The Sins of Investing

While our individual investment careers span a much longer time frame, Inkwell Capital recently passed its fifth anniversary of operations. Since Inkwell has been managing its clients' money for over half a decade now, it seems like a good time to review what has gone well and what hasn't. We don't know about you, but whenever someone offers to tell us "the good news and the bad news," we always opt to hear the bad news first. Good news has a way of taking care of itself, but we prefer to deal swiftly with whatever bad news there is so that we can get it out of the way and move on to happier things.

With that in mind, let's dwell here just on what has not worked well over the last five years. In the realm of investing, there are two main types of mistakes, whose names we will borrow from the Catholic Church: sins of omission and sins of commission.

According to the Bible, "Whoever knows the right thing to do and fails to do it, for him it is sin." That is a sin of omission. In investing, one example of this type of mistake is to analyze stock XYZ and think to yourself, "I calculate the company's intrinsic value to be $30 a share. If that stock ever gets down below $21, which would give me a healthy 30% discount, I'm going to buy it." Time passes, the stock drifts lower, usually because of some negative headlines or less-than-perfect financial reports, and then it hits $20. You notice it, but—for whatever reason—you neglect to follow through on your original intentions and you do not buy it. A year later, you happen to notice that it has recovered nicely and is now trading for $30. Just as quick as that, you have now missed out on a 50% gain on a portion of your portfolio.

Of course, you haven't lost any money in a tangible sense. The cash that you were planning to use to buy XYZ is still sitting there. Perhaps it has grown by 1% due to the interest earned, but that is a far cry from 50%. So even though your portfolio won't show a loss due to this mistake, you still will have missed out on a 50% gain that you could and should have made.

By the way, for us a sin of omission does not refer to any stock that we didn't buy and went up in price. It only refers to stocks of companies that we feel we understand, which we have analyzed, and which we have decided to buy at a specific, typically lower, price. For instance, a biotech company whose stock recently went up 200% is not a sin of omission for us, because the biotech industry is outside our circle of competence and we would probably have never bought that stock.

A sin of commission is much more easily explained and acutely felt: you feel like stock ABC is worth $50 a share, so its current price of $35 is a bargain, and you buy some. Then a few months later some negative issue arises, perhaps one that you should have foreseen, and the stock drops to $25. After considering the facts, you now believe ABC is worth much less than previously thought, so you sell, incurring a realized loss on your original investment. That is a sin of commission.

Inkwell's Sins of Commission

Just as there are no hitters in baseball who have a 1.000 batting average, there are no investors whose every investment is a success. Inkwell has certainly committed some sins of commission in its first five years of operations, and we will undoubtedly commit others in the years to come. We're always seeking to minimize their frequency and severity, though, and one of the best ways to do that is to perform a post-mortem analysis of each mistake, figure out what went wrong, then try to avoid similar situations in the future.

In our first five years, we made 74 investment purchases totaling approximately $41.5 million in aggregate. We still hold 57 of those securities, having sold 17 of them already. Of those 17, we sold 14 of the investments at a gain and 3 at a loss. These 3 losses accounted for a total of a little over $0.5 million, so our "Sin of Commission Hit Rate" was 4.1% of the number of investments we made (i.e., 3 out of 74) or 1.3% of the dollars involved (i.e., $0.5 out of $41.5 million). We did sell one other security at a loss, BP plc, but that was merely a way for us to harvest a realized tax loss, because we immediately used the proceeds to buy stock of a similar multi-national oil-and-gas company.

Fortunately, these mistakes have not been too costly for our clients in either a dollar or percentage basis, but they still sting from an intellectual perspective. Here is a quick analysis of each of these mistakes. Each of our client's experience with these was unique in terms of percentage and dollar losses, but we present the figures below in aggregate for all Inkwell clients.

Avon Products

We invested about $100 thousand into shares of Avon in 2011 and early 2012, then sold them later in 2012 through 2014 generating proceeds of about $80 thousand. In all, our aggregate loss was $17 thousand, or 18% of our cost basis.

Avon was fighting a battle on several fronts at this time. From domestic competition to bribery allegations in China to economic weakness in South America, Avon the company was struggling and Avon the stock showed it. Nevertheless, we bought the stock as we saw a century-old brand that sold high-margin, daily-use products all over the world. The company had generated consistently high returns on invested capital, and we were betting that results would revert to their historical average.

We were not the only ones to see value in the shares as Avon's stock dropped. A competitor attempted a takeover of Avon at the time, offering shareholders a 20% premium above its recent price. As the stock rallied in response to the offer, we sold a portion of our holdings to lock in some gains. Nevertheless, since the stock price was still trading at a discount to the offer price, we kept about half of our holdings.

Avon management, to our surprise and dismay, rebuffed that generous offer, and we eventually sold out at around $12 per share. Thank goodness we acted when we did, because we missed out on a 60% decline subsequent to our sale—Avon shares trade hands for around $5 these days. Our experience with Avon taught us a valuable lesson regarding management and incentives. Right around the time Avon got the takeover offer, the company had hired a new CEO. To the detriment of shareholders that executive had a higher incentive in keeping her new position than to selling the company and losing her job. The behavior of Avon management and their utter disregard for shareholder value still infuriates us to this day.

Dell Inc.

We invested about $445 thousand into shares of Dell in 2011 and 2012, then sold in 2013 generating proceeds of about $410 thousand. In all, our aggregate loss was $33 thousand, or 7% of our cost basis.

Dell was a powerhouse computer manufacturer in the 1990s and early 2000s. When the world began to adopt smaller devices such as tablets and smart phones, though, Dell struggled to keep pace. Its bread and butter business of laptops and desktops was in secular decline as more of us continued to snap up iPads and Kindles. We believed Dell's stock declined by more than its underlying business value, though, so we bought it. We were eventually bought out of our position by a management-led takeover. While it's clear with the benefit of hindsight that this takeover was done at a lowball price, we still could have saved our clients some losses if we had insisted on a larger margin of safety between our purchase price and our estimation of Dell's intrinsic value.

Tesco plc

We saved the biggest embarrassment for last. We invested about $1.2 million into shares of Tesco in 2012 through 2014, then sold in 2015 generating proceeds of about $0.7 million. In all, our aggregate loss was $0.5 million, or a whopping 42% of our cost basis.

Tesco is the dominant grocer in the UK, with its revenues representing nearly 30% of what Britons spend at all grocery stores. It had a long history of market dominance, with 20 consecutive years of profitability. Low-price, low-service competition from stores like Aldi, Lidl, and Asda began to significantly eat into Tesco's business, and its American shares (traded in U.S. dollars) declined from a high of $30 to $15, when we began to buy.

We incorrectly surmised that Tesco's British market share would stabilize and that its forays into other world markets such as South Korea and the U.S. would begin to bear fruit. We also took comfort in the fact that Tesco owned a large number of its stores, and that real estate would provide a margin of safety to the price we paid. We were wrong on all counts, meaning that Tesco's per-share intrinsic value was not in the low $20s as we had originally estimated, but was probably more like half that. This painful fact became more and more clear as Tesco's domestic sales continued to erode and it pulled back from its foreign investments—it left the U.S. market in 2013 and South Korea in 2015.

We were able to exit the stock at around $9, a price that it has not seen again since our sale. Tesco's strategy in recent years is sometimes described by the business press as a "turnaround." There are many types of investments available in the stock market, but turnarounds have one of the highest degrees of difficulty. If you can imagine a warship or ocean liner cruising full speed ahead and then attempting a turn to a different direction, you can imagine the difficulty of such a maneuver and all the things that have to go right below decks to make it happen. As Warren Buffett has often pointed out in his succinct way: "Turnarounds seldom turn." If and when we do invest in another turnaround, we will be much less optimistic in our estimation of the business' intrinsic value.

Inkwell's Sins of Omission

At Inkwell, sins of omission have turned out to be far costlier to our clients that sins of commission. While much more difficult to precisely quantify (how many shares would we have bought? would we have sold any since then? and so on), we can put ballpark estimates on the amount of wealth foregone by our inaction.

Apple Inc.

In 2013 shares of Apple Inc. were on a long, slow decline. This is a business we are familiar with, as we have been analyzing it for years. We had a pretty good idea of what the business was intrinsically worth, based on the number of iPads, iPhones, and other doo dads we expected them to sell, and we thought that any price below $400 at that time would represent a good bargain. In April and June of that year, Apple stock closed below $400 on six separate days. If we had initiated a medium-sized position, say 3% of a typical stock-only portfolio, we probably could have put about $0.5 million to work in Apple shares. Since then, the stock has effectively doubled while also paying out about 12% of what would have been our initial cost in quarterly dividends, meaning that this sin of omission is responsible for nearly $0.6 million in value that could have been.

Alphabet

The company formerly known as Google is one we have followed since before its IPO back in 2004. We have long been admirers of its business model, profitability, and culture. The only problem is that the stock has very rarely seemed like a bargain to our value-oriented sensibilities. There was one time when we had a brief chance to buy it, though, and we missed it. We decided a couple of years ago that if the stock traded below $500, we would initiate a position. There were about 7 days in December 2014 and January 2015 when the stock traded at that level, though it only closed below $500 on 2 of those 7 days.

Since that time, Alphabet stock is up over 60% compared to a 15% return produced by the S&P 500 index or a 1% to 2% return for cash-like holdings. We estimate that we could have put about $850 thousand to work in shares of Google at that time, which means this passed-over

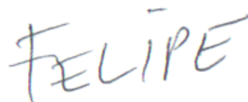
investment would have generated a return for our clients similar in size to what we might have earned from Apple—about $550 thousand.

Second Chances

Sometimes we have been lucky to get a second chance on a stock. If a stock gets to a price we'd be comfortable buying at, but then we miss it and it subsequently runs up a good bit, there have been a few times when it later comes back down to our buying range and we are able to pick it up at that time. In our first five years, this has already happened on a few occasions, and we are always grateful for when the stock market affords us such opportunities. Will the stocks of Apple or Alphabet ever get back to a range where we could buy them? Maybe, maybe not. But we remain vigilant in our search for bargains, and we hold these missed opportunities in our minds as a source of inspiration.

Conclusion

Our first five years have been incredibly rewarding, and we have enjoyed some measure of success in our stock market investing. Like all investors, we have made our share of mistakes too, and we know that we will continue to make mistakes in the years to come. Hopefully the mistakes we make in the future will be novel ones and not repetitions of the ones described above. An investor's education is never complete, so we know our batting average will never equal 1.000, but we will strive to always be improving by seeking to maximize our successes and minimize our mistakes.



Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC