WHERE TO INVEST?

Reading time ~ 10 min.

"A truly great business must have an enduring "moat". The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns. Therefore, a formidable barrier (the moat), such as low-cost or a powerful brand is essential for sustained success. Business history is filled with companies whose moats proved illusory and were soon crossed.

Our criterion of enduring eliminates businesses whose success depends on having a great manager. Of course, a terrific CEO is a huge asset for any enterprise, but if a business requires a superstar to produce great results, the business itself cannot be deemed great.

A medical partnership led by your area's premier brain surgeon may enjoy outsized and growing earnings, but that tells little about its future. The partnership's moat will go when the surgeon goes. You can count, though, on the moat of the Mayo Clinic to endure, even though you can't even remember the name of its CEO."

Warren Buffett

This is the third and the last part of our trilogy on Money, Debt, Inflation and Wealth Preservation. In Part 1 our friend asked how he should invest his $ 100 million inheritance, to safely preserve its purchasing power for the next twenty to thirty years. In this part of our trilogy, we will address our friend's question, which, by the way, is just as relevant to a $ 100,000 inheritance.

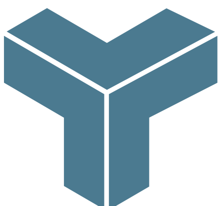
Bombardier corporation has been a world-famous Canadian manufacturer of ski jets, snowmobiles, airplanes and trains. Its shares have publicly traded since 1967. If our friend had invested $ 1,0 million into Bombardier shares in 2001 (twenty years ago) today his investment would have been worth around $ 100,000 (down by 90%).

Since 2001, the largest European banks (German, French, Italian….) have fallen by more than 75%. America's famous Citigroup has fallen by about 85%. Yet, Boeing corporation's shares are up by around 400%, the Royal Bank of Canada is up by around 600% and America's JP Morgan bank is up by 300% (all of these ignore the dividends paid out during this twenty-year period).

One British Pound (GBP) was worth about 1.4 US$ in 2001, it appreciated to 2.0 US$ in 2007 and now trades at 1.4 against the US$, exactly where it was in 2001. The Turkish lira, on the other hand, has depreciated by around 90% against the US$ since 2001.

Sberbank – Russia's largest bank – has appreciated from around 2,0 rubles per share in 2001 to 310,0 rubles per share today, so despite the 70% depreciation of the Russian ruble against the US$, within this period, a $ 1,0 million invested in Sberbank shares in 2001 would have been worth around $ 50,0 mil today (ignoring dividends).

All these examples indicate that it is not simply about a certain country, industry or currency. So far we haven't even talked about the world of bonds – sovereign, corporate, convertible – nor have we touched the subject of derivatives. The world of investments is complicated, so what should we tell our friend about his inheritance?



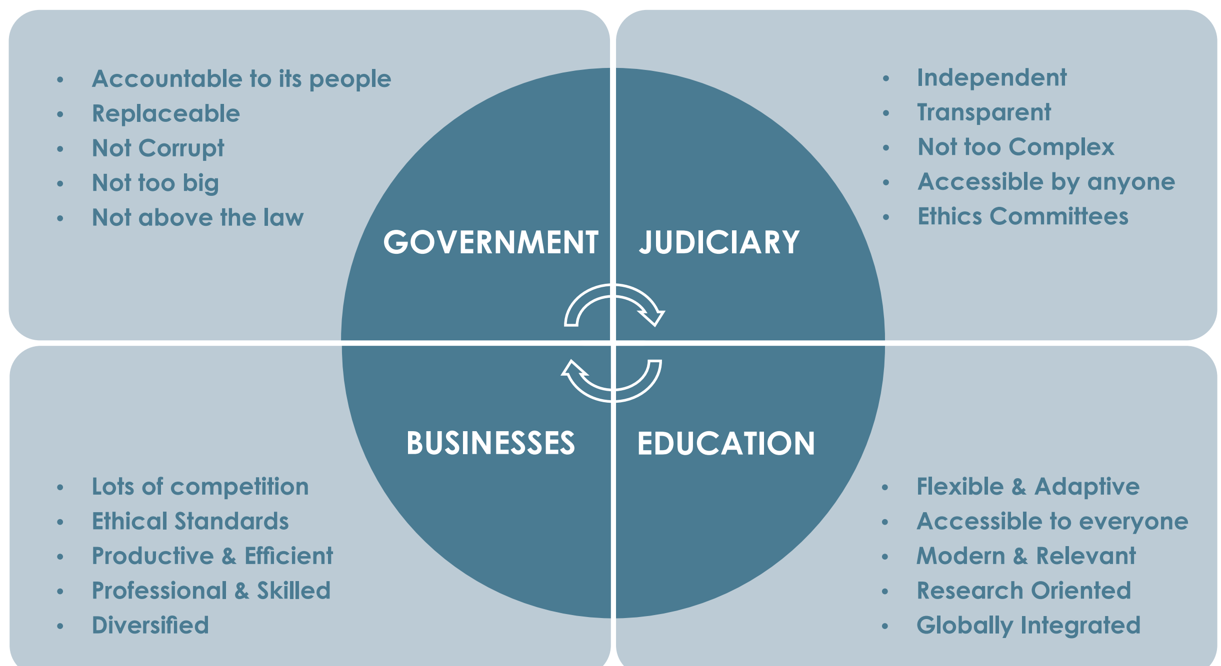
The basic principle of sound investing hasn't changed for centuries – assess the risks and estimate future profits. The combination of these – called the Risk-Reward Ratio – has been and will always be the foundation of all investments, regardless of asset class. The trouble is that it sounds much easier than it really is. How do we assess risks? People spend decades studying the subject of risk estimation. Other people spend decades studying forecasting methods of future profits. A much smaller group of people, such as Warren Buffett, combine the two – Risk and Reward – and apply them on a daily basis in real life. So the advice we could give our friend is to stick to the following five rules:

First, the only way to preserve or increase purchasing power is to invest in productive assets. Anything from farmland and real estate to human beings (including your kids) or a business can be a productive asset. A business can be private or public (with shares trading on an exchange), it doesn't matter. Investing in assets which do not produce anything, and which are held with a sole purpose to later sell at a higher price to someone else is speculating not investing. If you want to invest in gold, choose sound gold-mining companies instead of storing gold bars in a safety deposit box. If you want to invest in land, buy a piece of forest, an apple orchard or a farmland.

Second, clearly define your boundaries of competence. Figure out which businesses you understand and stick to them. Some people know which farmland is the most promising while others have an excellent understanding of certain industries.

Third, invest in businesses which are based in countries with sustainable ecosystems. We issued a report on Ecosystems, ***available on our website.*** Diagram 1 from that report – on sustainable ecosystems – is reprinted in this publication.

Diagram 1: The Four Pillars of the Ecosystem



Fourth, you can buy a wonderful asset at a fair price or a fair asset at a wonderful price. Most people spend their lives looking for wonderful prices. They often look at the price before they look at the business. This is often a big mistake. Wonderful assets are never cheap. They are either expensive or fairly priced, but never cheap. Fair assets, on the other hand, can trade at deep discounts (we call this a "wonderful price"). People who invest in fair assets at wonderful prices soon realise that those assets require too much time, cause too much stress and contain too much hidden risk. According to an ancient Armenian saying – nothing is cheaper than the expensive. The advice we give to our friend is – stick to wonderful assets and try to buy them at a fair price (as they can often be expensive).

Fifth, minimise trading or transaction costs. Do not buy and sell frequently, otherwise you will give away most of your gains to brokers – stock brokers, bond dealers or realtors. Once you figure out and apply the first four rules mentioned above, make your investments and stick to them. Sell only when you are reasonably sure you made a mistake or something fundamental has changed. Do not overestimate your ability to time the most efficient market in the world – the stock market. Overconfidence is a deadly sin for investors.

Conclusion

Being a good investor doesn't require extraordinary intelligence or expensive education. It simply requires hard work and discipline. Estimating risk and future profits is not as hard as finance and economics faculties of various world-famous universities would make you believe.

David Tavadian
Founding Partner

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