STONE PARK

The value of a concentrated portfolio

“Excellent ideas are rare, that’s why concentration is so important”

--Warren Buffett

“We wait for no brainers”

--Charlie Munger

What’s more ideal, owning a few of the best ideas you have, based on a detailed, thorough, and stringent process, or owning the whole market so it doesn’t matter what happens to a couple companies in your investments?

Although it may seem counterintuitive, a concentrated portfolio can reduce risk by investing in companies that have a margin of safety. In short, paying for an asset for less than what it’s worth. When a portfolio holds only a limited number of companies that fit a narrow profile, it can be easier to manage for risk, as there isn’t a need to own overpriced assets.

Let’s face it, there is no perfect portfolio strategy that works all the time. Today’s indexing and passive investing have become the dominant forces in the market place. Set it and forget it, as you cannot beat the market, or so the story goes. As the belief is there is safety in diversification and the “market” is efficient, thus stock prices are most often accurately reflecting all available information.

There is truth in that, especially when you get to the S&P 500 index, as most of the companies are so heavily followed that it is hard to gain enough of an advantage to make a living in the category for the vast majority of investors.

Going passive in the US equity markets as a whole isn’t a terrible strategy.

There are a few concentrated equity portfolios open to the public, mutual funds, SMAs, etc. If you look at most of their performances, they were lackluster at best, especially the US focused ones. As stated above, the US market is a really tough one to beat consistently. On the other hand, those investors that focus overseas have a lot of promise as well as more of an ability to beat their benchmarks. The reason is that most of the overseas markets are less followed than their US counterparts. That doesn’t diminish their value in any way.

The key to concentration is the process used to find the companies that go into the portfolio. The ability to put together a portfolio that emphasizes capital protection as a way of capital appreciation, will in most cases reduce the risks associated with being less diversified than the benchmark index. Investing defensively in a concentrated manner creates a margin of safety that allows for long-term growth, while working to avoid permanent loss of capital.

How does this work? The process for 3G Capital begins with looking for businesses that generally fit the following criteria:

- Candidates occupy leading positions in their respective industries and those industries have long track records of leadership sustainability.
- They generate returns on invested capital in excess of 15%.
- Companies that can pay off their debt with cash flow in less than three years
- These businesses are run by management teams that are both skillful operators and intelligent capital allocators.
- The stocks are available at single digit multiples– the lower, the better – multiples of normalized free cash flow.

Results matter, but do they tell the whole story?

3G Capital has returned 16.8% per annum since 2009 vs 5.2% by the MSCI ex US over the same period.

3G Capital has strict requirements and will not stretch for an investment. It's smarter to buy a few things the team knows really well, and to buy heavily when obvious pricing mistakes present themselves. The fund avoids the "institutional imperative" of mindlessly following others, finding ideas others cannot purchase or will not take the time to research.

For 3G Capital the goal is to find the best capital allocators for the price, based on industries that the team understands. The team likes investments where the risk is time, not price. Being unlevered enables the fund to take a long-term view of risky markets. The set up gives the fund the advantage of committed capital. 3G's talent is to understand the long-term potential of a business, and when the market gives you the opportunity to take advantage of what the emotional investor will buy or sell at versus the fundamental value of a company.

Yet for all the depth in the research and the highly stringent process that 3G Capital employs on its fund, their greatest strengths are their mental and emotional discipline. The team is so well prepared that when opportunities present themselves, they are able to pull the trigger without hesitation. Reducing emotional and mental mistakes has allowed them to create long-term returns that outpace the MSCI ex US benchmark by a significant margin.

Running a concentrated portfolio provides some great advantages. Owning only a few, one does not have to reach to fit an asset in the portfolio. It is significantly easier to find one or two great ideas a year. As Buffet's quote says so succinctly, "great ideas are rare, that's why concentration is so important".

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