*This article is authored by MOI Global instructor Matthew Sweeney, founder and managing partner of Laughing Water Capital, based in New York.*

Broadly speaking, our portfolio is comprised of two major investment archetypes: compounders and special situations.

In brief, compounders are businesses that can achieve supranormal returns on invested capital for long periods of time due to some combination of competitive advantages and/or extraordinarily talented management teams. Compounders typically justify a high multiple due to some combination of a predictable business, a longer runway to reinvest in the business at high rates of return, or the ability to return capital to shareholders. Identifying a compounder that is suitable for investment typically depends on identifying a great business and management team that are *even better* than the market realizes. As these are great businesses by definition, they will rarely appear cheap on any traditional metric outside of recessionary periods.

Special situations are investments where the business and management may be of lesser quality, but the opportunity exists less because of identifying a gap between the quality of the business and management vs. expectations, and more on identifying some failing in human nature or market structure that creates a mispricing. In the best cases, we will be able to find future compounders today, when they are available at special situation prices.

In the long term, I expect that our portfolio will increasingly tilt toward compounders. However, at the moment, our portfolio is tilting increasingly toward special situations. There is nothing wrong with this per se, but special situation investing will be less tax efficient, and has the unfortunate problem of requiring re-generation because unlike compounders, special situations are best sold when the temporary conditions that led to the mispricing have passed.

There are a number of reasons for the current tilt. First, in my view it is often more difficult to successfully identify compounders than special situations. Betting on a compounder can be thought of as betting that a company can defy the destructive forces of capitalism. Betting on a special situation can be thought of as betting that irrational behavior will eventually be replaced by rational behavior. I believe that betting on the return of rationality is simply a lower bar to step over.

To illustrate how difficult it is to successfully identify great businesses that are better than the market realizes, consider that in a recent interview, John Malone, Chairman of the Liberty Companies and easily one of the greatest investors of all time, told a story of how he advised Warren Buffett, literally the greatest investor of all time, to not invest in Microsoft, one of the greatest companies of all time led by one of the greatest entrepreneurs of all time, during its early days. If you are keeping score at home – that is one of the greatest, telling the greatest, NOT to invest in one of the greatest, led by one of the greatest. Buffett himself admits this was a colossal error of omission, and should be enough to cause any mortal to think twice before claiming they have found a business and management team so good that they are worth paying up for.

Second, special situations often resolve themselves over a defined – often short – period of time, independent of what the broader market does. To be clear, time is the friend of great businesses, which allows one to pay higher prices, but in today’s environment where we are likely closer to the end of the economic cycle than the beginning (although it can certainly continue longer than anyone expects), I believe it makes sense to tilt the portfolio toward shorter duration opportunities that are likely to be somewhat removed from broader market action.

Third, investing in special situations ties well with the competitive advantages we have as a small firm. For example, while Buffett evolved to focus primarily on compounders, when he managed smaller amounts of capital, he largely focused on special situations. Simply stated, there is often less competition investing in small special situations than there is when investing in larger compounders.