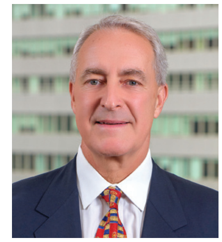

Thoughts for Investors

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"Invent and Wander" - A Book Report*

Fall Client Letter 2021

"No amount of sophistication is going to allay the fact that all your knowledge is about the past and all your decisions are about the future."

– Ian Wilson, former General Electric executive

Harvard Business Review Press compiled "Invent and Wander, The Collected Writings of Jeff Bezos." It contains Bezos' letters to shareowners along with his speeches. Many "business" books have been written by management, investment or self-help "experts." Clearly there is demand. Yet they often consist of the advice of spectators not participants. On the contrary, this book, in his own words, is the philosophy of perhaps the most innovative business person of our time (among the many other innovative people today). In this letter I will explain how Bezos' philosophy, outlined in his letters and speeches, has application for investors.

"Imagination is more important than knowledge. Knowledge is limited. Imagination encircles the world."

– Albert Einstein

The book starts with an introduction by Walter Isaacson who states that he considers Jeff Bezos "in the same league as those I have written about as a biographer: Leonardo da Vinci, Benjamin Franklin, Ada Lovelace, Steve Jobs, and Albert Einstein." Isaacson sums up the essence of Bezos' and Amazon's success: "Smart people are a dime a dozen… what counts is being creative and imaginative. That's what makes someone a true innovator." As investors in publicly traded equities, the #1 trait we look for in management teams (and demand of ourselves) is "imagination." Imagination is neither a "task" nor a "formula" but a state of mind, making it beyond the reach of artificial intelligence, a timetable or a device (though Steve Jobs' "bicycle for the mind" has helped immensely). Imagination starts, as Einstein also said, by being "passionately curious," a trait that can last a lifetime.

"Passionately curious" people are often "missionaries" for their cause. Bezos (2020) describes "missionaries" versus "mercenaries" in business. "'Mercenaries' try to maximize the value of their stock. Missionaries "love their product or their service and love their customers and are trying to build a great service. By the way, the great paradox here is that it's usually the missionaries who make more money."

"The reasonable man adapts himself to the world. The unreasonable one persists in trying to adapt the world to himself. Therefore all progress depends on theunreasonable man."

– George Bernard Shaw

Missionaries can seem "unreasonable," possessing a "reality-distortion field." Isaacson explains the term is based on a Star Trek episode where, through sheer mental force, aliens create an entire new world. He points out this term was used to describe Steve Jobs. I was fortunate to identify and invest in a communications industry "missionary" about 30 years ago. Irwin Jacobs, co-founder of Qualcomm, was a "missionary" for the development, acceptance and use of CDMA (Code Division Multiple Access), a digital wireless communications technology. CDMA had the potential for much more capacity than existing analog cellular though many "experts" said the technology was too complicated to commercialize. Further, they determined it was "unreasonable" to think the world would even need that much capacity. After the "experts" changed their minds, Qualcomm spent decades, even to today, defending their intellectual property. In 2001 at a ceremony I attended, Jacobs received a Franklin Institute Award (the U.S. equivalent to a Nobel Prize) for business leadership. CDMA was an important step in developing the technology of 2G and 3G cellular networks on their evolutionary path to 5G.

"Nearly every man who develops an idea works it up to the point where it looks impossible, and then he gets discouraged. That's not the place to become discouraged."

– Thomas Alva Edison, holder of 2,332 patents world-wide

Missionaries fail a lot. Bezos (2016) explained, "We are the best place in the world to fail." Being a missionary invites failure. So does "wandering," a seeming necessity to stave off discouragement. Bezos (2018) explained "Wandering is an essential counterbalance to efficiency. You need to employ both. The outsized discoveries – the 'non-linear ones' – are highly likely to require wandering." While "wandering" and "imagination" go hand in hand, "wandering" and "failing" doesn't sound like the prescription for fiscally sound business management, keeping your job or a formula for successful investing. But Bezos distinguishes between "experimental" versus "operational" failing. The former is invited, the latter is not. Bezos (2016) points out, "Most large organizations embrace the idea of invention, but are not willing to suffer the string of failed experiments necessary to get there. Outsized returns often come from betting against conventional wisdom, and conventional wisdom is usually right. Given a 10% chance of a 100 times payoff, you should take that bet every time. But you're still going to be wrong nine times out of ten."

Although it is not the only influencing factor, a baseball player has a chance of getting into the Hall of Fame with a lifetime .300 batting average. That is three hits out of 10 "at bats." Note: a hit can be a single or a grand slam. In baseball, unlike investing, they weigh the same. In our experience, many investors expect ten hits out of 10 "at bats" to deem themselves successful. Striking out nine times out of 10? Beyond frightening. In fact, many investors are so fearful of one strikeout that they never invest in stocks. Or they only invest in index funds/ETFs where the mediocre players and any strikeouts get comfortably hidden among 500 or more stocks. Worst of all, index fund/ETF products never experience any "grand slams." As of this writing, $30,000 invested a decade ago in the S&P 500 is worth $83,514 today. That same amount invested at the same time in Amazon alone is worth $444,489, arguably a "grand slam." By the way, $83,514 includes the #1, #2 and #3 S&P 500 index stocks Apple, Microsoft and Amazon. Though not a portfolio, if you owned $5,000 of each of these (totaling $15,000), collectively they would be worth $204,403 today**. To be fair, if the remaining $15,000 was invested equally in the worst three S&P 500 stocks, what would they be worth today? It's impossible to say. The S&P 500 index only consists of the 500 largest companies and the S&P 500 committee removes stocks that no longer fit this or other "criteria" of their choosing. So much for being a "passive" investment. In essence, they erase their mistakes. Thus, while rarely does an S&P 500 company go "out of business," this is effectively removing a base-runner before they can potentially "score!" Talk about changing the rules in the middle of the game! Nevertheless, even if you were to assume these three worst performing stocks "struck out" (losing your $15,000), you would still have $189,403, arguably a "home run." Bezos (2016) describes his philosophy of risk-taking more succinctly, explaining that risk-taking is worth it because, "In business, every once in a while, when you step up to the plate, you can score 1000 runs." These home runs and grand slams make your bat bigger and bigger! Conversely, after an investment "strikeout" your capital is reduced. That's akin to cutting off some of your bat. Strike out too many times in a row and you'll have no bat left to swing. Investors should always keep in mind that investing could result in complete loss of principal and past performance is not a guarantee or predictor of future results of either the index or any particular investment.

"Risk means more things can happen than will happen."

– Elroy Dimson

Often when investing, “volatility” is mistaken for risk or failure. Investors found out that COVID created volatility but not always failure. As a shareowner myself, I have endured numerous large declines in these stocks over the decades (including COVID-related declines in 2020) yet maintained faith in these missionaries and haven’t been disappointed. Assuming you don’t use leverage, even if an investment is truly a failure, your loss is limited to 100% of the amount you invested and in many cases can be written off against gains on taxes, lessening the pain.

“Success is not final, failure is not fatal. It is the courage to continue that counts.”

– Winston Churchill

Bezos (2015) pointed out, “Big winners pay for so many experiments.” “It’s not an experiment if you know it’s going to work.” Amazon uses their “cash flow” to “invent and wander.” The first slide (after the “forward-looking statements” slide) of every Amazon quarterly earnings report reiterates the same message, “Long Term Goal – Optimize Free Cash Flows.” Note use of the word “optimize” vs. “maximize.” Maximizing is much easier than optimizing. Right or wrong, maximizing makes us worry about “quality” whereas optimizing makes us think of our favorite words “effectiveness” and “efficiency.” It is all about the use of cash flow, not simply its creation. We like dividends, though we often wonder which is better in the long run, paying dividends or having companies reinvest that cash flow back into innovation.

Besides his space flight company Blue Origin, Bezos is leading an effort to build a clock that will tick for 10,000 years. Why? “It’s all about the long term” (1997). “Building for the long term” (1999). “Taking the long view” (2000). “Our ultimate financial measure, and the one we most want to drive over the long term, is free cash flow per share” (2004). “The patience to think long term” (2015). “Building a culture of high standards” (2017). Bezos continually reminds shareowners that it is “Day 1 for the internet and, if we execute well, for Amazon.com.” In 2016, he described “Day 2.” “Day 2 is stasis. Followed by irrelevance. Followed by excruciating, painful decline. Followed by death.” He explains that “Staying Day 1 requires you to experiment patiently, accept failures, plant seeds, protect saplings…” “Long term” thinking and acting is difficult for managements that want to show continual improvement and for investors who expect it. It requires patience. Bezos (2017) said, “I ask everybody to not think in two-to-three year time frames, but to think in five-to-seven year time frames.” For retirees who say they can’t afford to think long term, Bezos (2020) pointed out, “Right now I am working on a quarter that will reveal itself in 2023…” Something for retirees should be ripening about now.

“If we worked on the assumption that what is accepted as true really is true, then there would be little hope for advance.”

– Orville and Wilbur Wright

In summary, when investing, first, look for “missionaries” with “imagination” and the courage to experiment, fail and be called “unreasonable.” At the same time, beware of imposters. Ha! True missionaries are a minority, not easy to find and difficult to distinguish from imposters you say. Indeed. Most of our research time is spent meeting, listening to and sorting through lots of managements to find the missionaries and weed out the imposters. Adam Neumann, now infamous founder of failed company WeWork once explained the valuation of his company, “Our valuation and size today are much more based on our energy and spirituality than it is on a multiple of revenue.” Does that give you any hints? While the advent of video-conferencing and YouTube helps our search, in-person meetings are best. Marshalling all the human senses makes for an amazing tool. Second, don’t mistake volatility for failure (or success). As we remind investors, volatility is not risk unless you don’t know the difference. No business is immune to failure nor to volatility. Volatility is like wind going through the trees knocking out the dead and diseased branches. If a stock (or the market) seems immune to volatility it is time to be cautious.

“Thinking is difficult, that’s why most people judge.”

– Carl Jung

Finally, focus on the long term by studying managements’ philosophy. With a lot of money swishing around in the economy and the stock market and the media regaling us with stories of riches from short-term stock trading, it’s easier for managements and investors to substitute judgement for thinking. For companies looking to successfully “Invent and Wander,” Jeff Bezos’ advice (2011) can be summed up as follows, "If you are going to do large-scale invention, you have to be willing to do three things: You must be willing to fail; you have to be willing to think long term; and you have to be willing to be misunderstood for long periods of time." Investors looking to grow their net worth would do well to invest in stocks whose managements share the same philosophy.

"Not all those who wander are lost."

– J.R.R. Tolkien

*Thanks to my friend Greg Hagin for sending me this book! If you are a reader of this letter who is interested in the book, please contact us and we will send you a free copy. You can also download to your Kindle.

**Figures from Thompson One 9/7/21

AUDI PARTEM ALTERAM

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