

## MONTHLY COMMENTARY | APRIL 2023

*“Over the course of an investing life, stuff is going to happen—both good and bad—that no one saw coming. Instead of playing the guessing game, focus on the opportunities in front of you.”*

*- Chris Mayer*

In the investment business, by far the best path to creating wealth - wealth being defined as assets/capital that you will not consume in your lifetime - is compounding. Yet the pressure to force change, to recognize short term conditions, to adapt or conform to others' beliefs away from the compounding model, is constant.

A recent poll found that a large majority (60%) of Americans agreed that the federal government is spending too much. However, when asked to select specific areas for cuts, the only category a majority wanted to shrink was foreign aid, representing less than one percent of total spending. While the concept (reduce spending) may be correct, the strategy (shrink foreign aid) is misguided.

The concept of compounding is intuitively understood by everyone. Yet the application of the compounding principle in investing is misapplied.

For example, ten years ago Nvidia – the inventor of the graphics processing unit (“GPU”) – was a \$7 billion USD company generating \$0.33 per share in cash (about 10% yield on a share price of \$3.50 USD pre-split) and compounding capital at roughly 15% per year. The Company maintained a debt-free balance sheet with \$3.7 billion in cash, with a dominant and growing market share in GPUs, and 25% of its revenue spent on R&D to maintain a healthy pipeline of powerful products. And just as important, gross margins had grown from 35% to 52% in the prior three years.

Had one purchased the Company ten years ago for \$3.50, the compound annual return on Nvidia to its March 31, 2023 price of \$269.64 would have been roughly 55%. That's per year; in aggregate the return, before dividends, would be 8,227%.

Rising revenues, expanding margins and profitability, and multiple expansion. Now that's compounding.

Granted, Nvidia is a cyclical semiconductor company. Lots of volatility. And, at present, in a cyclical low so growth has slowed. And valuation has become an issue with investors plunging into the stock given the inertia of stock price movement over the past few years. At a market cap of \$668 billion today, Nvidia is no longer the same type of investment. It's been a wonderful decade but the likelihood of Nvidia generating a similar return profile over the next ten years is very low.

We, as investors, can so easily get lost in the weeds. Dithering over small changes in the quarterly financials. Focusing on what management says about the quarterly expenses or their expectations for the coming quarter. Macro talk on the economy. Worrying about the nickels and dimes on earnings forecasts.

There are forests ... and then there are trees.

Why do small cap indices outperform in the long term? Because they contain a few businesses like Nvidia that will, over the fullness of time, compound at high rates and generate performance above all the other smaller companies along with all the larger companies as well.

And you really don't need many of them. Morgan Housel quoted Warren Buffett as saying he's owned 400-500 stocks in his lifetime and made most of his money on just 10 of them.

The “trick” is to uncover those ten. Look for great business models in smaller companies that have a successful record of generating predictable cash flow. Narrow that group to those with strong capital allocations, measured by high returns on capital. Winnow that list down to those that have avoided leverage, or debt financing, to build the existing business. Finally, start interviewing the management teams of the residual group to uncover the very best at what they do. Simple.

Okay, maybe not so simple. But when you find a company that meets these criteria, one should buy and hold .. and hold .. and hold .. and hold.