Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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NET ASSESMENT

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Year to date (12 Dec 2022), the S&P 500 was down approx. 16%. The Energy and Materials sectors returned 54% and 10%, respectively, whilst Utilities, Consumer Staples, and Healthcare were flat. Industrials and Financials were down between -5% and -10%, and Technology, Real Estate, Consumer Discretionary and Communications were down between -24% and -35%.

In Michael Mauboussin's book, "More than you Know" Chapter 2, he compared the common traits of fund managers that had beaten the S&P 500 index (the 'competition' for active fund managers) over a reasonably long-term horizon and identified four attributes common to all of them. Specifically:

- Portfolio turnover: the successful fund managers had an average holding period of about three years versus less than one year for the average fund in the sample.
- Portfolio Concentration: the long-term outperformers tend to have higher portfolio concentration than the index.
- Investment style: Most of the above-average performers espouse an intrinsic value investment approach – i.e., they seek stocks with prices that are less than their value.
- Geographic location: only a small fraction of the high-performing investors hail from the east coast financial centres such as New York.

I would add an attribute that most successful fund managers don't consistently outperform every year in the analysis period.

In a recent publication titled "The Triumph of Experience Over Hope" by James Bullock of Lindsell Train, a fund manager I greatly admire. He asked the question if it was reasonable to have an investment strategy such as theirs of low turnover, very highly concentrated portfolios and where over half their portfolio's stock holdings are over 100 years old when empirical evidence shows that the average life expectancy of firms is between 15 to 20 years. He found that based on a normal distribution, the exitance of such companies, i.e. over 100 years old, was virtually a statistical impossibility. However, he went further to show that a power law can more realistically model the average life expectancy of firms. This implies that whilst very unusual; there are indeed some companies that can attain such high life expectancies. Michael Mauboussin has also investigated this phenomenon, where he found that power laws applied to the frequency and size of companies, i.e. lots of small-cap companies and few large-cap companies. Identifying the common traits of these 100-year-old companies is thus the key to predicting the longevity of such companies.

In James Bullock's opinion, he believes the key feature is that those companies generally possess what Warren Buffett termed a "moat".

These companies have something that endears their customers to their product or service and ensures that the return on invested capital does not regress to the mean

(a valid economic principle, that, by and large, applies to most companies but not to a handful of them).

In summary, for an investor to do better than average (i.e., outperform the index), it is necessary that they identify the things that give the highest chance of success and avoid the things that detract from them. Specifically,

a concentrated portfolio allows the fund managers' highest expected value options to have the most impact on the portfolio,

identifying those companies that have high returns on invested capital and can employ their retained at those returns and who have a "moat" are most likely to both grow in size and high a longer than average life expectancy. Finally, a long time horizon assuming that the previous assertions are correct will allow compound interest to work its magic.

Three fund managers I greatly admire and have been following rather closely over the last few years adhere to the principles I believe apply to successful investment. Unfortunately, this past year has been brutal to the relative performance of their funds. The two fund managers have stuck to their investment principles and in reporting their performance, they have focused on the performance of their underlying business, which has done rather well, all else considered. The other fund manager, on the other hand, seems to be digressing from their stated investment principles to try and capture the perceived opportunities presented by the spike in oil and commodity prices this year, irrespective of the underlying structural fundamentals of their business – something that I believe is wrong and will likely lead to a poor result.

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Strong Roots, Sustainable Growth

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