Laurus
MONTHLY COMMENT
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"Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life…."

- ***Warren Buffett***

If you were investing your own money, what type of investor would you be? Are you the conservative type – one who looks for an investment to generate cash flow while appreciating in asset value – or the aggressive type who looks for the "big win"?

At Laurus, our investment bias leads to high-quality investments with rising cash flow. But what does that really mean to our clients?

To explain why, let's make an imaginary investment in a commercial real estate building. First, we have to assess the purchase price of the actual asset – are we paying too much for the property, how much money has to be spent on upgrades, are the current tenants reliable, is the property attractive to new tenants, etc.? A simple rule of thumb is considering the "cap rate": net income after expense divided by the property cost.

If the cap rate on our hypothetical building is 6%, this means the property will generate 6% net income to us over time assuming nothing changes. However, there are likely occasional fluctuations in rental income over time (ie tenants come and tenants go). Let's assume the cap rate is a long term average, but the actual rate varies between 4% and 8% at any given time. Would you sell it on the fluctuation? Probably not, assuming you were still comfortable the net cash flow to you would increase over the longer term.

Eventually, you decide to sell the building ten years later. The next buyer will go through the same assessment you did to establish his "bid" on your property. The asset itself (the building) is only worth what the buyer is willing to pay (it's the assumption of the long term cash flow that is really being purchased). If we assume your building has appreciated by 50% over the period, your total investment (including the average 6% cap rate) will have generated 4.1% per year, assuming a 5% discount rate over time.

Interestingly, if you discount the $15 million received on the building sale in 10 years by 5% per year (as we used in the example above), the value would be $9.45 million. The value received from the new buyer in ten years is actually worth slightly less, using the same discount, than you paid for it. Without ongoing cash flow, our example would not be a good investment.

That's why we don't like commodity stocks in general. For example, the underlying cash flow of a gold company is simply a result of the commodity price (yes, the timing of extraction may increase or decrease the cash flow but the value of the asset is determined as a whole). Since the future commodity price can't be quantified, the asset itself cannot be quantified.

There are certainly many "gold bugs" out there. But Howard Marks framed it best: "…it's incredibly simple: either you believe in God or you don't…that's exactly the way I think it is with gold. Either you're a believer or you're not." The same holds true for every other commodity, including oil.

To our clients, outcome (performance) matters. Notwithstanding our industry disclaimer that "past performance is not guarantee of future performance", there are certain clues that support the repeatability of the track record over longer time frames. The types of investments held in a portfolio, and the consistency of those investments, are the biggest indicator of future success.

Future success can also be impacted by good or bad luck but, as we've written in the past, luck cannot be controlled. What can be controlled is the process. What does it mean to our clients? We believe buying high-quality businesses with rising cash flow skews the odds of better long term performance in our favour.

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