Margin for Error Chapter 2: The One Thing

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ABOUT THE AUTHOR

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In the movie *City Slickers*, Curly (played by Jack Palance) gives Mitch (Billy Crystal) a life lesson while sitting around the campfire. "Do you know what the secret to life is?" Curly asks as he holds up his index finger. "Your finger?" asks Mitch, confused. "No, it's one thing. Stick to one thing, and the rest don't mean s@&$." "What's the one thing?" Mitch asks curiously. "That's what you have to figure out for yourself," Curly says with a wry smile.[1]

In their book, The One Thing, Gary Keller and Jay Papasan believe that to achieve extraordinary business results, you must master a single task and repeat it. They go further to explain that multitasking has erroneously been praised as a desirable trait since it typically means someone does many things, but none of them very well. Keller says, "success isn't a game won by whoever does the most."[2]

I believe that the concept of "the one thing" also applies to investing. For the most part, the standard operating procedure for individual investors (and their advisors) is to "multitask." Portfolios are filled with hundreds of investments. We recently reviewed a fixed-income mutual fund that had over 3,000 holdings! I was dizzy just thinking of how anyone could truly monitor and understand that many positions. Investors constantly shift their allocations, chase the "hot dot," hire and fire mutual fund or separate account managers, or even trade in and out of various index funds based on tactical trends. However, no data that I have ever seen shows that all this "multitasking" produces superior returns for investors.

Merlin Wealth Management's Investment Discipline focuses on one thing: the ownership of great businesses. I know that many of you could repeat our investment philosophy back to us by memory, but after what we experienced in 2020 and what we see now at the beginning of 2021, I thought it was an excellent time to review it:

MWM Investment Discipline

We believe consistent earnings growth is the primary driver of intrinsic value and long-term stock appreciation. Investing in businesses with exceptional earnings growth, driven by a sustainable competitive advantage, superior financial strength, proven management teams, and extraordinary products and services is the key to long-term investment success. Further, we hold the view that such exceptional companies not only have the potential to achieve outsized returns but are also inherently less risky. Their superior earnings stability and financial strength serve as a "margin of safety" that typically results in less volatility in declining markets as well.

Keeping a long-term focus is one of the hardest things to do in today's investment environment. It is why of all the qualifications for success in equity investing, none is more important than a firm mind and steady hand. Investigating *thoroughly and intelligently in each company purchased allows us to remain unswayed by every breeze, satisfied as to the soundness and progressiveness of each company in which we have become part owners. Staying resolute and calm in periods of great uncertainty likely leads to the most favorable lifetime returns and keeps one from making emotional or premature decisions.*

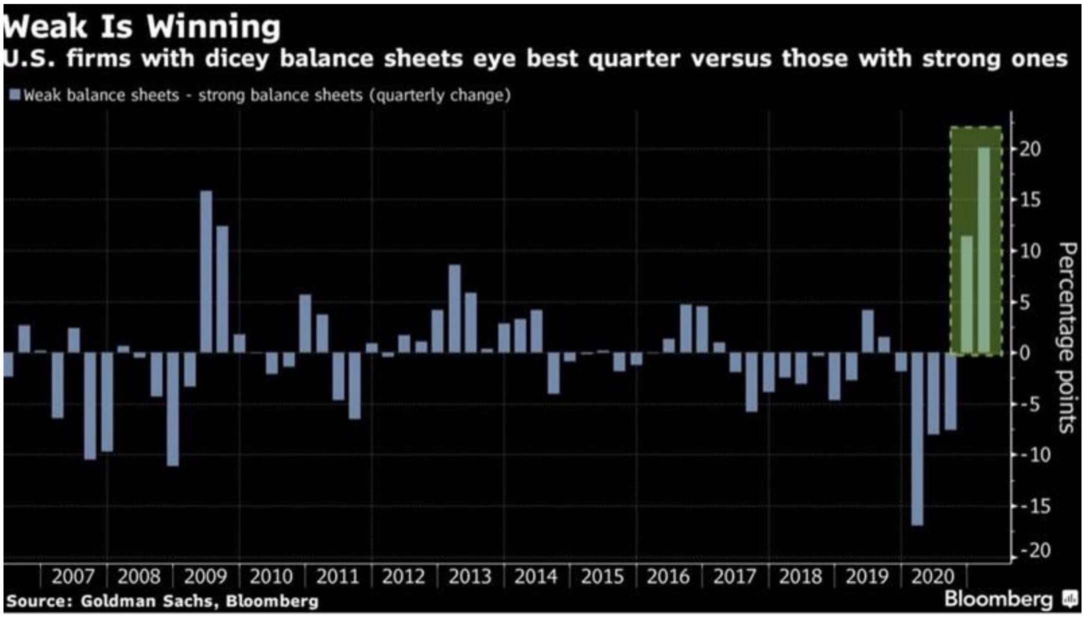
In our opinion, active quality management can add significant value in environments of uncertainty compared to index products. Broad market indices do not discern between companies with good and weak fundamentals, cannot evaluate forward business implications arising from economic or policy changes, and do not have the flexibility to adjust portfolios as active managers do. A strong, rising market may be forgiving of indiscriminate investment choices, but a more volatile one is likely to penalize such behavior.

At our core, we are fundamental investors. While there are many viable ways of identifying great companies with good management teams, strong balance sheets, sustainable business advantages, and excellent long-term growth prospects, the underlying characteristics we are looking for remain unchanged. We are not focused on a particular investment "style" or "trend," but instead on making solid and repeatable returns for our clients by owning great companies at prices that make sense. We believe that is a timeless strategy.

Today, it is apparent that 2021 will present a challenge for quality companies to continue to outperform markets. As you can see from the chart below, current market performance is being driven by lower-quality companies, defined by us as businesses with high levels of debt, negative earnings, declining market share, and eroding profit margins. We believe such an environment is developing as investors who either missed the market rally, which began a little more than a year ago, or have new cash to put into the market but are concerned about the better-quality businesses' valuations are trying to find places to invest. Such a dynamic leads this capital toward company stocks that have not experienced much of a recovery from the market lows reached in March 2020. Many who are investing like this right now would say they are following the oldest investment maxim, "buy low and sell high." We would beg to differ. The idea behind buying low and selling high is not about just looking for bargains but finding great long-term investment opportunities. We measure those great opportunities with a very high bar of quality, and as such, we rarely see a company stock that fits our eye and feels extremely cheap. Our goal is to find and stick with great growth businesses for the long term. Of all the qualities we look for in a great business, the most important to us is the power and durability of earnings growth. That is why we feel comfortable paying higher multiples for some companies at prices that reflect their future growth potential. That is our definition of how to "buy low and sell high."

Why Quality Stocks Should Offer Higher Return and Lower Risk

"In his address to Berkshire Hathaway's shareholders at their 1994 annual meeting, Warren Buffett told the gathering, 'I bought my first stock in April 1942 when I was 11. World War II did not look so good at the time. We were not doing well in the Pacific. Just think of all the things that have happened since. Atomic weapons and major wars. Presidents resigning, massive inflation at certain times.' Buffett then explained why he believes investing in good businesses for the long term is a better idea than trying to continuously rebalance your portfolio based upon the current news cycle. 'To give up what you're doing well because of guesses about what's going to happen in some macro way, just doesn't make any sense to us.'" [3] Of course, to adopt Buffett's long-term strategy requires an unquenchable optimism, like his and ours, and a belief that



it is "never a good time to bet against America," which history has proven correct.

British asset management firm, Schroders, has been studying the merits of an investment style called "Quality" for almost two decades. While most asset management firms try to fit into the "Growth" or "Value" camp, Schroders began offering a stand-alone Quality strategy in 2007. The strategy invests in financially strong companies that have a demonstrated record of generating superior and stable profitability. They believe that Quality is a more systematic and predictable investment approach than typical growth or value investing. Schroders's data suggests that Quality companies generate a return premium in excess of the market over time with lower risk (in fact, the premium is accentuated when risk aversion is high or rising). Lastly, Schroders points to strong management in Quality companies as a differentiating factor for long-term returns as well. These management teams are typically more shareholder-friendly, have greater clarity into and control of the company's finances and profitability metrics, and therefore provide much better communication to the investment community, making them far less likely to disappoint or catch their investors off-guard with unexpected bad news.

The idea of Quality as an investment style certainly resonates with us. While we may define a quality company in a slightly different way, a key tenant of our investment discipline is that quality businesses will continue to outperform over the long term. The Schroders report quantified that dynamic for us. Looking at data from the MSCI Index from 1988-2014, Schroders reported that "High Quality" companies produce approximately 5% annualized excess return versus lower quality cohorts. Further, Schroders also concluded that the High-Quality cohort exhibited lower volatility over the same 26-year period- a 14% standard deviation versus a 19% standard deviation for the low-quality cohort.[4]

A Needle in the Haystack

"Don't look for the needle in the haystack. Just buy the haystack!" John Bogle. Founder. Vanguard. 1960s.[5]

John Bogle was a proponent of investing in passive index mutual funds. He coined the phrase “buying the haystack” because he believed that it was too difficult for individual investors to find ways to own high-quality individual stocks, and even if they could do that, they had little chance to outperform the market. In fact, Bogle, like many other professional investors, turned his eye on his peers and questioned their ability to consistently outperform indexes over long periods of time. Even as recently as 2019, CNBC ran a headline story reporting that “active fund managers trail the S&P for the ninth year in a row.” In that same story, CNBC’s Bob Pisani stated that “after ten years, 85 percent of large cap funds underperformed the S&P, and after 15 years, nearly 92 percent are trailing the index.”[6] It is fair to conclude from this data that most active managers do underperform, which is why Merlin Wealth Management is very proud of our track record over the short, medium, and long term. But more than that, we are proud that our investment discipline and the philosophy we try to live every day when taking responsibility to invest client money has proven to be time-tested and fruit-bearing. Our success is undoubtedly based on our adherence to the principles of our investment discipline and because we have built an exceptionally talented, institutional-quality asset management team within Merlin Wealth Management. 2020 was a great test of both of those assets, and I believe we passed that test with flying colors. Our 2020 performance was beyond even our own high bar, especially considering the tense environment we experienced at the outset of the pandemic. Further, we believe we have also seen a paradigm shift in how businesses function, and many of the services required to accommodate this change in how people will work in the future are being provided by or incubated inside of MWM portfolio companies.

High-Quality Shareholders Should Be Rewarded

“All shareholders of Churchill Downs get free season passes to its racetracks. A nice perk, but why not offer special rewards, in cash or votes, to a company's most loyal shareholders?”[7]

In today's market, trading is driven by a large cohort of transient investors following news trends (or, more specifically, social media chat rooms and blogs). Pick your name from the headlines: GameStop, AMC Entertainment, Plug Power, Nokia all have stock charts that look like teeter-totters based on the trading of this class of "investors."

“Lost in this process are the steadying hands of long-term concentrated holders, today a minority group that Warren Buffett long ago dubbed ‘high-quality shareholders.’"[8]

“While trading provides liquidity benefits, average holding periods are at historic lows, moving under one year.”[9] On the other end of the spectrum, index funds have eternal holding periods but are so widely diversified they are not focused on the fundamental characteristics of the particular companies they nominally own. While making investing cheap and delivering market returns, they buy and sell without regard to actual value and have limited resources to weigh positions in corporate debates.[10]

“Much-publicized research on actively managed funds questions whether they can outperform passive indexes after fees. More advanced research, however, shows that quality shareholders- both long-term and concentrated- outperform rivals. Many companies recognize the value of these shareholders and attempt to attract them with effective capital allocation, shareholder communication focused on long-term business strategy, not splitting the stock even at high prices, and substantial insider ownership. All coupled, of course, with excellent business economics. A dozen companies have gone so far as to reward stockholders with increased voting power and larger dividends based on their holding period and portfolio concentration in the company's shares. A typical design grants four votes instead of one to all shares held longer than four years (in fact, this is the default rule for the largest public companies in France)."[11]

Just as MWM investors have benefitted from committed long-term ownership, companies with more patient and focused shareholders also gain. Shareholders like us offset short-term pressures that transient traders exert and provide a deterrent to overzealous activists. We will let you know when we get our thank you note from Elon Musk!

Too Good To Be True

As a huge fan of the hit sitcom Seinfeld, the crazes that seem to dominate the investment news so far in 2021 take me straight to "The Non-Fat Yogurt" episode of Season Five. [12] A quick synopsis, "Jerry, Elaine, and George eat at a non-fat frozen yogurt shop in which Kramer has invested. The yogurt is delicious, and they (along with Newman, of course) indulge, as it is 'non-fat.' When Kramer notices that Jerry and Elaine have gained weight, they become suspicious of the yogurt's contents. Elaine decides to send the yogurt to a laboratory for testing. Kramer, fearful of losing his investment, tries to sway a lab technician to falsify the yogurt analysis. In the process, they kiss passionately, and a sample of blood with high cholesterol falls into a test tube belonging to Rudy Giuliani, then a candidate for mayor of New York. In the end, the lab reveals that the yogurt does, indeed, contain fat. Business at the yogurt shop plummets, especially when Giuliani receives the results of his physical. He blames the yogurt for his high cholesterol and vows to eliminate false advertising in the city. "[13]

As my mom always told me, "if it's too good to be true, it usually is." Several apparent investment fads also seem way too good to be true if you believe what you read on social media. So, let us unpack the two most popular fashions: the Reddit community called r/wallstreetbets and Bitcoin and other cryptocurrencies.

r/wallstreetbets (WSB)

Stock advice and various investor newsletters have been available on the internet for decades, but there has never been anything quite like the Reddit community called r/wallstreetbets, also known as WSB.

"WSB takes something of an internet extremist's approach to investing." [14] Amateur investors on WSB discuss different stocks and attempt to affect the stock price as a collective. This year this group of investors decided to take on hedge funds that were shorting stock in GameStop. GameStop is a video game retailer. Like most stores still selling products in person, it has struggled lately as video game sales moved online. As such, it was heavily shorted by professional investors who saw little chance for the business to survive. That is where the WSB community decided to act. If the collective community could push up the price of GameStop stock, it would create what is called a short squeeze- where investors who are short a stock cannot find shares to purchase, leaving them at the mercy of the market to buy shares at higher and higher prices to close their short positions. "S3 Partners, a financial data company, said that its analysis found that short sellers lost $23.6 billion on GameStop stock in the month of January alone."[15]

This is the first time a group of amateur investors has taken on the professional investment community and won. With this in mind, there are some who believe the WSB phenomenon will usher in a new paradigm as large numbers of retail investors find influence by acting in concert or following one another into a big trade. "After all, with 2.9 million followers with an average of $6,200 to invest, WSB has the firepower to move like a top 20 global hedge fund."[16]

So, what is the problem? This David vs. Goliath battle finally puts the retail investor on the same playing field with institutions they have long felt have taken advantage of the markets without any checks-and-balances, right? Wrong. Very wrong. While WSB and platforms like Robinhood have access to similar tools used by hedge funds, the difference lies in their underlying investors' sophistication. Hedge funds are required to profile their investors and ensure they qualify as an accredited investor under financial regulation laws. This essentially means that if the investor were to lose their money invested in the hedge fund, it should not put them in financial distress based on the income and net worth levels they must reach to qualify. No such standards exist for investors in Robinhood's platform or those who subscribe to WSB. Without these standards, or any requirement to educate investors regarding the risks of investing 100% of one's portfolio in a single stock (as many WSB followers posted during the GameStop trade), or other unconventional trades, there is a distinct possibility that lives will be ruined by this rampant speculative action.

This realization hit hard on February 8th when the family of a 20-year-old Robinhood customer sued the company for wrongful death, claiming their son's suicide in June 2020 was caused by a perceived $730,000 loss he saw in his Robinhood account. This loss was later determined to be an error, but not until after the boy tried contacting Robinhood customer service three times with no response. In a note to his family, the boy wrote, "how was a 20-year-old with no income able to get assigned almost a million dollars' worth of leverage?" Good question.[17]

Bitcoin and other cryptocurrencies

Bitcoin has caught the imagination of many constituencies, as evidenced by its parabolic price rise. Institutions that previously doubted the validity of Bitcoin are now making a market for it. Tesla recently put over $1 billion of its corporate cash in Bitcoin.

So, what is Bitcoin? What is a cryptocurrency?

"Bitcoin is a decentralized digital currency, without a central bank or single administrator, that can be sent from user to user on the peer-to-peer bitcoin network with no need for intermediaries. Transactions are verified by network nodes through cryptography and recorded in a public ledger called a blockchain."[18]

Do not get me wrong; there are significant advantages to the idea of a digital currency. Faster transaction times, lower costs to process for the purchaser and the merchant, a secure ledger that memorializes the transaction. All of these benefits would be great, except for one thing: Bitcoin and other cryptocurrencies are not (yet) regulated. In fact, the video on the Bitcoin website argues that not being regulated by a central bank is a distinct advantage (and selling point) over other currencies. It is no wonder, then, that Bitcoin and other cryptocurrencies have become the payment method of choice for cybercrime and other nefarious activities.

How is Bitcoin priced? "Since its public launch in 2009, Bitcoin has risen dramatically because its supply is (supposedly) limited to 21 million coins. With a limited supply, many expect its price to keep rising as more coins are mined (the process of deploying computers to solve mathematical puzzles to add new transactions to the blockchain; miners are rewarded with new Bitcoins) and as more institutional investors begin treating it as a sort of digital gold to hedge against market volatility and inflation. 'The reason why [Bitcoin] is worth money is simply because we, as people, decided it has value- same as gold,' says Anton Mozgovoy, co-founder, and CEO of digital financial service company Holyheld."[19]

Is Bitcoin an investment? We have always contended that gold is not an investment but a store of value [a currency]. I feel similarly about Bitcoin. However, the lack of regulation around Bitcoin and the cryptocurrency market should bring serious caution to anyone investing sizeable amounts in Bitcoin. In January of this year, the media focused its attention on Tether, another cryptocurrency that is currently under investigation by the state of New York. While reports are not confirmed, it seems that Tether, which claimed that each of its coins was backed by one US dollar, had massively inflated the number of coins issued to drive up the price of Bitcoin. This is quite ironic (and scary) since the supposed value proposition for Bitcoin is limited quantity, yet the massive issuance of another cryptocurrency may have driven its recent price increase. Such an example proves that there are many things about the cryptocurrency ecosystem we just do not understand.

A Parting Thought

"A lady went to her Pastor and said, 'Pastor, I won't be going to your church anymore.'

The Pastor responded, 'But why?'

The lady said, 'Ah! I saw a woman gossiping about another member; a man that is a hypocrite; the worship team living wrong; people looking at their phone during service; among so many other things wrong in your church.'

The Pastor replied, 'OK. But before you go, do me a favor: take a full glass of water and walk around the church three times without spilling a drop on the ground. Afterward, leave the church if you desire.'

The lady thought: too easy! She walked three times around the church as the Pastor had asked. When she finished, she told the Pastor she was ready to leave.

The Pastor said, 'Before you leave, I want to ask you one more question. When you were walking around the church, did you see anyone gossiping?' The lady replied, 'No.' 'Did you see any hypocrites?' The lady said 'No.' ‘Anyone looking at their phone?’ ‘No.’ ‘You know why?’ ‘No.’

‘You were focused on the glass, to make sure you didn’t stumble and spill any water.’”[20]

As we continue to navigate what will undoubtedly be a “noisy” time globally and in the investment markets, Merlin Wealth Management remains resolute in our advisory and investment process. As Adam Compton will talk more about in his MWM Market Corner, we remain incredibly comfortable with the companies we hold in our strategies and are even seeing many of these great businesses now trading at discounts to the market (a rare occurrence). Our discipline and our commitment to provide you with the best advice, service, and results will continue to be our “full water glass.”

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