own comprehension in not worth my time, and amounts to no more than somewhat-educated guesswork on my part. I certainly would not purchase an entire business when I had no comprehension of what the business did or how it made money. Neither will I purchase minority ownership positions in those businesses. For that reason, we will miss out on some of the hottest momentum stocks in the marketplace if I cannot understand the businesses behind those stocks or the businesses prove to be full of complex, not easily understandable layers. We have a "too hard" pile like Messrs. Buffett and Munger, and we are equally unafraid to move ideas there.

Mr. Buffett states that he wants his businesses to be protected by economic moats. His preference is for the moats to be deep, wide, and filled with piranhas. Mr. Buffett describes colorfully his requirement that the businesses in which he invests enjoy strong and durable competitive advantages to ward off competitors and prevent the decline of business operations. The nature of capitalism is that investment finds the sources of excess return and competes away those returns. However, there are a select group of businesses that consistently earn substantial returns on the capital they use to fund their business. These returns are protected by the competitive advantage built around the business.

Mr. Munger has spoken about returns from stocks following generally the same trajectory as the returns on capital of the underlying business. Mr. Munger opines that investors will be hard pressed to earn better returns from stocks than the returns on capital enjoyed by the business. If you own a business with six percent returns on capital over forty years, and you hold the business for that period, you're going to earn roughly the equivalent return on your investment, according to Mr. Munger. Thus, if you own a business that earns eighteen percent on capital over a long period of years, you are likely to be rewarded handsomely, even if the price you paid for the shares looked expensive at the time.

While we try to take a slightly more value-oriented approach, preferring to pay no more than a fair price for shares of competitively advantaged businesses, we agree wholeheartedly with Mr. Munger's opinion as to the long-term results of stock investments following a similar path to the returns on capital of the underlying business. For this reason, we seek out businesses that have high probabilities of earning significant returns on capital over a long-term period.

At the end of the day, I allocate capital within our portfolio with those insights in mind. Taking a businesslike approach to our portfolio allows me to be a better investor and ensure that I am allocating my capital and the capital of my clients and partners to the best businesses I can find. By focusing on businesses with exceptional compounding potential, I am confident that our portfolio, our "mini-Berkshire" financial conglomeration of minority equity stakes, will compound in value over the long-term with little to no risk of permanent capital impairment. The state of our business is strong.

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