Fairlight Capital

# Bill, Warren, and Competitive Games

Current Investment Market Conditions (December 2020)

Fairlight Capital believes certain securities offer above average absolute returns because of a fear (sometimes rational and sometimes irrational) of illiquidity and volatility. These fears have been around for decades if not centuries. However, events over the last decade, combined with the progression of financial theories and development of financial markets, have institutionalized these concerns. Investors (and by this, we mean end-investors who own capital or are at least responsible for dispersing it to beneficiaries and not fund managers who skim off the top) are still scarred from the Global Financial Crisis. This has led investors to seek investments that are both more liquid and less volatile. With equities down 50% or more on a marked-to-market basis during the GFC and over 20% in less than a month at the height of anxiety over the pandemic in March 2020, the vast majority of investors have been frightened out of volatile investment classes. Instead, investors have flocked to cash, bonds, private equity, venture capital funds and index funds (which can be volatile but are highly liquid). Private equity and venture capital funds have one great feature and that is they don’t need to be marked to market daily. Further, if capital continues to flow into these sectors, valuations will remain stable and continue to increase.

In our estimation, investors on average today are not seeking to minimize fundamental risks, such as price relative to value, business model durability, balance sheet strength, etc. They assume the market is efficient and establishes a fair price relative to fundamental risks for free. Instead, investors are seeking to avoid mark-to-market and drawdown risks. If this is indeed the case, as we believe it is, market sectors offering the highest returns should be characterized by having illiquid and volatile securities. Many or most equities in this sector today are also highly priced. However, there is more opportunity in smaller market capitalization securities to find companies that are mispriced due to having one or two negative factors that could materially affect valuations. Nonetheless, from time to time, the market misprices the stability of cash flows, downside protection or the upside optionality, and when business conditions or market perceptions change, the price movement can be swift and substantial. In these instances, market participants are fearful that negative news events can severely affect liquidity and cause a sharp drop in price. And yes, in the small-cap and nano-cap equity sector, single news events can cause the price of a stock to drop by 20% to 50% or more in a single day with almost no volume—so the fear is not 100% irrational.

<u>The Investment Game</u>

So, does being different from most investors by investing in illiquid and volatile securities guarantee success? No, it certainly does not. Yes, to generate outsized returns, it is necessary to be different but being different without reasoning from first principles and testing a theory in the real world is dumb. Investing in illiquid stocks requires skill that takes time to develop—one wrong choice could be very damaging. Moreover, investing in nanocap stock without stable capital is plain crazy.

Here is an interesting question: why have Bill Belichick and Warren Buffett been so successful over long periods of time whereas most professionals in these same fields have one or two successes and then fade from memory? Upon first reflection, it seems that they operate in very different fields—coaching professional football (where the inherent strategy involved in the game reduces the importance of player skill, and the modern area of salary cap, free agency and draft rules makes dynasties very difficult) and capital allocation. A recent USA Today article noted that it is Belichick's ability to adapt and change has led to his continue success:

> *"That is the key, and that is the difference. Whether by draft or free agency, when you become a member of the Patriots' roster, you know you're going to have to do things differently all the time. You know change will be constant. And because the guy in charge of it all is who he is, there is an intractable belief that it will work. Because it <u>generally</u> does.*
>
> *The larger question is, why don't more coaches follow the Belichick trend of no trends and constant opponent adjustment? As much as Belichick is rightly lionized for his ability to adapt, it says a great deal about many NFL coaches who are unwilling to make the same adjustments. The NFL has more schematic and statistical information at its disposal than at any other time in the league's history, but you wouldn't know it to see a lot of coaches—even highly successful coaches—refuse to bail out of their own schematic binkies.*
>
> *Are they afraid to be wrong? Is there too much ego involved? Did these coaches not have the same training Belichick had under Parcells, to break tendency whenever possible? How can it possibly make sense to stick with what you know, even when it isn't working?*
>
> *These are questions that should bother any coach who isn't studying Belichick and his chameleonic philosophies and looking to adopt that mindset."*

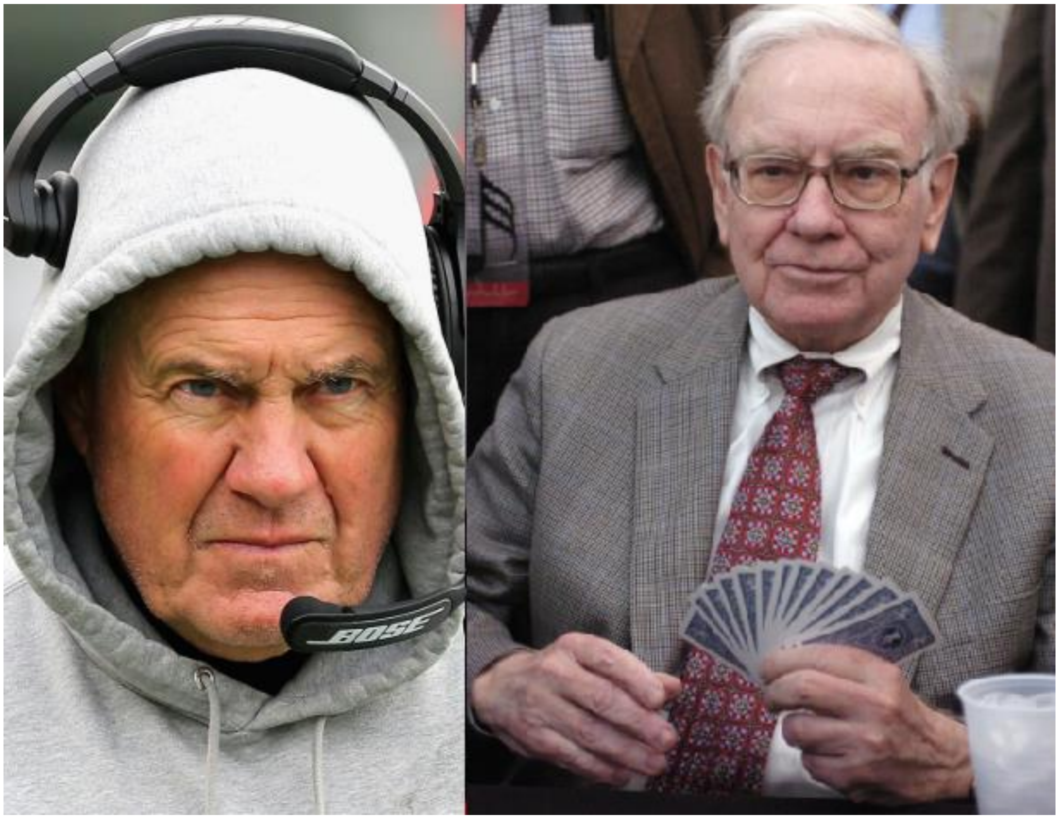
However, the article doesn't go on to answer why other coaches can't match Coach Belichick's behavior which would negate his advantage.

Most people would assume Belichick, like Buffett, is just a genius and knows that much more about football than his competitors. We would mostly disagree with this. Yes, Coach Belichick's and Buffet's knowledge and skill levels are likely in the top 10%--and dedication levels are probably in the top 5%--of their profession, but this doesn't make them extraordinary. So, if they don't have extraordinary knowledge or skills, what sets them apart? And can their successes be replicated? Before we try to answer these questions, it is important to note that Bill and Warren's day jobs have two common features: 1) Both individuals need to make decisions with highly uncertain outcomes using incomplete information, and 2) outside parties who know less about the profession can greatly influence the careers of both individuals. Warren is lucky in that most of his decisions are hidden from his investors (at least they were when he was much younger and generating much better returns), whereas Bill's decisions are usually in full view of fans, management and owners. An article from theringer.com gets to the heart why long-term success is so hard to replicate in coaching football:

> "*Part of this, Joel Corry (a salary cap expert and former agent) explains, is simple: "Extreme job security," he said. "A lot of coaches trading a star would face a fan revolt. Coaches and GMs are thinking short term and not long term to keep their jobs. Belichick doesn't have to think like that.*"

We would argue that while knowledge, skill and dedication are necessary to achieve the level of success attained by Bill Belichick or Warren Buffett, one also needs to be able to think long-term. Both individuals have been able to make unorthodox decisions because they knew they would survive subpar outcomes that would lead to disaster for others. What they do works—generally but not always. Having the ability to still be standing after a run of bad luck or poor returns allows a professional to take risks and be different; and being different is the only way to generate above average success in competitive games where information disseminates quickly and participants adapt almost instantaneously. Few coaches from youth to professional teams have true freedom to make optimal choices to win games under all circumstances. Think about coaching a team while trying to win a popularity contest or managing a fund that owns securities where values change by 25%-50% in a month, a week or even a single day. In both instances, it is easy to look dumb while still being very successful.

Furthermore, how do you manage the volatility if you are afraid of being fired or facing large redemptions?



Michael Burry noted the pressures most investment managers face in a Scion Value Funds letter in 2000:

> *"In order that this Fund's performance escape the randomness of return that defines much of the investment management industry, it is imperative that I as manager respond only to the value of an individual investment when making capital allocation decisions.*
>
> *Value is far from the only potential input in the typical portfolio manager's investment process, however. Throughout the universe of public and private funds, managers are measured quarterly against one index or another, defined by statistics, and corralled into this category or that category so that fund of funds, pensions, and other institutions can make comforting – if not necessarily prudent – asset allocation decisions. Such forces restrict and otherwise harm the manager's ability to invest intelligently and are entirely deleterious to performance. Managers who respond to such inputs fight an uphill battle.*
>
> *The Fund is structured to allow its manager to ignore these secondary inputs. The less definition offered, the less positions revealed, the less statistics applied – all the better for the portfolio that aims for these supra-normal returns. Hence, the Fund's individual portfolio positions may not be revealed except at the discretion of the manager."*