[*Saturday, October 20th – OTC Markets (OTCM) by Philip Hutchinson*]

[*Episode #66: Checking Stock Prices, Detecting Frauds, Avoiding Behavioral Biases, and Other FAQS*]

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"Rearview Mirror Risk"

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To Focused Compounding Members:

On last Wednesday's podcast episode (#66, there's a link at the top of this memo), Andrew and I went over the email questions I get asked most frequently. I get a ton of email questions. And the tenor of these emails – like a lot of things in investing – is cyclical. I started my blog – ***gannononinvesting.com*** – back in 2005. I've been getting email questions ever since. One of the most common questions I get today is whether the questioner has been too conservative in avoiding certain kinds of seemingly riskier compounders. This is very different from the email questions I got in 2009. I got more than one email question that year asking if a true value investor could ***ever*** own a bank. After all, Warren Buffett's rule #1 is: "Never lose money". But, in recent months, I've gotten questions asking if it was a mistake to have avoided some specific leasing companies, subprime auto companies, and banks involved in construction lending simply because the investor sending the email did not understand the business model or the accounting well enough himself. But, he did trust management and management's amazing track record. There are people who invest as much in managers (the "jockey") as businesses (the "horse"). I'm not one of them. But, there are plenty of cases where betting the jockey paid off. In the 1960s, Berkshire Hathaway wasn't the right horse to bet on. But, Warren Buffett was the right jockey. Academics talk a lot about risk adjusted returns. I don't. But, I still do believe that two stocks – or two portfolios – that have both compounded at 20% a year over the last 5, 10, 20, or 40 years may not have taken the same amount of risk to achieve that return. Looking back – we can see that some portfolios do take more business risk than others. Other things equal, a less leveraged portfolio took less risk than a portfolio full of debt laden companies. And other things equal, a less cyclical portfolio took less risk than a portfolio that got all its winners from the same boom. A business that trades at 10 times EBITDA with 5 times EBITDA in debt has much less of a margin of safety (only 50% of its business value comes in the form of the equity you – the shareholder – own) than a business that trades at 10 times EBITDA with zero debt. This kind of risk will show up in the volatility of the stock. The volatility of a security is a symptom of risk. Consider the case of Hostess Brands. That business has debt, common stock, and warrants. The price of the debt will be the least volatile, the price of the common stock will be more volatile, and the price of the warrants will be the most volatile. If you believe in Hostess Brands as a business – if you think Twinkies, CupCakes, DingDongs, and Zingers will gain market share – you are best off buying warrants. But, even if those warrants work out over the next 3 years and you make 30-40% a year as they rise from say $1 to $2.50, there's no denying you've taken a bigger risk than if you'd owned the common stock or the debt. It's easy to see this risk even in hindsight. The risk of owning a warrant (an option) is very visible. It's much harder to see the risk you take when betting on some company's overly aggressive business model. Today, a lot of the email questions I get are about companies with aggressive business models that produced some amazing returns in their rearview mirror. But, before you go out and buy those stocks – do your best to measure how much risk was taken to generate that past performance. Whether or not that past performance carries on into the future – the risk in the company's business model will be there while you own the stock.

To learn more about our managed accounts, call or text Andrew at 469-207-5844 or email him at info@focusedcompounding.com

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