We'd Rather Not Sleep

There is a tilt in our portfolio toward value stories where we think the consensus investor is biased against processing improving fundamentals. That said, we're happy to own any name along the spectrum of consensus sentiment, and even the rare "expensive" story, so long as each investment case has idiosyncratic fundamental features that we believe are materially better than consensus expectations. In its essence, our process insists that we have some sort of distance between ourselves and what we believe to be the market view; and a belief that the market view will eventually change. Hopefully, this process will continue to enable us to generate significant alpha across our concentrated portfolio of individual equity securities.

Some investors are drawn to different types of ideas. Some may like to own high-visibility business models, with obviously compelling characteristics, and little regard for consensus expectations or the views of Mr. Market. In other words, some investors really like to sleep well at night.

We don't like to sleep well at night.

If we are too comfortable, we are consensus, and we lose. That is the nature of this game; if we aren't agonizing over an investment, then it isn't risky, and if it isn't risky we can't generate excess returns. This is especially important to consider during times of market distress.

In fact, we have a fundamental problem with investors that ignore fundamental expectations. If stock prices are reflecting views of the consensus investor (and they are) then the only way to have a chance to generate alpha is to own a different portfolio than Mr. Market owns. That's just math. To do so with the most potential risk per unit of reward, we must own securities where we have a view on fundamental developments that conflicts sharply with that of Mr. Market, and we must be more right than we are wrong.

A necessary ingredient…

Sure, some managers might have a "strategy" where they hold "good companies" at any price, hoping that others will one day decide to pay even higher multiples for these same "good" companies – but as we have said many times, we just don't think that market-timing is a skill that many have.

And let's be clear, if you own a nice bond-proxying, high-quality, defensive, secularly-growing name with a PEG of 3x at 25x earnings, you aren't picking stocks, you are playing top-down themes, and market-timing. You are hoping that interest rates stay low, and that the consensus investor will not only continue to be comfortable paying high multiples to sleep easy at night, but that the consensus investor will need to pay even higher multiples for these same obviously good stories tomorrow. Granted, those types of stories have worked well for a few years now, but we've been in this business long enough to know that they work until they don't. And when they don't, Mr. Market will lose his wits, because he is used to getting a lot more sleep.

Do we care about moats, margins of safety and high-quality businesses managed by CEOs and CFOs with strong character? Of course we do, but we also know there is a price for everything. We agree with Benjamin Graham in that regard.[1]

So, even if a company has an unregulated monopoly, and an iron-clad, sole-sourced, riskless 100 year contract to deliver these goods to inelastic consumers in Boston, Frankfurt, Greenwich or Mayfair; and even if the management of that company consists of a resurrected Mother Teresa, Martin Luther King, Mahatma Ghandi, Winston Churchill, and Nelson Mandela, it can still be priced wrong.

[1] *"The current market price already takes into account the consensus of opinion as to future prospects." Security Analysis, 1934, page 614.*
"Nearly every issue might conceivably be cheap in one price range and dear in another." Security Analysis, 1934, page 22.
"A stock may have investment merit at one price level but not at another." Security Analysis, 1934, page 55.

There can still be too much risk given the likely reward of ownership. Nothing is a buy at any price, and nearly everything is a buy at some price (again, see Graham).

We do not own a portfolio of unlisted, private investments. We do not own companies for which there has been no price discovery, with such a price set by Mr. Market. We do not own companies where we cannot find a divergent view between Alpha Europe and that of our enemy, the consensus investor. Our task, and our goal, is to engage in battle with our opponent, and to consequently (we hope) generate significant alpha in the process. To do so requires us to be successful in two simple areas:

We must expertly and rigorously analyse and predict company fundamentals, and do so objectively; and we must discover a behavioural bias that is preventing Mr. Market from doing the same.

If that sounds simple, that's because it is. The work required is onerous, arduous and time-consuming, and de-biasing ourselves is a difficult pursuit that requires constant attention; but these two basic rules of engagement are fairly straightforward. As our process plays out, we expect to lose a few battles here and there, but hope to win the war.