

Mental Models: Leaking Balloon or Coiled Spring?

This article by Tom Russo has been excerpted from a letter of Semper Vic Partners.

One of the most astute Wall Street professionals I have had the pleasure of spending time with over the years is Raphael Bernstein. Mr. Bernstein's decades-long involvement as a senior investment banker at Bear Stearns left him wise in the way of Wall Street. At one particular wise moment, Mr. Bernstein posed a question to me about one company whose investment performance had up to that point lagged, despite my particular interest and my passion in its "value." Mr. Bernstein asked me whether I thought the investment prospects for the company under review seemed to be more like "a coiled spring or a leaking balloon."

Clearly, my response to Raphael's question about the company whose prospects I still highly esteemed was that, without doubt, it was more the former than the latter ... a spring whose very coil promised to give our portfolio a very nice, sustained boost in performance once it began to release.

Well, much like my response to Raphael's query decades ago, today I believe that that portion of investments which I oversee on your behalf through your portfolio of "global value" equity holdings is no "leaking balloon." The portfolio, indeed, as I reflected on the promise of our companies at year-end, possessed the ability to spring sharply forward as the coil releases returns.

Indeed, I believe this to be the case because within the portfolio are concentrated holdings in leading global companies that possess the capacity to grow value during periods like the past three or four years, even when markets for whatever reason chose not to value increases in intrinsic value derived from such reinvestment. This disconnect between growing intrinsic value through effective reinvestment in promising geographies and adjacent categories can last for prolonged periods of time.

I surely believe that the past several years have been so characterized for many of Semper Vic Partners' core holdings. Equity investors have taken their eyes off specific investment in specific companies, even when those companies carefully, year in and year out, exercise their highly value-creating "capacity to reinvest." Globally, today's investors have moved increasingly in sync together into index funds, in general, and into the mother of all index funds, the Standard & Poor's 500, in particular. Investors are blinded by risks attendant to such crowd behavior on Wall Street. Induced by index funds' lure of low management fees, investors increasingly mistake low cost advisory fees with low risks. I believe that they do so at their own peril.

Capital flows into indices and as well as into Exchange-Traded Funds (ETFs), the country cousins of the big index funds, have occurred at increasing rates over the past four years. Today they reach stampede proportions. Their allure has even driven upwards the value of the US dollar since, on balance, global equity investors who increasingly have switched to US-based index funds over the past three years have had to trade in their euros, renminbi, rubles, etc. for the greenback, the only currency through which you can settle purchases of S&P 500 index funds.

This incremental demand for dollars to underwrite the purchases by foreigners of US-based index funds contributed to the very rise in the value of the dollar that has created a headwind for Semper Vic Partners' returns over the past several years. The increased value of the US dollar effectively "devalued" reported operating income sourced from abroad and "devalued" reported period-end valuations of our foreign equity holdings upon translation into US dollars.

Many of the above factors have led global investors to fear that my style of long-term, fundamental,

research-based investing, for businesses capable of reinvestment, resembles more the “leaking balloon” than “coiled spring.” The broad switch to US equity market indexation which has grown at a torrid pace over the past four years has driven capital away from the internationally based businesses that form the core of our portfolio. Capital flows from those holdings have restrained growth in their market value, tightening the coil for later springing into higher valuations. International investors’ moves into US-based equity index funds have had a secondary effect of contributing to the rise in the value of the US dollar, which I believe to represent another spring coiling for release as the US dollar, I suspect, will inevitably retrace its advance if/when capital flows return to invest in other markets.

Macro forces and global capital flows create for Semper Vic Partners reasons discussed above that I believe support the view that we possess more “coiled springs” than “leaking balloons” in our portfolio. However, despite the above macro influences on our portfolio companies’ share prices in the near term, I am nonetheless acutely aware of competitive dynamics across our entire portfolio which might lead some to believe that the very franchises which I have preferred to invest in over decades may themselves be once grand balloons that now leak. I am acutely aware of such threats to our branded consumer products companies’ long-standing, durable “competitive moats.”

The world is evolving so dramatically and along so many different axes that investors absolutely have to be sensitive to the increased probability of risks of “leaking balloons.” One need only consider some of the following realities that our portfolio companies confront. For investors who prefer consumer brands, due to their historic ability to invest mature market free cash flow to expand their franchises into emerging markets, and due to their ability to take advantage of latent brand appeal to offer increasingly within arm’s reach products that enhance consumers’ lives, the world seems to present increased risks, some of which are discussed below.

First, there is the risk of digital dislocation and disruption. Consumers today, especially trendsetting younger consumers who historically have been first adopters of products introduced around the world, are increasingly influenced by trends of social media. Their brand loyalties are less gripping. Gone are the days, for instance, when Budweiser represented over 55 percent of the US domestic beer consumption. Today, in fact, brand Budweiser may have dipped below 20 percent in some trendsetting California markets, like San Diego.

Second, the ability through e-commerce to access alternative products outside the tight channel of traditional routes-to-markets allows competitors’ products to enter markets once blocked to them. Alibaba Group, Amazon.com, Inc., and others will make sure that such products can find their consumers.

Third, economies around the world, especially developing and emerging markets, confront a host of pressures not felt to this extent over the past thirty-plus years. Indeed, during the first thirty-plus years of my career in investing globally, I have had the blessing of a gentle tailwind. Governments around the world were increasingly transparent. Consumers around the world enjoyed growing Gross Domestic Products (GDP) per capita and growing consumer disposable incomes. Relatively borderless trade around the world offered first-time prospects of work, with concomitant ability to purchase long-admired and aspirational products but heretofore unaffordable and inaccessible.

Finally, there is the very real possibility of increasing political fraying of many of the multilateral agreements and global alliances, upon which we have rested for post-World War II global balance, which have begun to be unwound. We have absolutely no idea either how far and fast such unwinding will go or who will benefit and/or lose from such developments. It is clear, however, from my perspective, that we are entering into the most disruptive and unconventional period of time economically, politically, and socially that we have seen in the modern era. The prospects alone of resettling over 10 million refugees adrift due to just the past five-year’s worth of Middle East conflict

dwarf imagination when trying to consider how societies will absorb such demographic disruptions. Borderless trade of consumer products, which formed the basis of great gains for our portfolio companies over the past three decades, seems to be potentially a victim of rising nationalism and potentially restrictive trade policies.

Despite possible threats alluded to above, I do take comfort on several levels that our holdings will continue to balance risk and reward as effectively as I can find amongst the seemingly endless other investments available.

I base my continued enthusiasm for the “coiled spring” that is our portfolio on several broad fronts. First, I return to core values which, in my case, have typically been borrowed from experiences expressed by Warren Buffett. In this case, as the list of uncertainties described above mounted, I continue to fall back on Mr. Buffett’s observation about the political, economic, and social upheaval he confronted back at the dawn of his investing career. There were countless reasons why not to invest at that time, but Warren suggested that rather than retreat to cash he simply sought best investments possible to confront the risks head-on and attempt to eke out returns. He fondly observes that, had he waited for green lights for all three components of risk discussed above, he would still have his first \$10,000 waiting to be invested.

Second, I comfort myself on the ability of our companies to react. This statement is particularly true, for instance, in our business’ growing willingness to respond to new business practices, consumer preferences, etc. shaped by the digital revolution underway in consumer products companies. Compagnie Financière Richemont SA, for instance, recently announced strategic partnership in China to engage Tencent’s WeChat subsidiary to power up one aspect of their digital commerce strategy in China. China has begun to experience sharp recovery in demand for Richemont’s aspirational jewelry, Pernod Ricard’s cognac, etc. Similarly, Nestlé’s diverse product offering featured this past year, on an exclusive Alibaba site, a dedicated range of offerings that celebrated Nestlé’s 150th anniversary as a company.

Our portfolio companies increasingly have to obsolete their own long-standing consumer brands by launching their own craft and artisanal competitive products, realizing that no one should be better to take share from the market leader than themselves. Philip Morris’ recent launch of its highly disruptive product, IQOS, provides a great example of this phenomenon. Finally, all of our companies are invested deeply into new ways of consumer communication, relying on new digital campaigns, new sampling campaigns, new direct-to-consumer marketing through high-touch human interaction, etc.

Third, I comfort myself on the very reality that for every country in political, economic, and social free fall, there are counter examples of companies coming out of darkness. Even while Turkey, Russia, Venezuela, Syria, North Korea, etc. descend into political and economic turmoil, other parts of the world advance. I am particularly mindful of two of South America’s most long-standing, dysfunctional, and corrupt countries, Brazil and Argentina. It is impressive to think that they have, for the first time in decades, seated governments that have come to power by popular vote with a clear mandate to rout out corrupt practices that have held both countries back for decades. It is the same within many of our companies who, despite having products or geographies that suffer setbacks, enjoy a portfolio breadth and geographic breadth that allows for other regions to advance, often allowing our companies to more than make up for setbacks elsewhere.

Finally, I take comfort from our companies’ long-standing competitive advantages, realizing that brands that deliver billions of servings a day do enjoy the benefit of consumer long-standing habit and preferences. I take comfort from the fact that the problems which will confront the world, most notably population growth and scarce resources such as food and water, are in the sweet spot for our portfolio companies that in most instances possess global leadership in important areas of corporate

social responsibility. They express that responsibility themselves by innovation into best corporate practices that address local needs, reduce harmful byproducts of their businesses, and increasingly attend to shared programs with local governments to address their consumers' needs in environmentally safe and sustainable fashion.

Our portfolio companies in Nigeria, for instance, will bring the scale and insights of their products over the coming years that will help them build from their already enormous base of business today to meet the demand if indeed the population of Nigeria does grow from 190 million people today to over 500 million in two decades. Nestlé and Unilever, with affordable food services through their Maggi and Knorr brands, will deliver food and nutrition economically around the world in markets like Nigeria, India, China, etc. Nestlé, for instance, sells over 80 million Maggi bouillon cubes a day in Nigeria!

Moreover, they will be able to provide solutions on vast scale that will be demanded of them as they alone will likely have the capacity to develop solutions required to deliver food, beverages, and branded consumer products to increasingly urban societies. The world will become far more populous, far more urban, and far younger, on average, over the coming decades. I prefer confronting those problems and challenges by investing in companies with vast reach such as Nestlé, who operates in over 125 countries, with a workforce exceeding 300,000, with unrivaled primary research in food, health, and nutrition, and secure in its mission to source health and nutrition solutions worldwide.

On a final note, I believe we are privileged to approach the threats of "leaking balloons" that arise due to a handful of challenges described above and countless others not addressed herein with a portfolio of company managers who approach our companies' ability to navigate the challenges described with world-class alignment of interests and low agency cost risks. Even though I recognize how hard it is to oversee companies with such global scale, I am sure that the corporate cultures with which we address those challenges are amongst the best. Though occasionally cultures may fall from their own illustrious past (e.g., Wells Fargo's recent cross-selling compensation snafu), I believe that the focus on the long term (most notably in our family-controlled companies) and the capacity for managements to not have to do what is asked of them by short-term-minded financial world participants position us well. We can rely on our preferred management bench to meet challenges that all too quickly can convert "coiled springs" into "leaking balloons" if our corporate focus and cultures were to weaken.