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An Investment Journey

I recently finished reading *When Giants Fall*, a historical novel about World War I by Ken Follett. I find that historical fiction can bring the past to life by describing the lives of fictional characters experiencing actual events first hand. The format provides a framework for the author to present history in a way that can be far more engaging and revealing than a textbook-style listing of dry facts. Some of my favorite examples include *Killer Angels*, *a* novel about the Civil War by Michael Shaarar, the Asian saga by James Clavell that includes *Shogun,* and James Michener's *The Caribbean*. In this client letter I introduce a fictional character, Jim, in order to illustrate the thinking behind our investment approach. Jim represents an amalgamation of traits, experiences, and wisdom of mentors and clients I have learned from over the years. My goal is to use the story of Jim's life to personalize a discussion of our investment philosophy, put the current environment into perspective, and highlight a few additions made to client portfolios this year.

Jim got his first job when he was twelve years old. It was 1962, and he made six dollars per week delivering his hometown's morning newspaper before school. He did not like getting up so early, but he enjoyed providing an important service and was proud that he was able to help his mother financially. School, on the other hand, made him miserable. He was good at math and enjoyed science but found reading extremely difficult. His grades in grammar, reading, and spelling had been awful since first grade. Reading aloud and spelling on the chalkboard were especially painful experiences as classmates snickered while he struggled with even simple words. The embarrassing episodes often ended with a teacher lecturing him about putting more effort into his schoolwork and telling him to sit down. In actuality Jim was not lazy; he was dyslexic, though his learning disability would not be diagnosed until years later. Jim was not a popular kid. He was not good looking or athletic and lived in a little house on the "wrong side of the tracks" in what some people called a "broken family."

His mom worked as a cleaning lady and did odd jobs babysitting, sewing, doing laundry, and basically any other work she could find. His dad was long gone. Jim cut grass in the summer and shoveled snow in the winter in addition to delivering the morning paper. The money he made helped pay the mortgage, the utility bills, and the car repairs. As a teenager Jim noticed things his peers were oblivious to. He saw that his mother's mortgage rate was higher because his father had run up debts that hurt her credit. He noticed that his home's drafty windows and old furnace drove up their utility bills. He could see that home prices in his neighborhood were falling as the area deteriorated. The trend seemed to be accelerating as neighbors who took good care of their homes moved out, replaced by people who did not seem to care. Jim saw the large towing bills that had to be paid when their old car broke down. He knew his mother had lost a job because she arrived late for work after the car blew a radiator hose. Jim added up the extra expenses that piled up when his mother made a little mistake balancing her checkbook. Her small error snowballed into a costly burden as bounced check charges and late fees compounded.

Jim loved and admired his mother; she was hardworking, honest, and kind. Her faith in Jim's potential was so strong he could see it in her eyes. She had gotten pregnant with Jim in high school, and any long term plans she might have had were quickly forgotten. Her lack of any specialized skill left her at the bottom of the wage scale. Seeing his mother constantly battling but still losing ground instilled a profound respect for the importance of income and the power of compounding. Jim was an optimistic kid at heart and believed that somehow he could help his mom generate enough income to get ahead. He could imagine a day when bills and worries about money no longer dominated her life and the power of compounding would work in their favor.

Mr. Patterson, the owner of the local auto parts store, inspired a sense of possibilities in Jim. He was always happy to help when his mother's car broke down. When Jim's mom could not afford a part he told Jim not to worry, that he and his mom could pay when they got the money. Jim always found a way to pay within a few weeks. When Jim turned sixteen, Mr. Patterson offered him a job and he jumped at the opportunity. He started as a stock boy, and when a cashier left he learned to work the cash register. Jim soon became the main cashier and stocked shelves after the store closed. He often helped customers install parts in the store parking lot. Just about everything that could go wrong with a car had gone wrong with his mother's car, so he knew how to fix a great many problems. Jim got a big kick out of seeing customers' eyes light up when he solved a problem that had frustrated them.

Mr. Patterson, store employees, and customers all grew to depend more and more on Jim as the months went by. When the bookkeeper retired, Mr. Patterson asked Jim to take over the books. He went into the store before school to prepare orders for parts and went straight back when school let out. He knew more about running the store than anyone except Mr. Patterson who had owned it for more than 20 years. When Jim graduated from high school in 1968, he felt like a prisoner freed after an unjust verdict was finally overturned. Mr. Patterson was just as happy as Jim and rewarded him with more responsibility and a raise.

Three years after Jim started working full time, Mr. Patterson promoted him to store manager and gave him a new bonus structure— 10% of any increase in store profits. Jim's performance exceeded Mr. Patterson's highest hopes. Store profits doubled over the following three years as Jim improved merchandising and replaced slow moving items with fast selling new products that offered better margins. Mr. Patterson was amazed that Jim seemed to know the cost and turnover of every product in the store. He came to the conclusion that passion enhanced memory, energy, focus, and all sorts of other good things. Jim noticed that more and more customers needed help installing parts and convinced Mr. Patterson to build a service garage next to the store. Three years after the garage opened, it contributed nearly half of the business's total profit. When Jim was not at the store, he was travelling to nearby towns visiting auto parts stores in search of ideas to improve Mr. Patterson's store, checking competitors' merchandise, prices, displays, aisle widths, and countless other details.

When Mr. Patterson turned 65, he told Jim over a cup of coffee that he would like to sell the store. It was 1980, and Jim was about to turn 30. Mr. Patterson was more than confident that the store would prosper under Jim's ownership. He explained that he and his wife wanted to retire and spend more time at their beach house down south. He shared that he had been investing the additional income the store had generated under Jim's management. Mr. Patterson pulled out the little notebook he carried with him nearly everywhere he went. He showed Jim entries he had made over the years, noting the details of each of his investments. He walked Jim through a couple of recent entries— a municipal bond paying 9% which, he emphasized, generated income that was free from both federal and state income taxes. Next he noted a recent purchase of stock in a phone company with a dividend yield just over 6%. He explained that only half of the company's earnings were being paid out in dividends and that earnings were growing nicely, key factors that led him to expect dividends to increase in the years ahead. He went on to share that the income from their tax free bonds, stocks, social security, and his wife's pension were more than enough to fund their living expenses. Mr. Patterson could see that Jim was interested in learning more, so he went on to discuss his investment approach. Investing was not rocket science— it was simply about buying future income. Currently, he explained, income was inexpensive and getting cheaper as widespread inflation fears were driving interest rates higher and stock prices lower— both of which were good for people with money to invest. He added with a smile that he felt sure buying the store was the first of many good investments for Jim.

Since he did not need the money from the sale of the store to live on and was fully confident Jim would succeed, Mr. Patterson offered to finance the purchase himself. Over a couple more cups of coffee they agreed on terms. Jim sketched out the deal on a napkin. Mr. Patterson wrote the details down in his little notebook. He would take a ten-year note with a fixed rate of 15%, attractive terms for Jim given that the prime rate was 20% at the time. Jim would sign a five-year renewable lease for the land and building with rent to be adjusted with the consumer price index at the end of each five-year period. Jim did some calculating and figured, based on his cash flow expectations for the store and garage, he could pay off the loan in as little as seven years. Jim's plan would be to apply every dollar he could spare without compromising the quality of the store to paying down the loan. He knew that at 15% money doubled in five years— compounding that worked for you if you were collecting the interest but against you if you were paying it. He also wanted to pay the loan down as much as possible during the first five years, before his rent jumped as a result of the CPI adjustment.

After they had agreed on the key terms of the deal, Mr. Patterson reminisced a bit over their last cup of coffee. He shared with Jim that he had made three decisions that had made an incredible difference in his life. The first was to marry his wife, Jane. He thought she was the smartest person he had ever met, and her faith in him and wise counsel were crucial to his best decisions. The second was to quit his job at the factory and open the auto parts store, a decision he would not have made without Jane's encouragement and would not have been possible without the money she somehow managed to save on their meager income. He shared his belief that you must have capital working for you to get ahead— you cannot get ahead in this world by your labor alone. He went on to say his third great decision was hiring Jim. He said that in any endeavor people are by far the most important factor. If you get the right people involved, you are almost destined for success. He drank down the last drops of his coffee, set the cup down, looked Jim in the eyes and told him to think big, that the sky was the limit for a person with his passion and determination.

Jim thought about Mr. Patterson's advice many times in the years that followed. Once he had paid off the store he started expanding by opening stores in nearby markets that he knew had weak competition and growing populations. He opened a new store when he found a good location at an attractive price, but only if he could hire a dependable manager to run it. Every new store was a calculated risk. He worried over each, never certain they would be successful and always limiting his downside to prevent a failure of one store from forcing him to sell other assets to pay for the loss. He purchased some existing stores, typically from retiring owners but sometimes from distressed sellers who had overextended during good times. At first he was only able to open one new location per year. Over time, however, the knowledge he gained from experience, combined with his chain's growing reputation for being a great place to shop and work, enabled him to expand much more quickly.

Jim made decisions on new locations using straightforward investment analysis, estimating the amount of money a new location could generate versus what he thought it would cost to build, stock with inventory, and run. He evaluated the competition in the area and sought out someone he could depend on to run the new location. He made his decisions one store and one manager at a time. He was thorough with his analysis, always assessing income versus cost and passing on locations that he did not think could generate enough return to make the risk worth taking. Over the years he had gotten very good at estimating store sales and cash flow; still he had made some mistakes and knew that closing an unsuccessful store was painful and expensive. Those unsuccessful stores were always on his mind as he evaluated potential new locations. During the financial crisis he acquired inventory from a bankrupt store at 50 cents on the dollar but in the past couple of years he had found fewer opportunities. Credit had become relatively cheap and easy once again, allowing competitors to pay more for new locations than he thought was wise. He had borrowed to buy many stores over the years but only when he estimated the store would generate enough cash to pay off the debt within seven years. At current prices it could take ten years or more to pay off a store even under relatively optimistic assumptions.

Over the years, Jim had observed that when banks were lending freely prices often rose to dangerous levels. Such freewheeling times were frequently followed by periods of high loan losses, causing banks to pull back and prices to fall. His experience led him to believe these cycles were inevitable in an economy heavily dependent on credit. The credit cycle worked in favor of those who had the ability and courage to buy when banks were retrenching and sellers outnumbered buyers. Accordingly, Jim maintained a strong financial position so that he could buy assets when fear was widespread and banks were not lending.

As he expanded his business, Jim developed a unique way of tracking his financial progress. He focused on accumulating assets that produced income and paid little attention to changes in his net worth. This was, in large part, an extension of Mr. Patterson's investment philosophy of buying future income. Jim knew that if his analysis proved correct, each store that he opened would increase his future income. He concentrated on adding to his income producing asset base rather than worrying about how much he could get if he sold an asset he already owned. Jim believed that focusing on income held crucial advantages over tracking prices and asset values. Price watchers tended to feel confident when prices were climbing and threatened when prices were falling. Jim's focus on acquiring income gave him a different perspective. When prices fell he was able to buy more income for less and that made him feel more optimistic about his financial future. He thought it was far more productive to focus on expanding the number of stores he owned than to worry about what someone might pay for them at any given moment. His view was that prices only mattered when buying or selling, while income provided recurring cash flow that could be used as he wished. Moreover, during his many years in business, he had observed that asset prices tended to be much more volatile than underlying income. In times of economic crisis prices typically fell much more than income, while in booms prices tended to increase much more than income. In Jim's experience, income was not only less volatile and more predictable, but also had the crucial advantage of being more important— more important because it was the ultimate long term driver of value and the most dependable fuel for compounding wealth.

After 30-plus years Jim had managed to build Patterson's Auto Parts into a regional chain of more than 100 locations. The chain's success had caught the attention of national competitors and buy-out firms. Just last year a private equity firm offered to pay Jim a large premium to buy his stores. The firm had access to capital at extremely low interest rates and planned to borrow 80% of the purchase price. The leverage would enable the firm to generate attractive returns on equity if things went according to plan. Jim, now 60, had seen many ups and downs in the economy and financial markets and did not know if or when he would get another offer at such a high price. Although he had received offers in the past, this one was especially tempting since he was not enjoying running the business nearly as much as he had in the early years. Now that he had so many stores to manage, he found that he spent more time in the back office dealing with administration and red tape than in the stores with his employees and customers— the people who gave him energy and a sense of accomplishment. He was starting to look forward to traveling with his wife more, enjoying their grandkids together, and helping a few charities he thought were doing important work. After careful thought and a long conversation with his wife, he decided to accept the offer and sell the business.

Once the deal closed, Jim was faced with the intimidating task of investing the proceeds from the sale of a business he had devoted most of his life to building. Jim and his wife met with a number of financial advisors but could not get comfortable with their recommendations. Jim had built what most people would consider a large fortune as— in the truest sense of the word— an investor. He made his first investment back when he bought his first store from his mentor, Mr. Patterson. Over the following three decades he had made countless investment decisions regarding stores, inventory, and most importantly, people.

After listening to recommendations from people in the wealth management business, it became clear to Jim that his approach to investing was surprisingly different from the standard industry advice. To Jim investing had always been about buying assets with the potential to generate a growing stream of income. Most of the investment industry, on the other hand, seemed more focused on the ups and downs of the market, preoccupied with outperforming market indices and beating benchmarks. Jim worried that strategies designed to beat the market were inherently price focused and were likely to be overly aggressive as markets approached peaks and too conservative when prices fell to bargain levels.

Jim had a different view of risk management as well. To Jim mitigating risk meant guarding against the potential loss of future income, but in the investment industry risk management seemed to be more about reducing volatility. In Jim's experience, volatility was an inherent part of both business and investing and was something to capitalize on rather than fear or spend a lot of time, energy, and money attempting to eliminate. Volatility was the ally of those with plenty of cash flow and the courage to invest when prices were down and times were tough.

He was skeptical of strategies relying on minimizing correlation among asset prices and wary of hedging techniques using leverage, derivatives, or short selling. He was not comfortable with complicated trading strategies designed to reduce volatility, outperform markets, or somehow attempt to accomplish both at the same time. Jim preferred to keep things as simple as possible. In his experience, complexity tended to increase unpredictability and obscure accountability. Jim preferred a patient, longer-term approach and, even in the most volatile times, took comfort from owning assets that he understood and were run by people he believed he could count on.

Everything Jim had learned about building wealth since that conversation with Mr. Patterson so many years ago led him to believe he should use the proceeds from selling his company to acquire assets— companies and real estate— that he expected to generate a growing stream of income. After meeting with several wealth advisors and listening to presentations on all sorts of exclusive investments for high net worth individuals, Jim decided to pass on the professional advice and invest on his own. It was not that he did not think the advisors were smart or trustworthy— the difference was more one of philosophy, approach, and goals.

Jim started building his portfolio one investment at a time. He was in no hurry. It had taken him more than 30 years to build up his capital, and there was no way to go back and make it over again. His first investment involved partnering with his cousin, Bob. Bob owned a very large, ideally located U-store-it facility. Unfortunately Bob was going through a divorce, and his soon-to-be ex-wife wanted cash for her half of some illiquid assets. His cousin did not want to borrow money to settle the divorce and asked Jim if he would be interested in buying half the U-store-it business. Jim knew Bob was a diligent operator, and the price was attractive from an income perspective. Jim and his cousin expected the rental income to rise over time and figured the property would appreciate as well.

He was on a constant lookout for assets that produced income that he thought would rise with inflation and were run by people he had confidence would do a good job. He invested in several public companies, all of which were relatively simple businesses managed by people he thought would be good stewards. He put a small portion in municipal bonds for tax-free income. The percentage was small because interest rates were low and the risks were difficult to assess. He would never forget how high rates were when he bought the original store from Mr. Patterson and was not inclined to lend his money long term at such low interest rates. He believed official government statistics understated inflation and that the financial system, with its basis in paper money, was inevitably inflationary in the long run.

Free from the daily responsibilities of running a business, Jim went down south to spend some time with his mother. She was so busy with friends and activities that it was hard to believe she was in her eighties. His mom lived in what she called her "dream home"— a large, beautiful condominium with a panoramic view of the ocean. Jim bought the condo a number of years ago from a bank that was eager to "get it off their books" as losses piled up on loans that were made during the previous boom. Jim and his mom sat together on her veranda enjoying a cup of coffee. It was a beautiful morning in December, and they were far enough south that the sun was nice and warm. They admired the beautiful view, and took in the sound and smell of the ocean as they enjoyed each other's company, laughing together as they shared funny stories. Knowing it was one of his favorite subjects, his mother asked if he had found any attractive investments lately. She was curious, but she mostly asked because she enjoyed seeing the energy the subject of investing sparked in him. It reminded her of the enthusiasm he had shown for working at Mr. Patterson's store so many years ago.

Jim shared that he added three companies to his portfolio during the year that he thought would generate growing income in the years ahead. He bought shares in a pet store chain that he thought was a bargain after the price fell due to fears regarding online competition. Jim thought the pet store chain was financially strong and well run. It offered services including pet boarding, grooming, and training that customers valued and could not get from on-line competitors. He went on to say his largest investment of the year was in a leading provider of wireless service. The company's wireless network was rated best by customers, and he thought demand for wireless connectivity would continue to grow as people depended more and more on connected devices. The company paid an attractive dividend which was only about half of its healthy and growing free cash flow. As Jim started to talk about the last company, his mom refreshed their coffees. He went on to describe a training school for automotive mechanics as his mother enjoyed the warming sunshine. She knew, of course, just what he was going to say. The company was financially strong, generated attractive income by providing a good value to its customers, had an advantage over its competitors (in this case it was contracts with automobile manufacturers), and, of course, had trustworthy management. She listened as she admired the progress of a sailboat in the distance and enjoyed the breeze off the ocean. She was filled with a tremendous sense of gratitude for her son, his mentor Mr. Patterson, and what seemed to her to be countless blessings in her life.

It is my hope that through Jim's story I was able to communicate the way our group thinks about investing in an interesting and compelling way. Jim is my fictional hero, a character inspired by real clients and mentors who have been crucial to the formation of my personal philosophy on both investing and life. To me, adding a new company to client portfolios is a lot like Jim adding a new store location. The focus is on increasing future income without taking on excessive risk. My many years of investment experience have led me to the conclusion that accumulating long-term assets that produce growing income streams is the most dependable path to building wealth. As we work to follow the trail blazed by our heroes both real and imagined, we view each new investment as a step forward on our mission to accumulate high-quality, well-managed assets that will provide a growing income stream for our clients for many years to come.

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