December 22nd, 2018

To Focused Compounding Capital Management Clients:

There is nothing of note to report in your accounts. We sold off one position to start making room for a new position – or, possibly two new positions. However, we have not put in any bids for totally new positions yet. We (very recently as of the time I'm writing this letter) were topping off a position that is already one of your biggest. So, perhaps I should talk a little more – as I have in nearly every letter so far – about concentration and diversification.

Expect individual positions in your account to be no smaller than 10% of your total account and no larger than 30% of your total account. I say "expect" because sometimes you will see positions fall below 10% or rise above 30%. However, the buy rule to keep in mind is that we will stop buying a stock – no matter how much we like it – once it reaches 30% of your account. And the sell rule to keep in mind is: if we sell a stock to bring it below 10% of your account, we will probably continue to sell that position till it becomes 0% of your account. We aren't interested in keeping 3% or 5% positions. Their performance – good or bad – simply won't move the needle for your account overall.

And, on the other side, we do have limits to how much we are willing to concentrate even in the right stock at the right price. Nonetheless, the primary goal is not diversification. The primary goal is getting as much of your money in the "right stocks" at the "right price". For the word "right" read: 1) safest, 2) cheapest, and 3) best businesses we can find.

An ideal portfolio would have 4 stocks: 30%, 30%, 30%, and 10%. Do I think we'll ever reach that ideal? I'm skeptical. Right now, you have only one stock that I'm really happy to see be 30% of your account. You have another that is 30% of your account where I feel we got the stock at good prices and it's safe enough. But, I can imagine selling some of that one – especially if its price rises – to buy more 10% type sized positions that are clearly cheaper (especially on an earnings basis rather than just an asset value basis).

Since some of your account is in cash at the moment and I've said we aim to be 100% invested at all times – you may be wondering why that is. I've been seriously considering buying 3 different stocks – in fact, very different stocks – over the last month or two. We've bought none of them so far. To buy any of those stocks, I would need to have cash on hand. Most of your positions are illiquid. So, we would have to start planning the sales a week or more – sometimes, a lot more – in advance of when I would want to make any large purchases. As of the time I'm writing this, 2 of those 3 potential buys remain potential buys. The third stock rose 25-30% in about a day. The new pricing on that potential buy makes it a much less likely candidate for purchase in the future. But, stocks that rise 25% in a day sometimes fall 25% in a day – or at least 50% in six months – and, so, I wouldn't say it's impossible for even that stock to one day end up in your portfolio.

Of the two remaining potential buys one is in the U.K. The other is actually in Plano, Texas (the town where I'm writing you this letter from). Some of you may have accounts that limit our ability to place orders in the U.K. If you have such an account, Andrew should have mentioned this to you already. If you can do whatever he askes paperwork wise as quickly as possible – should we buy a U.K. stock, you'd get your shares along with everyone else. At this point, if we have an account or three that can't buy in the U.K., but everyone else can – we're just going to go ahead and buy without you and you'll keep that portion of your account in cash till you work things out with Andrew.

This is not a guarantee we will be buying that U.K. stock. That is one of the things that makes writing these letters difficult. I can talk a little about what I might "plan" to do. But, I have no plan. Only options ranked first, second, third, etc. as of this moment. I looked at 3 stocks for about two months. And yet we bought none. If you'd asked me two months ago I would've put the odds at us buying something higher. It's probably not a good thing – in terms of how it affects my decision making – to go on record with you about considering buying something. There's always a reason we don't own it till the moment we do. If I was sure we were going to buy it – we'd already own it. So, any future plans I talk to you about in terms of buys, sells, etc. are just potential options that rank highly in my decision-making queue as of the moment I happen to be writing this letter. All these stocks – both the ones you own and might sell, and the ones you don't own and might buy – move in price daily. And their price moves relative to each other change the attractiveness of these various buy/sell decisions.

This mention of U.K. stocks brings up the topic of foreign stocks. Will you own them? And, if so, how much might you own? Just as the ideal – but possibly unattainable degree of concentration would be 30%, 30%, 30%, and 10% - there is a dream foreign/domestic split for me. It's 50/50. Do I think it'll happen? Again, I'm skeptical. I'd love to have 50% of your account in stocks outside the U.S. and 50% inside the U.S. while keeping your non-U.S. currency unhedged. This would bring a nice amount of diversification to the portfolio. So, why haven't I done it? A 50/50 split sounds great from the top down. But, it's hard to make work from the bottom up. It means I'd need to find as many non-U.S. stocks I'm as certain are safe, cheap, and good as stocks in the U.S. I know meet those criteria. I am working to get more knowledgeable about other markets. But, I doubt I will ever be as comfortable with non-U.S. stocks. So, we might get a 50/50 split of foreign and domestic at some point. But, it'd probably be more a matter of luck – a couple foreign markets I know best getting cheap while the U.S. is still expensive – rather than my process improving enough to make a 50/50 split the norm in your account going forward.

For similar reasons, I don't think you should take my "ideal" degree of concentration of 30%, 30%, 30%, and 10% too seriously. I'd love for you to have an account that would look like that. And if this was December of 2008 – instead of December of 2018 – you might have such an account. There would be enough safe, good, ***AND*** cheap stocks out there.

The hard part lately has been finding cheap stocks. As I write this, you own 4 stocks. One of them is truly cheap. One is a bit cheap. The other two aren't cheap. None of the stocks you own is the least bit expensive. And that's something most other investors can't say. But we're not looking for just "not expensive" – we like to find the "truly cheap" ones. By "truly" cheap I mean not just cheap for this moment in "the cycle", stock market history, etc. but a stock that would be considered cheap in every place and time. Right now, you own only one such stock. It's one of your two biggest positions. And there are good reasons why other investors – but not me – dislike the business at any price.

I will talk to you about performance in January. That'll probably be a much shorter letter.

If you have any preferences about:

1. How frequent these letters are
2. Whether they come out on a particular day of the month or not
3. What topics they cover
4. Whether they name specific stocks and
5. How long they are

Please email Andrew at info@focusedcompounding.com with the subject letter "**Client Letter Suggestions**". He can forward me any thoughts you have that might help me decide what kind of letters to give you in the future.

Sincerely,

Geoffry Gannon

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