Laurus
MONTHLY COMMENT
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"In Ajit, we have an underwriter equipped with the intelligence to properly rate most risks; the realism to forget about those he can't evaluate; the courage to write huge policies when the premium is appropriate; and the discipline to reject even the smallest risk when the premium is inadequate. It is rare to find a person possessing any one of these talents. For one person to have them all is remarkable."

…Warren Buffett, Shareholder Letter, 1999

Buffett's comment emulates the qualities necessary to be a successful long-term investor. Perhaps that's why he also later suggested that if he (Buffett), Munger, and Ajit Jain were in a sinking boat and only one could be saved, it should be Ajit.

To be a successful long-term investor, one must first properly assess the future prospects of a potential investment, avoid businesses that are difficult to understand, have the courage to allocate large capital when the "odds" are in your favour, and also have the courage to avoid investments where the margin of safety is too small.

Of course, these points have graced our past monthlies – we just thought a couple of current examples this month might be helpful.

A couple of years back, one of the market "stars" was AutoCanada Inc. (ACQ-T). By mid-2014, the stock had risen about 450% in the prior two years, and market pundits were describing the business as the largest multi-location dealership group in Canada with 20+% expected growth in the foreseeable future. With a strong return on equity, strong management ownership, and after-tax return on capital of 8%, despite the rich valuation of 20x earnings this story looked interesting.

As we dove deeper into the business, a number of issues began to crop up. First, we failed to see how the business model of consolidating auto dealerships across the country would create any synergistic effects (other than simple multiple arbitrage). In addition, there were two major conflicts; a) it had come to light some major manufacturers would not allow publicly-traded companies to own dealerships, so the company allowed executives (largely the CEO) to purchase these dealerships individually; and, b) ACQ was paying $10 million annual rent to the CEO's personal corporation on 13 dealerships. Our perspective on future growth, combined its governance issues, increased our expectation that this investment could prove disappointing. Our decision proved fortunate – ACQ trades today at just over $23, well off the $84 high in June 2014.

Conversely, Harman International – also in the auto space - is a recent addition to our US small cap fund. Harman designs, engineers, manufactures, and markets audio, visual, and infotainment systems. Best known for their Harman/Kardon stereo brand loved by audiophiles worldwide, the business has integrated their proprietary capability into various channels beyond the home stereo business, becoming a premier supplier to the high-end automotive market (including cyber-security options), as well as healthcare, media, and other consumer electronic services.

Our enthusiasm for Harman International comes from their business transformation. Harman avoided the commodity-like pricing issues inherent in the automotive business by focusing on the branded premium-end of the market. They recognized early on that the industry was moving to a "connected car" approach where all systems were integrated with devices both inside and outside the vehicle. Their leadership in 3D navigation and voice recognition, as well as industry-leading driver assistance programming (like collision warning systems) has transformed Harman away from a price-taker to a price giver.

This business generates good operating margins, high returns on capital and strong free cash flow. However, the automotive cycle has hampered the stock price in the past year, increasing the long term value for patient investors. We believe their market leadership, transformative r&d capability, diverse product range, and experienced management team will ensure our clients receive solid investment growth over the years to come.

In his 2014 Letter to Shareholders, Jeff Bezos of Amazon begins with his own set of criteria for a "dreamy business offering": customers love it; it can grow to a very large size; it has strong returns on capital; and, it's durable in time – with the potential to endure for decades. Clearly Harmon, and not AutoCanada, meets these criteria and warrants investment for years to come.

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