

Some Thoughts on Downside Protection in Investing

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I want to share some thoughts around how we think about downside protection at Billinger Förvaltning. Like most significant ideas we have adopted as part of our process, this is based on various adaptations of thinking around downside protection by investing greats, including Warren Buffett (“rule number one, never lose money; rule number two, don’t forget rule number one”), Charlie Munger (“invert, always invert”), Mohnish Pabrai (“worry about the downside, the upside will take care of itself”), George Soros (describing his big bet against sterling as low-risk despite the significant amounts of money and high leverage involved), as well as thinkers like Karl Popper (the scientific method and the concept of falsification) and Nassim Taleb (“via negativa”, etc).

Foundations

A number of elements form the foundations for this kind of thinking, in my view.

At its most basic level, the foundations are formed by the scientific method proposed by Karl Popper and others, which views falsification as central to any type of scientific enquiry. While it would take a great leap to label investing (and, in particular, equity investing) a scientific endeavour, I think any process that aims to be robust can benefit greatly from adopting this way of thinking. Essentially, we start out by looking for flaws in any potential investment case and, only once we have failed to detect any obvious issues, will we move on to considering the upside potential. What we really want to find in an investment is limited downside and unlimited or at least very significant upside. This may sound like common sense but I would argue that in the world of institutional money management the emphasis is on large potential gains more than anything (recall the number of times you have sat through “best ideas” presentations where all that seems to matter is the percentage upside potential for the stock in question in a “blue sky” scenario without any regard to the potential downside).

Looking at the world around us and evolutionary processes, there is also another key argument for applying this kind of thinking, which has to do with survival. For anyone looking to compound capital over a long period of time, the number one consideration has to be to stay in the game by not blowing up. Much of modern portfolio theory is based on thinking around cross-sectional returns (e.g., the average return for fifty money managers during a year) rather than time series returns (e.g., the average return for one money manager over fifty years). It is all very well to say that equities return say 10% annually *on average or as an aggregate* but this is only relevant for those investors that have managed not to blow up. The average number is not relevant for a time series that includes a zero (i.e., a blowup) anywhere along the way.

There is also the fact that our ability to forecast anything to do with meaningful drivers of equity returns is limited at best. Our solution at Billinger Förvaltning to this problem has not been to attempt to improve our forecasting but rather to limit our exposure to any forecasting errors through a number of measures outlined below, all with the ultimate aim of creating redundancy in our investment process and its resulting portfolios.

The ultimate test, though, is that this approach seems to work, for us and for others. I am not suggesting, of course, that it is a universal truth in investing. All we can claim is that with our

structure and temperament, trying not to lose money is a sensible approach.

Aspects of downside protection

In the following I want to describe four aspects of how we aim to achieve downside protection in our portfolio.

1) Security selection

First, we have chosen to invest in the equity part of the capital structure as we find the asymmetry between downside and upside appealing.

What we then effectively do is to invert the investment problem i.e. how do I lose money on this investment? We can then figure out ways of hopefully avoiding such losses. The idea here is that *not losing money* is the best way of *making money*. For instance, if I think up a business that would be likely to result in losses over the long term, I would probably imagine a business with no moat or real competitive advantage (e.g. selling a commodity product), highly cyclical revenues, a significant fixed cost base (which in combination with volatile revenues will result in periodic losses), high financial gearing (which together with the above increases the likelihood that we will end up in financial distress), lack of liquidity in the shares (so that we are unable to exit the position without incurring significant losses), etc.

When we have identified businesses within our circle of competence, we can apply the above inverted thinking and analyse these businesses through several lenses to try and make sure that they are robust by displaying the opposite characteristics, e.g.:

- Revenues (we look for diversified revenue streams, recurring revenues, limited cyclicity, low exposure to potential technology disruption, etc)
- Cost structure (we look for flexibility/limited operating leverage)
- Balance sheet (we look for strong balance sheets, limited complexity in terms of the capital structure, etc)
- Governance (long-term owners, often in the form of families, tend to focus on the survival of the business; their primary focus is preserving the business for their children and beyond)

In addition, we want the companies we invest in to be time-tested with long track records across different types of environments, etc. The reason for this is that regardless of the amount of work and analysis we perform on a business, time is a much better arbiter of its ultimate durability, often through filters that are not visible to us as investors. This is a case of what Charlie Munger would probably refer to as “looking at what works and what doesn’t, and why”. I also come to think of Terry Smith of Fundsmith who often likes to say that, “we are not trying to pick the next winner, we are looking for businesses that have already won”. There is valuable information in a company’s paper record, and we like to use that information as much as we can.

Overall, this would tend to lead us towards “good” companies for which time equals optionality. In fact, I often find that a useful way to identify ‘good’ companies is to look at whether a business has a history of throwing up positive or negative surprises; good things tend to happen to good companies. In my view, this is really what Buffett is getting at when he says that ‘time is the friend of the wonderful company and the enemy of the mediocre one’. One of the advantages that I find in this approach is that we end up invested in businesses that create value (e.g. as measured by a high return on capital) in almost all environments. Looking at track records over the 2008-2010 e.g. can be very instructive; most of the businesses that I would classify as ‘good’ generated healthy returns on capital also in this kind of environment. What this does is to reduce the importance of timing in our entry into

an investment (a poor business could e.g. find itself in financial distress or even bankruptcy in a 2008-2010 scenario and we would need to know “when to own it” rather than just own it over time).

Other advantages are that we find these robust businesses are easier to value (partly due to the fact that their earnings are less volatile and therefore a more solid foundation for working out the earnings capacity and present value of the business) and easier to operate for management (in terms of resourcing/budgeting, managing the balance sheet/leverage, etc).

Some examples of businesses that we feel meet many of the criteria listed above would be found in consumer goods (e.g., beverages, luxury goods), engineering (e.g., elevators and escalators), TIC (testing, inspection, and certification), and real estate.

2) *Portfolio construction*

Once we have identified suitable securities, we combine them into a portfolio. No matter how much work we do, there will always be unknowns and factors beyond our control. We try to manage this exposure by *some* diversification. This needs to be balanced against the risk of *excessive* diversification with the potential for dilution of our best ideas, difficulties in keeping on top of all of our portfolio holdings, etc. In our case, this means holding around twenty positions at any time across different industries and geographies.

Beyond diversification, we also want most of our holdings to be relatively liquid. This gives us a “right to change our mind”, whether because our analysis was wrong or because new facts emerge.

At the portfolio level, we want to maintain financial flexibility, which means avoiding leverage as much as possible.

In terms of position sizing, we like to build positions over time as we get to know a business better and as its track record builds. I like the way the great Tom Gayner describes the gradualism that is practised at Markel by the expression ‘crawl, walk, run’; this is what we aim to emulate.

3) *Structure*

The idea of downside protection and the approach I have described cannot be seen in isolation from the vehicle through which we aim to implement it.

First, we need to consider asset/liability matching. In mutual fund terms, the liability will be in the form of potential redemptions from investors, which will often make it difficult to implement a strategy that focuses on downside protection first (there is pressure to perform on a quarterly or even monthly basis and therefore to look for “triggers”, etc).

We have chosen a structure with permanent capital in a private environment which is well-aligned with our long-term approach and focus on downside protection. I also think having a simple organisational structure helps.

4) *Process*

In terms of daily activities, one important way of building optionality into one’s business is to allow plenty of time for reading and thinking. While we do see a meaningful number of companies each year, we try to keep our diary as free as possible (think of Buffett and his “haircut days”).

We also aim to learn and improve through identifying and analysing investment mistakes. This is an important aspect of robustness, i.e., improving over time. One especially productive way to

incorporate mistakes into the process is to use investment checklists based on previous mistakes, e.g., leverage, technology risks, and governance issues.

Crucially, in an activity as inherently uncertain as equity investing, we should be prepared to reassess our positions, financial and otherwise. As an example, consumer staples has historically been seen as a defensive, safe place to invest for the long term. Is this still true given the suggested rise of challenger brands and private label, changes to the distribution model, etc? My answer is “I don’t know”, but I believe there are still parts of this industry that offer rewarding long-term investment opportunities. What I do know is that we have to constantly reassess this view, and this in fact takes up much of our time. Most businesses end up in the “too hard” pile.

Conclusion

Investing, especially in equities, inevitably exposes us to uncertainty. While the approach I have described will not allow us to avoid mistakes and losses, it does seem to offer us a reasonable chance of growing our capital in real terms over the long run with limited risk of ruin.

There are certainly relevant questions to ask around the types of positions that result from this approach. Are time horizons compressing with regard to great businesses remaining great? Perhaps. Have some great businesses become overvalued, at least temporarily? Perhaps. However, I firmly believe this is the best we can do in attempting to grow our capital over the long run given our setup and temperament. This is not to suggest that it is an approach that is universally appropriate, but it suits us well.

What we are really trying to achieve is to avoid being ‘obviously stupid’ rather than trying to be smart. We are not ignoring the potential upside of an investment but want to do everything we can to limit the downside first.

I haven’t really mentioned valuation. That is by design; while most institutional investors focus more on valuations/ratings (than the quality of the business) as these often drive returns over the kind of time horizons that the industry focuses on, we believe that over the long run returns will be determined by the trajectory of the underlying earnings capacity of the businesses we own. Thus, while valuations matter, to us they matter a lot less than the characteristics of the companies we invest in.

Looking at all the above aspects and more, we are trying to add layer after layer of redundancy to “build a fortress” that will last a long time. Being in the game a long time really matters in investing.

I do identify with how Tom Russo describes his investment approach, which is that of a farmer rather than a hunter. This idea of slow, gradual accumulation suits us well. Over a long enough period of time, we are hopeful this will result in rich harvests.