

Infinite Horizon, Finite Assets

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Investing's greatest challenge

Investing in finite assets with an infinite investment horizon is one of the unstated challenges of our business. The task becomes even more difficult as the markets boost prices of assets that are not only intangible in nature, but also whose profit-generating ability is questionable or potentially short-lived.

First, some definitions. For us, an "infinite horizon" is one without a specific point in time when all investments must be liquidated and proceeds have an immediate use. We consider any asset whose eventual value is zero (or not far from it) as "finite."

If you invest with an infinite horizon in assets that will eventually expire worthless, you are facing a challenge much greater than just keeping up with a rising bull market or trailing an arbitrary index by a point or two. This is how we at Sicart look at investing, though. We help families and entrepreneurs retain and grow their fortunes over multiple generations. As much as wealth creation is a combination of skill, hard work and luck, wealth preservation is an exacting time-tested process that can be consistently repeated over generations.

In the long run we might be all dead, but our wealth isn't

John Maynard Keynes, a well-known Great Depression era British economist, reminded us that "in the long run we are all dead", and we don't argue with that, but there is a way to preserve wealth beyond our time on Earth. It is secondary whether we keep the wealth in the family or give it away. The wealth will live on, and benefit others.

As a matter of fact, all the wealth ever created, and accumulated that wasn't destroyed or lost is still around us. Its nature is infinite, though assets it is stored in are very often finite.

Investors with an infinite horizon face one big challenge that is also a big opportunity.

-The challenge is finding assets that have the highest likelihood of retaining and increasing their value over time.

-The opportunity exists in the mispricing of assets that will continue to occur as long as fear and greed influence markets. Our patient long-term perspective allows us and our clients to benefit. This is as true as it was in the mid-20th century, when Benjamin Graham, the father of value investing reminded us that "in one important respect we have made practically no progress at all, and that is human nature."

From a cigarette butt to a wide moat - the investment horizon gets longer

It was Benjamin Graham who, in the 1930s, laid the foundation for value investing. His philosophy has influenced generations of successful investors, including Warren Buffett. Ben Graham found early success in the 1920s by doing what few did at the time: he actually read and analyzed company records to establish the value of a business. He was searching for obvious mispricing. (Unfortunately,

even Graham's acumen didn't protect him from harm in the 1929 market crash, which, let us remember, led to a 90% decline in the Dow Jones Industrial Average through 1932.)

Graham's simple method was to focus primarily on the quantitative side of the businesses he studied, almost ignoring the qualitative side. He tested the concept in 1930-32 as the market sought its lowest level and published it in the first edition of his ground-breaking book *Security Analysis*. He introduced the concept of net current asset value as "current assets alone, minus all liabilities and claims ahead of the issue." Graham notably took into account only cash and assets easily convertible into cash. His definition of net current asset value excluded not just intangible but also fixed assets, including land and buildings. His investment priority was buying companies at a discount to the net current asset value - in other words, companies that were *worth more dead than alive*. Graham knew that many companies fail, and he had no intention of holding them forever. He purchased finite assets with the intention of holding them for the duration of a finite investment horizon.

Why would he do that? First, he learned the hard way, as so many investors did during the Depression. Through October 1929 companies were trading at very high valuations, assuming endless investor enthusiasm and increasing prosperity for American business. That turned out to be a recipe for disaster. Second, countless companies on the stock exchange did trade at a large discount to net current asset value, so he had ample opportunities. Third, he was more focused on wealth preservation than on phantom market gains. The economy was shrinking, deflation was rampant, and few people, in the 1930s, remained interested in stock investing.

As the economy picked up and the post-WW2 boom brought a huge demographic tailwind in the Baby Boom, the obvious mispricings that Graham sought to profit from started to disappear. His thinking evolved, and in 1974 his intrinsic value formula took into account not only earnings and growth, but also interest rates. This was a big leap away from buying stocks for less than net cash assets on the balance sheet.

It was Warren Buffett, however, who, with the help of his partner Charles Munger, successfully graduated from *cigarette butt investing* (i.e. *searching out the last puff in assets discarded by the market*) to *wide moat investing*, where the long-term earning power of companies takes precedence over liquidation value.

Over the last 50 years, Buffett's Berkshire Hathaway annual letters have taught us the importance of a lasting competitive advantage - a "wide moat" that defends a business from possible competitors. Buffett knew well that it is not enough to find businesses with fat margins. Businesses need to hold on to those margins for many decades.

This "wide moat" approach brought Buffett closer to an infinite investment horizon, which is how we at Sicart think of managing family fortunes. As a matter of fact, Buffett often says that his preferred holding period is "forever." Many of his investments not only successfully defended their market share and margins, but also grew many times over - Coca-Cola, GEICO, and American Express, for instance. Others succumbed to technological change - newspapers and textile mills are two examples. Berkshire Hathaway, in fact, originated as a textile mill, which proved to be a textbook example of a finite asset. The whole industry eventually lost the battle to low-cost overseas competitors. Berkshire Hathaway was possibly one of Buffett's last "cigarette butt" investments, held too long past the last proverbial puff.

Although Ben Graham had no interest in intangible assets like brand, Warren Buffett taught us to pay attention to the power that brands have over consumers. That's what allows businesses to reach more people, stay relevant, and most of all, charge a premium price!

Intangible economy, intangible assets

It's a long way from the early-1930s value mindset — shopping for businesses which can be bought for less than net cash assets — to taking the brand's intangible value into account. It's been a journey from "cigarette butts" to "wide moats" and now we are headed beyond that.

We consider ourselves contrarian long-term value investors, but we don't care if a company's operations rely on hard assets or intangible assets. Ultimately, we look for bargains: quality at a meaningful discount. As long as there is an existing or potential earning power, we will consider investing in a company whose only meaningful assets are intangible in nature. We appreciate the benefits of the wide moat that can be established by lasting competitive advantage derived from a brand, network effect, or scale. We also notice that companies built with intangible assets tend to require less capital and have potentially higher margins - which is music to our ears.

It can be complicated to assess how finite these assets are - what the expiration date might be. We've all had food go bad in our homes, and investing is no different. Consumer habits change slowly, and the brand value of a chewing gum can last for many decades before slowly eroding. A competitive advantage earned by technological progress reaps benefits fast, but also vanishes abruptly.

We have seen market leaders like Blackberry, Kodak or Nokia lose customers, market share, and market value in what felt like a heartbeat. That's especially dangerous for value investors who are prone to reaching deep into bargain bins and may at times pick up a "value trap" - a company that looks cheap but will only get cheaper.

At the other end of the spectrum, we see the growing importance in market indices of today's highest-valued tech stocks, and their breathtaking outperformance of the rest of the stock market in the last few years. The more they grow, the higher the market values them. It's not the first and won't be the last time the market gets excited by a new wave of fast-growing companies. Radio stocks created equal enthusiasm during Ben Graham's early days on Wall Street. Remember radios? Nothing lasts forever.

We fear that investors might be forgetting the finite nature of those fashionable intangible assets, which may be poor choices for investors with an infinite investment horizon. They might want to focus on a durable "wide moat" that can extend the life of an asset or provide enough time to exit unscathed.

The challenge of wealth preservation has possibly never been bigger.

The challenge is threefold:

- We are facing unprecedented prices in most assets around the world. Seldom has this much future earning power been attributed to not only intangible, but also finite assets; two early 18th century "bubbles" involving the South Sea Company and the Mississippi Company come to mind.
- All asset prices are denominated in fiat currencies, i.e. they are legal tender not backed by any commodity such as gold. Instead they are backed by weakening governments' power to tax an ageing world population.
- We see unsettling levels of debt at the consumer, business, and government levels.

The three challenges are entwined. And much as we appreciate the value of the intangible economy, in times like this we gravitate toward businesses with wide and *lasting* moats that are less susceptible to changes than the high-flying stars of the tech world with its intangible assets.

Creating a wide moat and retaining one are separate accomplishments. So are making a

fortune and holding on to it. Investing with an infinite time horizon, but in unavoidably finite assets poses a real though not necessarily clearly visible challenge for those aspiring to keep and grow their fortune in the long-run.