Intelligent Cloning

The Spring 2022 Edition

You're lucky if you have four great assets.

This is a quote by Charlie Munger and obviously Charlie is not a huge fan of diversification. He believes that a concentrated portfolio of strong and predictable companies acquired at a price that makes sense will do the job. Very few people have enough brains to get 20 good investments. He argues that a portfolio of 20 stocks is way too diversified and actually "asking for egg in your beer."

Why is it, that copying great investors, better known as "cloning", is that hard? Once you've decided to run a concentrated portfolio of no more than 20 stocks, which indeed is quite a lot, it is beyond stupid to not try to understand the company you're investing in and do the necessary in-depth due diligence. If you don't enjoy reading and understanding annual reports and industry outlooks, then forget about it. If you want to be the best in business, you'd better make sure you understand the companies you're investing in better than anybody else.

Over the last eight years, I bought two stocks in which, as of today, I believe it makes a lot of sense to simply let them run for the next 25 years or so. The letters "X" and "E" are shared by both of these four-letter companies. If I can find another two of those in the next eight years, and just forget about all the other mistakes I made, I'll be set and done.

Given that, you could argue that all the fuss about investing robots is a waste of time, and you'd be right. But it's a lot of fun, so I'll keep doing it for a while.

Previously, I introduced you to Q3, the investing robot with a four-year CAGR of 25.6%. It refreshes its constituents once a year. In this write-up, we'll focus entirely on the "buy-and-hold robot", which is a standalone algorithm that makes all the BUY and SELL decision for what is known as "The Wizard Portfolio." Enjoy!

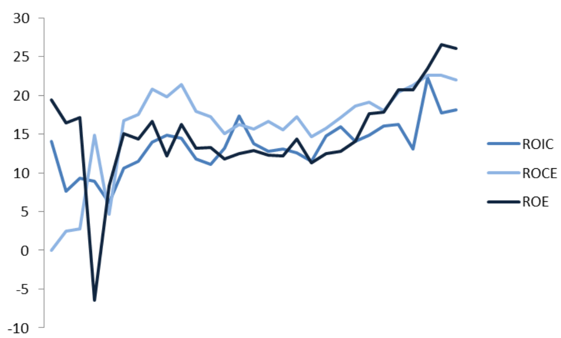
The Wizard vs The Oracle

Here are the rules of The Wizard Portfolio:

1. Every decade you have 5 buying opportunities to buy the top 6 stocks generated by the algorithm, e.g. once every two years. You're not allowed to buy into the same company twice.
2. If a major crash occurs you are forced to buy into the top 6 stocks by then, bringing down the number of buying opportunities with one.
3. Each stock will stay in the portfolio for at least 10 years, preferably longer.
4. Once a year every stock in the portfolio will be assessed in terms of its VCE and margins. If the quality deteriorates rapidly, the stock will be removed. No questions asked.

The "June 2020 basket of stocks", with in it Medifast, Ulta Beauty, XPEL, Domino's Pizza, Nova and Fortinet, is off to a good start. As of today, all of these stocks still represent ownership in great companies, so we simply hold the stock. Let's have an in-depth look at the algorithm that chooses these stocks.

In the graph below you'll find the ROIC, ROCE and ROE for Costco over the last 30 years. The algorithm would have flashed a BUY signal for Costco, already in 1994, and no SELL signal up until today. The result is a 16.8% stock price CAGR since June 1994. That's the type of opportunity I am looking for.



Intuitively, I've always believed that a sliver of multi-baggers can be identified early on by balancing ROIC and GROWTH. The harsh reality is that it is much easier said than done. After slicing and dicing the historical data of many, many successful multi-baggers, I discovered a for GROWTH adjusted ROIC measure that works well for me: The Value Creation Engine (VCE).

Last year I showed you the 10 year CAGR results for the 2010 HVCs, which were exceptional. For instance the top 5 stocks generated a 10 year CAGR of 31.2%. Now we have the 10 year CAGR results of the 2011 HVCs available, and I like what I see. Next year, I will add the 2012 HVCs and so on.

HVCs	Top 3	Top 5	Top 10	Top 15	Top 20
2010	31.5%	31.2%	27.2%	24.2%	22.1%
2011	30.1%	27.2%	22.5%	20.7%	21.7%
2012					
2013					
2014					
2015					

This table shows the 10 year CAGR for the 2010 and 2011 HVCs. The results of the 2011 HVCs are per March 28, 2022.

The only point I'm trying to make over here is that it makes sense to fish for multi-baggers in for instance the top 6 HVCs.

Some may argue that these results were inflated by connecting the dots backwards, or "hindsight bias," as it is known. Unfortunately, this is the only way to "train" the algorithm to become smarter. What might give you some solace is that the proof of the pudding for whatever approach you choose will be in the future results.

It is critical to recognize that one of the prerequisites for this algorithm to be successful is that the United States continues to produce exceptional multi-bagger companies like Netflix and Amazon.com. What worries me more, though, is that we haven't seen a classic 50+% crash with multiple years of recovery, between 2010 and now. Such a crash will happen someday. These numbers will be lower by then.

Last year, I didn't publish the 2021 Hyper Value Creators because I thought it was way too soon. The algorithm was still in its infancy. I did send the results to a few of you, and I recently went back over it to see if there were any superinvestor holdings on it as of today.

2021 HVC	Superinvestor holding
Fortinet	Terry Smith
Paycom Software	Terry Smith
Int. Money Express	Greg Alexander
Align Technology	Daniel Loeb
Nexstar Media Group	Seth Klarman
ANSYS	Chuck Akre, Terry Smith

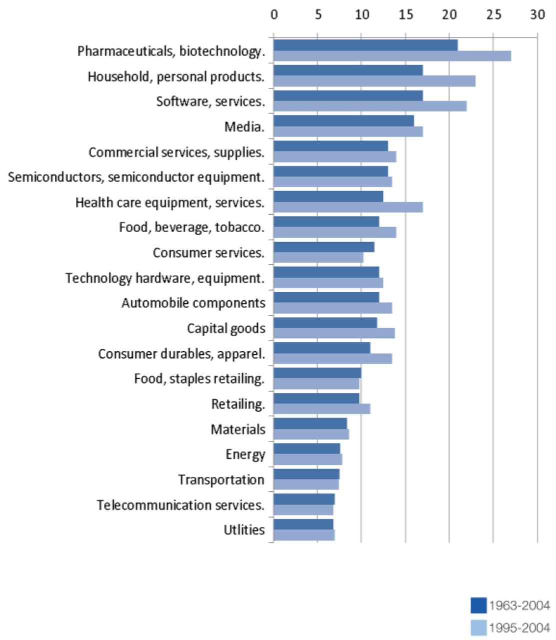
Six out of the Top 25 HVCs turned out to be or to become superinvestor holdings. Terry Smith is clearly favored by the algorithm. And then we have XPEL in the Top 25. That's a company I believe the superinvestors covered by Dataroma.Com still have to discover. Whether or not you believe the earlier results were inflated by hindsight bias, I will continue to use the algorithm if you don't mind.

This algorithm is my company's number one innovation. The back test results look very promising, but let's see what it does under real world pressures. Just imagine that it stands the test of time. It's worth trying.

Let me now walk you through the entire process of obtaining these 2011 HVC results, emphasizing the importance of "cleansing" the algorithm's output. If you want to receive the full 2011 HVC "cleansing considerations", drop me an e-mail: peter@thevaluefirm.com.

In 2011 the algorithm found 62 HVCs, or potential multi-baggers if you will. Multi-baggers can be found in any industry, but there are some industries where the chances of finding one are much higher. The study by Alta Fox, entitled "The Makings of a Multi-Bagger" shows us which industries will do the job. Technology and healthcare count for more than 50% of the multi-baggers.

The McKinsey research on industry-specific ROIC variation is also very useful in this context. Here are some results from the McKinsey Quarterly from February 1, 2006. To me, it makes a lot of sense to avoid the low ROIC industries, like utilities, telecommunication services, transportation, energy, materials and retailing.



That brings us to one of the many contradictions in investing: in 2022, the low ROIC industry "energy" has performed the best to date.

After "cleansing" the algorithm's results, only 25 company names remained out of the many thousands of companies trading in the United States by then. Looking at the individual company 10 year Total Shareholders Return (TSR), you'll notice that this is a very interesting fishing pond.

Company	TSR (%)
Booking Holdings Inc	213
Netflix Inc	2103
Amazon.com Inc	1538
Synaptics Inc	515
Apple Inc	692
Team Inc	-95
Ebix Inc	51
Gilead Sciences Inc	148
Credit Acceptance Corp	418
MercadoLibre Inc	1046
LHC Group Inc	723
Salesforce.com Inc	447
The Mosaic Co	22
TransDigm Group Inc	482
Cimpress PLC	61
PetMed Express Inc	125
Medifast Inc	897
Monolithic Power Systems Inc	2413
Bruker Corp	321
Hawkins Inc	143
Chipotle Mexican Grill Inc	270
Monster Beverage Corp	282
Amedisys Inc	1068
CommVault Systems Inc	33
Intuitive Surgical Inc	375

Results as of March 28, 2022. TSR data is from GuruFocus.Com.

Many of these companies were identified as a HVC much earlier than in 2011. For instance, Amazon.com showed up as a HVC in 2006, Netflix in 2005, Monster Beverage in 2001 and Apple in 1994. Just think about what might have happened if you had the algorithm results by then!

Family owned

Some may argue that the cleansing process remains arbitrary and susceptible to human error. Studying the Altafox research will help you become a more "professional & consistent cleanser." That is how you gain a better understanding and experience of the industries and sectors to look for.

Wouldn't it be great if there was a method that simply avoided the cleansing? I believe there is. Focus on family owned HVCs! There are several characteristics of family-owned businesses that contribute to their long-term viability, according to EXOR CEO John Elkann:

- They tend to be prudent in how they are run, particularly in relation to financial matters, which means they remain robust when they face downturns, crises and unexpected events;
- They have the patience not to act when action is unnecessary and resist the pressure to do so. As Charlie Munger says, “Success means being very patient, but aggressive when it’s time”;
- They are aware of changes in the world and are able to adapt when those changes require it;
- They have strong cultures, clearly defined purposes and a sense of responsibility. Their cultures, rather than pay, help them to retain talent and to grow leaders internally.

In addition, Chris Mayer, author of the investment classic "100 Baggers," recently published a very insightful BLOG on family ownership and "skin in the game." He contends that looking for significant shareholders among the executives and directors is a good filter for finding winners.

What makes a company a “family owned business”? Unfortunately, there is no simple and straight forward answer. Often you have to dig in deep into the ownership structure to find out that for instance Heineken Holding N.V. owns 50.005%, retaining the family involvement and vision. That makes Heineken a “family owned” or “family controlled” business.

It brings up the question what would have happened if you just bought one or more of the highest ranking family controlled Hyper Value Creators from the “uncleansed” list of HVCs?

Here is an overview of some exceptional family owned HVCs identified as such before 2006:

Family owned HVC	Identified as such in	CAGR
Brown & Brown Inc	1994	17.3%
Oracle	1994	14.3%
Costco	1994	16.8%
CorVel	1997	17.4%
Heico	1999	17.2%
Nike	1999	14.4%
Copart	2000	18.9%
Constellation Brands	2002	14.9%
IAC/Interactive Corp	2002	16.9%
Rollins	2005	16.6%

Results as per 1 March 2022.

Let me be very clear about what I mean when I say "Identified as such in." Rollins, for example, could have easily been identified by scrolling through the list of 2005 top-ranked HVCs, specifically looking for family-owned businesses.

All of these family-owned HVCs were excellent buy-and-hold investments, though there are family-owned HVCs with lower returns. The CAGR in the last column refers to the stock price CAGR since the moment of buying, dividends included. The algorithm did not generate any warning signals from the moment of buying until the present, with the exception of IAC/Interactive. Between 2008 and 2012 the company was underperforming according to its VCE, but further inspection of the revenue growth and gross margin prevented the algorithm from generating a SELL signal.

So here we are…

The key takeaway is that there is an algorithm that can generate a concentrated list of investment opportunities, with a high degree of potential multi-baggers in this list. From this list, the algorithm generates the constituents for The Wizard Portfolio, balancing value creation and valuation. No human intelligence or interference allowed.

Another way to capitalize on this exceptional list is to seek out the highest ranked:

- Superinvestor holdings
- Family controlled businesses
- Owner-operators with skin in the game
- Monopolies/duopolies with pricing power

Although the results of Q3, as well as the buy-and-hold robot back tests, appear to be very promising, please keep in mind that this is just an attempt to beat the market with an algorithm, or robot if you will, and you'd be well on your way to tempering expectations.

Do you enjoy egg in your beer?

Peter

Peter Coenen
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The Value Firm®
28 March 2022

Post scriptum. The latest addition to The Intelligent Cloning Portfolio is IDT Corp. I did not expect to add a new constituent that soon, but this "on my radar screen stock" went down more than 50% in a few months.

Everybody makes mistakes now and then. If you find any, let me know: peter@thevaluefirm.com. Always do your own research!