Friday, May 25th – Pandora A/S (PNDORA) by LUKE ELLIOTT

Friday, May 25th – GameStop (GME) by VETLE FORSLAND

Sunday, May 27th – "Value Trading – Does It Ever Make Sense?" by DAVE ROTTMAN

"Efficiency vs. Reliability"

May 27th, 2018

To Focused Compounding members:

Two different Focused Compounding members are to blame for this week's memo. One is Dave Rottman who wrote an article entitled *"Value Trading – Does it Ever Make Sense?"*. The other is someone I was talking to this week on Skype. The discussion on Skype centered on the idea that I had said somewhere before that I thought it was possible to achieve 30% annual returns. What I think I meant by this – because I've said it elsewhere – is that an investor who puts together a run of 30% annual returns is like a Major League player batting .400. Over a career length period of time 30% annual returns are the highest you're likely to see. Warren Buffett roughly did it over the years he ran his partnership. Peter Lynch roughly did it over the years he ran Magellan, and Joel Greenblatt did even better at Gotham from 1985-1994. A period of 10-15 years is basically the length of a professional athlete's career. So, we could say Buffett, Lynch, and Greenblatt were 30% annual return career hitters.

Imagine that you – a very good, but not a truly great value investor – are running a portfolio that has chugged along at 20% a year for the last 15 years. You know that other investors at other times – Buffett, Lynch, and Greenblatt – ran portfolios that chugged along at 30% a year for almost as many years as you've been going at this. So, you know your portfolio is running at only two-thirds of its optimal efficiency. Where is the "waste" so to speak? Why aren't you doing 30% a year? I can think of 4 possible reasons. One, you are making mistakes they did not. Two, you are using less leverage. Three, you are putting less into each stock you own. And four, you are owning each stock longer than they did. A portfolio running at optimal efficiency would be: 1) Free from human error, 2) Leveraged, 3) Concentrated, and 4) Have a high turnover. Why would it have a high turnover? Because the portfolio manager would have more ideas than money. This is also why it would use leverage. The question of leverage brings us to the difference between efficiency and reliability. An investing system that is maxed out for efficiency will – in any given year – achieve the highest return. On the other hand, an investing system that is maxed out for reliability will last the greatest numbers of years. Compound results are a combination of efficiency and reliability. The article published this week on Focused Compounding argues that – if a value investor has enough good, reliable businesses to invest in that he knows very well – he should (like Allan Mecham does) constantly be rotating out of his most expensive good idea and into his cheapest good idea. He should trade around his ideas purely on their relative price-to-value gaps. The formula for added efficiency in a value portfolio would then be: Sell the 70-cent dollar and buy the 40-cent dollar. Repeat. But what about reliability? Sure. Trading around a position is reliable for a computer following pre-set rules. But, is it reliable for a human who learns? Will trading success teach a human investor to become a trader and therefore lower the system's reliability?

I don't have an answer. That's my question for you this week. Imagine you're that human…