

This letter was written by Philip McCauley IV in July 2023

Pursuit of Pretty Good

In the physical world, Force = Mass x Acceleration. In Investing, Force = Focus x Capability.

Most investors, often unknowingly, focus on “predicting”. Predicting the level and effect of rates, inflation, economic news, quarterly earnings, etc. is so tempting. It feels so good to be “right”. Unfortunately, almost all of us are ineffective predictors of complex systems. You can be correct about a data point prediction, but wrong about how the market reacts.

Even if you get it right, accurate predictions don’t last very long. Once your correct prediction plays out, you are often required to make another big one because your portfolio is so correlated with one variable. For example, you accurately predicted the rise in rates. Now where are rates going? Your portfolio built for rising rates may be poorly positioned for the next move.

Everyone wants to outperform... and outperform quickly. Using predictions to make your perfect portfolio is an obvious path to glory. Unfortunately, nothing performs worse than a bold inaccurate prediction. If you are willing to outperform slowly, you can build a portfolio that performs pretty good in most all futures and ride the wave of progress.

Predicting is not our thing. Sure, we have viewpoints, but we are under no illusion that we know what will happen. The future is an ever-evolving asymmetrical set of probabilities. We judge investments not based on one view of the future but upon the investment’s plausible performance in many possible futures.

We focus on companies that can survive and thrive long from now. We sacrifice some near-term upside in exchange for long-term upside. Most investors don’t make this “trade” because they are confident, they can predict this move and then the next move and then the next move. Sounds exhausting, but at least you get to have great talking points at meetings and cocktail parties. We are boring. What investments do I like today? Mostly the ones I mentioned the last time we spoke.

We focus on finding companies that can get stronger each passing year and can handle whatever comes their way. Durable companies need to have a defensible business model, a prudent management team and most importantly, excess financial capacity. If you know the future, excess financial capacity is just a drag on your performance.

Owning companies for many years allows you to both benefit from reinvestment and to reduce the “costs” of turnover. We identify companies that have the business model, people and financials that give them the opportunity to attractively reinvest. We are often surprised at

exactly what amazing product or service a company develops, but we are never surprised they had the opportunity to do so. These new products or services often drive a step function growth in free cash flow and take the investment to higher highs and higher lows.

Turnover has indirect and direct costs. The learning curve is steep in investing. The longer you own an asset, the better you understand it. Also, lower turnover equals lower taxes. And you thought you were going to make it through a Madison Group letter without a mention of taxes!

If you want long-term performance, focus on long-term performance drivers. May the force be with you.

Thank you for taking the time to read. Please reach out if you would like to discuss further,

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