SPROTT FOCUSED STRATEGY

A whitepaper on Dennis Mitchell's Focused Business Investing approach.

For those of you that have heard me speak before, you know that I am a disciple of Warren Buffett and his approach to investing. Over the last decade and a half, I've been exposed to the teachings of other investment professionals and I've managed through some very trying market cycles and events. These experiences have been additive to my investment knowledge and while my process has evolved over the years, the core remains distinctly Buffett.

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One of the many books I have read about Buffett is "The Snowball", written by Alice Schroeder. In this book, she recounts an exchange that took place when Warren Buffett and Bill Gates first met.

> *When Warren Buffett and Bill Gates first met, their dinner host, Gates' mother, asked all seated at the table to identify what they felt was the single biggest factor in their success in life. Buffett and Gates gave the same one-word answer.* ***Focus.***

When I read that passage it resonated with me. In that simple, one word answer, I recognized the secret to being successful in most endeavours, including investing. It's the ability to focus our energy and attention on key value drivers and success factors in order to generate the results we are looking for in the most efficient manner. **Focus**.

I have managed real estate, infrastructure and global equity portfolios and all of them have been managed according to the same investment philosophy and process. This paper will attempt to distill all of that into three words that outline my investment approach – **Focused Business Investing**.

In the simplest terms, Focused Business Investing is "investing in a focused manner, in high quality businesses." I chose each word carefully to ensure that it captured the essence of what I have learned over the years in managing a number of investment portfolios.

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Focus

Focus refers to a number of things. The MSCI All Country World Index contains over 2,400 companies, all domiciled in developed countries. Fortunately for me, I'm not required to have an opinion on all 2,400+ companies because most of them do NOT meet my quality hurdle. Many of them are commodity businesses and by that I mean, the good or service they provide is undifferentiated from that offered by their competitors. As such, they are left to compete on price and are incapable of consistently generating strong returns on capital.

One of the easiest ways to identify a commodity business is to examine the manner in which you consume its goods and services. "I've got to put gas in the tank", " I'm going to be late for my flight" or "I'm going grocery shopping" are all common phrases that we have all likely used at some point. However, the absence of a brand name (say Shell Oil Company, Air Canada or Loblaws Companies Limited) is a good indication that the industry, or these companies, offer commoditized goods and services with little differentiation from their competitor's offerings.

Now contrast that with "Google it", "Don't step on my Nikes" or "I'll have a rum and Coke" and you begin to see the contrast with businesses that have "franchises" that allow them to compete on something other than price. These businesses (Google Inc., Nike Inc. and The Coca-Cola Company) are all world-class businesses that generate strong returns on capital and have rewarded investors with outperformance for decades. In the process, they have become household names and the goods and services that they provide have become ubiquitous in our daily lives. So I tend to focus my attention on those businesses with franchise value as evidenced by their pricing power, differentiated service or product and superior long-term returns on capital.

I also tend to concentrate or focus my portfolio into approximately 35 to 45 companies at any one time. There are only so many truly high-quality businesses to invest in. Most of them are very well known and consequently they are often expensive – more on this later. I don't believe in putting money into my 80th best idea when I can allocate more capital into one of my 10 or 20 best ideas. In addition, how much does anyone really follow the 80th position in their fund, especially if the weighting is insignificant? Instead, I think it makes more sense to focus on a select group of high-quality businesses and concentrate the portfolio in these companies.

Some might look at a concentrated portfolio and deem it to be a risky strategy. I feel that it is less risky to run a portfolio of 40 high-quality companies that have been well-researched and are thoroughly understood, versus a portfolio of 200 mediocre companies, some of which are not fully researched or well understood. I've never understood the indexer tendency to underweight poor businesses or businesses with bleak prospects. All investors have limited time and energy and it seems to me that successful investors will maximize their personal "return on effort" by focusing on high-probability-of-success operations. That is what I try to accomplish by focusing on high-quality companies and concentrating my portfolio.

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Business

The Business itself is what we are investing in, so I'll spend a disproportionate amount of time discussing what makes a high-quality business and why this is so important to my investment process. To me, a high-quality business is one which generates 1) strong returns on invested capital, 2) strong recurring free cash flow from 3) a collection of irreplaceable assets capitalized with 4) low amounts of debt.

1 **Return on invested capital** measures the after-tax, operating return of the business as a function of the capital raised by the business. Simply put, it is the return a business has generated on ALL of the capital it has raised. In my opinion, it is the best measure of the quality of a business and the skill of the management team operating the business. Historically, the average company in the S&P 500 has generated a 15% return on invested capital, while the number is 12% for MSCI Euro companies. This is a good measuring stick to compare companies and determine whether they are likely to outperform the market and their peers over long periods of time.

Charlie Munger has been Warren Buffett's investing partner for decades now. He has said on a number of occasions that the long-term return in the equity securities of a firm will closely mirror the return on invested capital generated by the firm. At times the market will be overly-exuberant or overly-pessimistic about the outlook for a firm and bid up or down the value of the firm's equity securities. However, over the long term, equity returns are mean reverting to the long-term return on invested capital generated by the firm since this is the value creation shareholders will experience.

I try to buy companies with long-term returns on invested capital in excess of 15% so you might say that this is the cost of capital of my fund or my target return. Occasionally I will purchase a firm with a lower return on invested capital than 15% but usually only when the firm is experiencing rising returns on invested capital or the share price is severely depressed due to exogenous factors rather than factors tied to the operating performance of the business. Otherwise, 15% return on invested capital is my benchmark for firms to warrant consideration.

2 **Recurring free cash flow:** There is an old saying that "cash is king". Well if cash is king then cash flow is divine because it literally gives a business life. I only invest in businesses with strong, recurring POSITIVE free cash flow. Any business that does not generate positive free cash flow over the long term is just a collection of liquidating assets that will eventually hit the wall and collapse. Those businesses cannot be invested in, only traded and I try to avoid those types of situations.

Charlie Munger also likes to say that most "wonderful businesses" generate more free cash flow internally than is needed to fund the business. That allows the management team to return it to the people it belongs to –the shareholders. As a result, many high-quality businesses have a track record of paying rising dividends and/or buying back considerable amounts of their stock. While appreciated, it is not essential to my investment process. Several companies I have owned over the years do NOT pay dividends or buy back stock. Often it is because they have opportunities to deploy capital at high rates of return. In those rare cases, I am happy for a rational management team to retain and profitably deploy capital. From all others, we prefer cash!

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3 **Irreplaceable assets** can be tangible or intangible and are easily spotted in many franchise businesses. Union Pacific Corporation ("UNP") is one of the six large, Class 1 railroads in North America. I will go out on a limb and say that there will NEVER be another large Class 1 railroad built in North America, making UNP's tracks and rights of way an irreplaceable asset. As UNP invests more into this network to make it more efficient over shorter distances, UNP will displace more truck traffic and increase the value of this network.

Ditto for The Coca-Cola Corporation's ("Coke") brand, an intangible asset but no less irreplaceable. I'm confident that even with $200B and access to the best management team on the planet, it would not be possible to overtake Coke's dominant position in the carbonated beverage market. Now Coke's business is shockingly simple (they don't even put the syrup in the soda water, the bottlers do!) but it is the brand and the billions of dollars of investment over decades that has built that brand into the irreplaceable asset that it is now. When is the last time you walked into the bar and asked for a rum and Pepsi?

4 **Debt** is something I like my companies to avoid. It's not because I fear these businesses will go bankrupt. It's because I want fewer claims between me and the cash flow the business generates. Debt generally comes with debt service costs, usually interest expense. This must be serviced before free cash flow can be paid out to shareholders. During a cyclical downturn, when revenues and cash flow decline, debt service generally remains fixed and eats up a larger percentage of cash flow, leaving less for shareholders. There's no hard and fast leverage limit, it depends on the volatility of the cash flow the business generates and the duration of the assets capitalized. But less is generally better.

Finally, I like businesses run by management teams that behave like owners and treat you like partners. Everyone wants to invest in companies run by strong management teams but what does that actually mean? To me, a strong management team is one that generates consistently high returns on invested capital. They behave like owners because hopefully they are owners of stock they purchased with their salaries and bonuses. And they treat you like partners by providing you with sufficient information to accurately assess the value and condition of the business. Management is crucial since they decide which assets to own, how to capitalize them and what to do with the resulting free cash flow. Investing in a business run by a weak management team is an invitation to destroy capital.

Investing

Investing is what everyone claims to do however, much of the advice that is provided by "experts" is really trading advice. Positioning for datapoints, playing an event and rotating into a sector are all common examples of behaviours that are really trading in nature and not investing. In my experience, investing is a longer-term operation, focused on the quality and returns of a business across a cycle. Accordingly, I tend to build portfolios that feature lower turnover with fewer positions and larger weights.

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Many times I've heard people say that buy and hold is dead or no longer works. I usually correct them by saying that buy and hold has NEVER worked. Simply buying good businesses and expecting to get extraordinary results is destined to disappoint. Investors must always ensure that they are getting enough return for the risk incurred. Overpaying for great businesses is almost as bad as overpaying for mediocre ones (almost). Any business has operating and financial risk and ignoring these to invest in a business when it offers low returns is to invite excess volatility and suboptimal results.

If you read "Buffettology", you will learn that some of Warren Buffett's favourite companies included The Bear Stearns Companies Inc., Circuit City Stores Inc., Federal Home Loan Mortgage Corporation ("Freddie Mac"), Federal National Mortgage Association ("Fannie Mae"), MBIA, Inc. and Merrill Lynch & Co. A buy and hold portfolio containing those companies would have yielded a very unpleasant experience over the last 10 years. Even great businesses can run into trouble in a truly adverse environment. A wise investor is alert to the potential for a great business to deteriorate in the face of unanticipated stress – like a global recession second only to the Great Depression, caused by the bursting of a global financial bubble.

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Another reason buy and hold is perilous is the fact that there are only 3 sources of return for any equity security – yield, growth and trading multiple. Investors often know the yield of a security but ignore the sustainability of that yield. Or they are seduced by the promise of growth and ignore the probability and/or riskiness of that growth. Or they may simply fail to notice that the market has already priced in the growth they are anticipating. Whatever the oversight, failing to respect all 3 sources of return usually results in investors being disappointed with the return they realize.

In the short term the stock market is a popularity contest but over the long run it is a weighing mechanism. It weighs the value created by the business as a function of the risk incurred to generate it. If the goal of your portfolio is to generate alpha, why not build that portfolio out of companies that have historically created more shareholder value? I believe this is best accomplished by purchasing companies with higher returns on invested capital than the market as a whole.

So in summary, Focused Business Investing attempts to build a concentrated portfolio of high-quality businesses that will generate superior risk-adjusted returns over the long term. Companies with high returns on invested capital run by management teams that behave like true stewards of investor capital. But only when these companies are priced to deliver sufficient return for the risk incurred. Executed with discipline, this strategy has served me and my unitholders well for the last decade and I'm confident it will continue to do so in the decades to come.

Thank you, and stay focused.

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