A Letter to my Younger Self

August 2015

Dear New Analyst Walter,

You are about to be appointed as an analyst. Your boss Jan Kuiper, the head of Syfrets Managed Assets, is going to give you a break and allow you to follow your passion to become an investment professional. It's just two years since the walkout of the investment team that left to start Coronation Asset Management, a company that you will be invited to join. Now you will, as in most cases, start off as an analyst of Pharmaceutical and Construction companies. Typically these sectors were ignored by most fund managers and here you will learn the first lesson of investing; pessimism is on the side of the buyer. This is because the most important part of investing is that your return is determined by the price you pay and pessimism tends to increase the odds of not overpaying for assets.

From time to time Jan will walk down the passage and quote a gentleman by the name of Warren Buffett. A pity you do not pay greater attention because, had you listened and invested in Buffet's Company, Berkshire Hathaway, you would have paid US$16 300. But hey, you were lucky to meet Buffet later on and invest in 2000 for US$57 200 - a difference US$40 900. Warren Buffett and Charlie Munger, Buffett's partner will, in later years, become a major influence in your life. More on this later...

For the next two years you will work with one of South Africa's best fund managers, Tim Allsop. Tim will ask you to co-manage a fund called Prime Select, a fund that specialises in emerging companies. The lesson you will learn is that small companies can grow into large companies and become ten baggers while large companies find it difficult to grow. As Jim Slater, a well-known UK investor would say "Elephants don't gallop". Prime Select will also allow you to invest in TMT, Telecoms, Media and Technology stocks. These would be called growth stocks and command very high multiples and eventually cause one of the biggest bubbles in stock market history. Travel will become an important part of your investment toolkit as you try to understand stocks such as Didata by visiting Cisco the hardware business they represent. In time to come, exchange control will be relaxed and you will be allowed to invest offshore and follow the words of Nils Taube, another well-respected global investor who used to say "Use eyes and plagiarise''. As the world globalises, fund managers are able to identify a trend and anticipate it in other parts of the world.

Use your common sense to understand the economics of the business focus on cash flow and to ascertain what the managers of these businesses do with the cash. Are they rational with the capital which belongs to shareholders? Beware of the institutional imperative, an unseen force which is the tendency of management to do foolish things such as make unwise acquisitions or imitate their peers.

If it seems too good to be true, it probably is. And if you don't trust management, don't bother, and if the models don't makes sense, walk away. The problem you will find is that the market will support these companies for extended periods to the point that it will threaten asset managers who do not follow the herd. This will be the toughest part of investing; to be able to say no and follow your convictions. But don't worry; it eventually plays out and in the end it will all play out – sometimes with dire consequences. That's why you don't borrow money to invest; sometimes the banker will not let you sit it out. As the saying goes, the banker is willing to lend an umbrella while the sun is shining but at the first sign of rain they demand it back.

Two years later you will be asked to join Coronation Asset Management. They experience some difficulties and decide to bring in new blood. Here you will learn the danger of investing in commodities. In short, they had significant investments in gold companies run by management whose actions were questionable and ultimately fraudulent. Study this failure and do not ever invest in gold companies despite the fact that the gold price will go from a low of US$300 to a high of US$1 770. Companies that can neither control their revenues nor know what they will be in the future do not make for good investments. Selling is sometimes more important than investing. At some time you will inherit a fund with a company called Transhex, a diamond company in decline. Sell it; the story will make no sense.

During the next 16 years you will witness many crises ranging from stock market bubbles, countries trying to peg their currencies to the dollar, overleveraged economies, a developed country going insolvent, fund managers that borrow too much money, many wars and acts of terrorism and a commodity boom that comes to an end. The lesson to take from all this is that bad news does come to an end and tends to offer you opportunities at prices that would be incomprehensible.

Remember the market is here to serve you and from time to time it will lose its mind and offer prices way below what it was offering you the previous week. Take advantage of Mr Market when he loses his mind. More importantly, being the manic person Mr Market is, he will always be there to make a price; you can be assured he won't go away. This is important because it means you don't have to take his price but rather accept the price when it suits you i.e. when the odds are in your favour. Another important point to remember is that time is your biggest advantage, the more you have, the greater your chance of success. That's why shorting is a mug's game – you don't know when the umbrella is going to be taken away. Finally never forget these four words in the English language "This time it's different". It never is and that's why reading is so important. I know of no successful person who does not read. Develop checklists, study failure and avoid those models that fail or consume shareholders free cash flow.

Talking about 'this time it's different', at the turn of the century you will manage a fund called the Coronation New Era fund that specialises in 'this time it's different' stocks. You will be a successful fund manager achieving the feat of doubling your unit price and exiting before the crash of the NASDAQ. This will not be because of your skill but because you started reading about the Sage of Omaha and his partner Charlie Munger who will get you out in time. They will also change the way you think about the markets and over time will have a significant influence on your investment process and the way you live your life. The strange thing you will find is that despite their success, little attention will be paid to them by the academics and investment professionals. It's too simplistic and smacks too much of common sense. In fact, it's just too rational.

In the next few years you will be successful in the markets, mainly by buying shares when there is a lot of pessimism and when markets keep looking at investments through the rear-view mirror and not through the windscreen. By avoiding the US before the crash and buying stocks when the market corrects in the 9/11 crisis (yes, two planes will be flown into the Twin Towers, New York by fanatics) you will go onto prove much of what has been written above. Your visits to Omaha to attend the AGM of Berkshire Hathaway will reinforce many of your actions that will lead to success. Compound interest (the eighth wonder of the world), investing in a few good ideas, being patient and never telling lies so you don't have to remember them will be mentioned at these shareholder meetings. In time you will attend at least 14 annual meetings and will ultimately be the reason you leave Coronation in 2005 to start your own asset management business. Some of your best investments will be made in the following ten years.

The economics of gold mines in South Africa will make no sense to you and your resolve to never invest in these much challenged business models will serve you well. This will be hard at times but as long as you stick to the principles of investing learnt in Omaha you will be fine while some of the finest brains in the industry will lose their heads. This is the trick to investing; to not lose your head while others do. Read the poem by Rudyard Kipling called IF. Stay away from executives who are worried about their share price and happy to spend many hours talking to investors rather than running the business.

One of the very best investments your team at Aylett and Co will make will be a company called Lewis. This furniture retailer/micro lender will come under the spotlight of the regulators many times and will give you many buying opportunities because the facts will be on your side. Interestingly, you will sell the stock at quite a profit but when the stock retreats to buying levels you will not invest again because the story has changed. Beware of poor disclosure and management explanations that do not satisfy your request for clarity. This is a fool-sure way to avoid losses. Attend the 2015 AGM and you will learn much about many other things, in particular where the executive have to defend indefensible management actions and a poor business model.

Another great story will be Discovery, a company that starts out as a medical aid company but evolves into a financial services company. Its strategy is to take advantage of the poor competitive landscape and simply delight its customer base. It will take the market some time to realise the effect of these actions on enlarging the moat year after year around its business. This was a classic 'sit on your ass' investment as coined by Charlie Munger.

There will be a real estate crisis that will lead to an upheaval in markets last seen in the 1930's. In short, real estate loans will backed by no real estate. This, because the financial wizards using very fancy terms and Greek symbols will sell over and over again loans worth nothing; a bit like 'pass the parcel' and bankers will not be happy to be left out. In 2005 you will express your fears but it will take another three years for it to play out. Eventually the authorities will come to the rescue and print money at a speed never seen before.

There will be fascinating consequences to this intervention one of which will be that anyone employed during or after 2005 will not witness a rate hike until 2015! You may ask how this ends. We don't know but your job is to think about the unknown and to prepare for the worst. Fortune favours a prepared mind.

Some of your best investments are made when the performance of your funds look anaemic – as long as mistakes have not been made in purchasing stocks that are out of favour at the time. The market corrects downwards and gives another opportunity to purchase these unloved stocks and this will lead to spectacular results. As you know, this is a tough thing to do; do not be dogmatic and be sure that the facts are on your side.

Don't underestimate the value of doing nothing in markets for long periods. You will come to appreciate inactivity as intelligent behaviour.

In due course, a new investment product called an Exchange Traded Fund known as an ETF will be launched. These funds will track markets and will try to mimic market returns. These funds will be successful in attracting the majority of savings from investors in 2015 at the expense of long only funds and hedge funds. The effect will be large amounts of money chasing a few large shares. I suspect these funds will create another bubble. It will remind you of a time when Didata was included in the FTSE 100 Index. A popular IT share, it would go from about R19 in 1999 to about R65 in early 2000. However, because it was going to be included in the tracker funds of the FTSE 100 over 22 million shares were sold by South African fund managers in a single day at R100! It wasn't long before the NASDAQ bubble burst and the shares fell to a low of about R2. Eventually Didata was taken out by a Japanese company at a price of about R14-15. What is remarkable about this story is that it took more than 9 years for it to unfold and therein lies the problem for fund managers; a fund manager is more likely to go bust than the underlying investment. It follows that first prize would be to manage your own capital which is permanent.

As you move into your third decade as an investment professional, continue to remind yourself of what works and what does not work. There will be no shortage of surprises; 100 year Mexican bonds will trade in euros and European bonds will trade at negative interest rates (please tell me who buys these bonds) – there will be many more of these strange payoffs. Ignore trying to figure out the economy and focus on the economics of businesses. The only economic indicator that will matter will be when your wallet is empty. Staying independent in your thinking is important but can lead to difficult and challenging conversations. It is possible that over a market cycle the only clients you are left with are the ones that feel really sorry for you or have forgotten that they have money with you. Be prepared, because markets can do insane things and it takes courage to be different because the facts don't appear to line up. The good news is that you will prevail.

Finally it is better to lose clients than to lose permanent capital and because most of your own wealth is invested in your funds, work hard with integrity, stay true to yourself and invest when the odds favour you and you won't go wrong.

Sincerely,

WALTER