

Two Components of “Edge” in Investing

This article by John Huber is excerpted from a letter of [Saber Capital Management](#).

Every so often, it’s helpful to outline Saber’s basic philosophy. Since we have a number of new investors who have yet to be indoctrinated, I thought it would be a good time to make a few comments on our approach.

Saber’s investment strategy focuses on making carefully selected investments in high-quality businesses at attractive prices. This ubiquitous description of a well-trafficked investment philosophy does not take away from the soundness of the approach, nor does it compromise our ability to capitalize on its merits, for two main reasons that I’ll describe below.

Some of the key tenets to my investment approach are:

- Understanding the business model and how a company makes money
- Considering the value customers place on a company’s product or service
- Focusing on durable businesses with predictable cash flow
- Preferring a management team that thinks and acts like owners
- Demanding an obvious gap between price and value (margin of safety)

When it comes to stocks, simplicity and common sense work well. I try to focus on restricting our investments to companies that implement a business model that makes sense to me. I want to not only understand how the company makes money, but I want to understand the value proposition it offers its customers. Good businesses have good economics such as high returns on invested capital and consistent free cash flow, but they also provide a product or service that offers value to the buyer on the other end of the transaction (the customer).

As I’ve learned over the past few years watching debacles such as [Valeant](#) and [SunEdison](#), a business with good economics that is coupled with a business model that extracts value from its customers (rather than adds value to its customers) is not a good business. The financial metrics might appear attractive, but a parasitic relationship with customers usually ends up destroying shareholder value at some point. So guarding against this type of business risk is a major focal point at Saber.

Also, while my twin two-year olds would quickly challenge this assertion, sleeping well at night is a must, and so I like businesses with strong balance sheets and preferably without much debt.

And since my economic crystal ball has never worked well, I look for durable businesses that can withstand a variety of economic headwinds, which are certain to occur over time.

Two Important Advantages (Our “Edge”)

Finally, I believe there are two requirements in order to implement this approach successfully:

- Maintaining a long-term time horizon
- Focusing on only the very best investment ideas

Both principles are often preached, but very rarely practiced. Institutional constraints and good old fashioned human nature can make it very difficult to actually utilize those two advantages. This difficulty is the reason the advantages exist, and I believe—since human nature is here to stay for a while—these advantages are permanent for those who can capitalize on them.

The Long-Term Advantage

The first is to maintain a long-term time horizon, which I believe is now a bigger advantage than ever. Fifty years ago, the average stock was held for 14 years—today it is disposed of after about 11 months. The short-termism that is pervasive in the stock market creates lots of irrational buying and selling for all sorts of reasons that have everything to do with the short-term direction of the stock, but nothing to do with long-term value of the business. By the very nature of the ever increasing focus on the next quarter, I believe this long-term mindset—when actually implemented—is a sustainable advantage, and one that is likely to strengthen over time.

Technological innovations over the years have vastly increased the breadth of available information, the speed at which the information travels, and the ease with which that information can be obtained. With so much human and physical capital spent on trying to gain an information advantage, it's best to bypass that short-term focus completely, and quietly consider the bigger picture. This helps identify the key variables that really matter, and those variables are rarely the consensus estimates for next quarter's EPS or the decimal-point accuracy of the gross margins.

Predicting an acquisition based by tracking the cities that an acquirer's executive airplane travels to, or using satellite imagery to track the number of cars in a retailer's parking lot to better predict this quarter's revenue numbers (two things hedge funds have done recently to try and gain an information advantage) is not a game that I can (or desire) to play. But the fact that so many resources are focused on competing in this short-term arena leaves an opportunity for those who can look out past the noise and think about the situation from a different view.

Capitalizing on others' desire to avoid volatility is what makes this strategy work. Dealing with this interim volatility is the price of admission, but it's more than a fair trade.

Waiting for Great Ideas

"I just wait until there is money lying in the corner, and all I have to do is go over there and pick it up." -Jim Rogers

I've always felt that Rogers, who helped build the foundation for one of the greatest investment track records in history during the 1960s and '70s, perfectly encapsulates this second main pillar of my investment approach: **do nothing until there is something really obvious to do.**

Charlie Munger said that it isn't possible for humans to know "everything all the time". But, he said, it is possible to occasionally find something of value. When that happens, it's important to capitalize on it in a big way. But the other variable to this equation that is

probably even more important is to avoid investing in less-than-great ideas just to fill out a portfolio or meet some sort of arbitrary quota for diversification.

The benefits of focus investing are well known (and talked about ad nauseam), but there is a dichotomy between what investors say and what they do. Portfolio managers have a bias toward activity to justify their high fees. They also would much rather act conventionally (make frequent investments and own lots of stocks) than risk their jobs. The drumbeat of “what have you done for me lately” is very rarely muted in professional investing circles. Unfortunately, individual investors succumb to many of these pitfalls as well. This conventional wisdom is like a powerful magnet that eventually attracts most market participants. Social proof is a powerful force.

Everyone knows that to obtain results that are different from the crowd, you must behave differently than the crowd. But the reality when it comes to performance is that 90% of the people will make up the bottom 90%. I think it’s imperative to recognize the reasons why this is the case, especially since we desire to be among the 10% of the people who are in the top 10%.

I really believe that, unlike in years past where investors’ main advantage was finding hidden gems or uncovering information that others didn’t have, the biggest advantage today is to leapfrog the short-term noise by maintaining a multi-year view and to patiently wait for great investments to present themselves.

Disclosure: Returns are based on the “Saber Capital Portfolio”—a real money account that is managed alongside all other accounts. I also refer to this as Saber’s model portfolio. Performance data of this account is produced directly from Interactive Brokers. Returns are not audited. It is important to note that each client may experience slightly different results from the model depending on the timing of deposits, withdrawals, the opening/closing of the account, the fee structure specific to each account, other timing issues, etc... The valuations of your investments at the time of purchase may be significantly different than the valuations at the time of purchase in the model because of these timing issues. I expect the net results of the model account to roughly equal the results of client accounts over time, although there can be no guarantee because of the timing issues referenced above. The gross returns of the Saber Capital Portfolio are taken directly from Interactive Brokers. The net returns are estimated using a 1% management fee and 15% incentive fee. Your net returns could vary from the model depending on the fee structure of your account. Your personal account statements with your account specific performance net of all fees will be coming in the mail each quarter, and can also be accessed anytime online. Please note that any performance fees earned during this year will show up in the following year’s 1st quarter’s statement. Also note that the time weighted return (TWR) on your account specific performance summary is net of all fees.