Wagner Road Capital Management

Why We Choose Quality Over Quantity

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Passively owning "the whole market" has become a popular investment strategy, and for a good reason. It is widely reported that the average investor dramatically underperforms the overall market. Using an index fund, and just trying to match the market, eliminates the uncertainty of deciding which investment idea might be the best. It also generally comes with low costs. For the average investor, it makes sense.

But there is a benefit to including an actively-managed investment strategy as part of an overall portfolio.

When someone buys an investment fund that follows an index like the S&P 500, they are buying everything in the index—the good, the bad, and the really bad—without knowing what it's worth (or even knowing if it's worth anything at all!). It can be moderately compared to a hoarder who keeps everything, including their garbage, assuming that someday it will all be useful and valuable. At a basic level, we'd at least like to avoid the really bad stuff.[1]

This was not always an obvious way of investing. It has a simple origin.

The idea of value investing was first introduced by Benjamin Graham in the 1930s. His idea was to only buy the companies that are selling for an extremely low price. Then, after the stock price rose to the company's value, he would sell. [2]

Cheapness, not quality, was the primary focus. It's easy to understand, but hard to follow through. It required two features to work properly:

1. **A long term view.** Buying a cheap stock meant waiting for the price to return to normal (think "buy low and sell well" instead of "buy low and sell high"). In the short term, price does not always match the value, but this will be true over the long term.
2. **A large portfolio.** The strategy was statistically sound, but individual investments could have a wide range of outcomes. Stocks that appeared to be

[1] The comparison is somewhat unfair. Almost all investments do have some value, while almost all hoarded items have no value. The point is to illustrate that it can be helpful to sort through everything and only keep what is *really* expected to be valuable.

[2] Benjamin Graham literally wrote the book on value investing. Actually, he wrote two of them: *Security Analysis*, a technical, dry explanation of value investing's foundation (don't read it). And *The Intelligent Investor*, a more general overview of how value investing can lead to better returns (chapter 8 and chapter 20 of this book are essential reading for *all* investors).

cheap would often stay cheap; or worse, their value was imaginary the whole time. Many were on the edge of going bankrupt. The few great performers would be offset by a huge number of duds.

Warren Buffett, an investor who was mentored by Ben Graham, followed this practice in the 1960s. He would invest in what he called “cigar butts,” or companies that seem doomed to failure, but have one more “puff” left in them. The purpose was to extract what little value remained, and then move on. Again, cheapness, not quality, was the focus.

Over time, this philosophy changed. With a nudge from his friend, Charlie Munger, Buffett began buying businesses that he considered to be high quality, even if they were not extremely cheap.[3] And, as you probably know, it has paid off—in 2008, Buffett briefly topped the Forbes list of the world’s wealthiest billionaires, and has been near the top of the list for decades. He could not have done that by only using the cigar butt approach to investing.

Quality, not cheapness, became the new focus. The shift led to two major changes in portfolio management:

1. **An extra-long term view.** Instead of waiting for the price of the company to catch up with its value, this new strategy also relied on the business performance over a long period of time. Finding the right price buy was still a factor, but it was more important to have ownership in a business that could sustain long-term success. Selling was reserved only for the times when the company’s quality began to deteriorate, or when the price was way too high.
2. **A small, concentrated portfolio.** High quality companies are rare. And, by definition, they do not fail as often as low quality companies. This made it possible to concentrate on only the best investment ideas. The cigar butts were left in the garbage. Instead, the portfolio was filled with exceptional businesses, with only a handful of stocks making up two-thirds or even three-quarters of the entire portfolio.

This is how the portfolio for Buffett’s company, Berkshire Hathaway, has been constructed, and it’s a similar philosophy to what we use.

But what do we mean when we talk about a high quality company?

The short version is that a high quality company is one that takes care of your investment. When a recession comes, or the stock market crashes, we can feel comfort

[3] This transition is well documented in two excellent books by Robert Hagstrom: *The Warren Buffett Way* and *The Warren Buffett Portfolio*.

in the fact that our businesses will end up better off on the other side. We consider how this works on many different levels.

It starts with the type of products that the business is selling:

- The most robust markets involve products that people will still use even when their income drops. Some basic examples would be healthcare, or energy, or food. People may not buy as much when their money is tight, but they will still buy.
- There are products that consumers can “trade down” to during a recession, such as discount brands.
- Luxury brands may suffer when consumers trade down to the discount brands, but they can recover quickly when economic growth returns. There are also cases where people will continue to choose the premium product, when the benefits are significantly more valuable than the cost of a higher price.

An emphasis on quality also considers the financial health and financial returns of the business. Fast growth is exciting, but it is not always ideal. When growth is fueled by too much debt, or when it comes without profits, it can threaten the foundation of the entire company. Mistakes, and normal periods of bad performance, are amplified by borrowed money. Opportunities have no meaning when the business can’t pay its bills.

We prefer a more measured approach, inspired by one of the lessons from Romeo and Juliet. As Friar Lawrence warns the young Romeo: “Wisely and slow. They stumble that run fast.” The young Romeos of the investment world are often seduced by the fastest-growing companies (or, more often, the fastest-rising stock prices). But, like Romeo, their love is shallow, and it only lasts for a short time; at least until something newer and more exciting catches their attention. We want something more durable. Growth is good, but financial health comes before fast growth.

Stability is necessary, but so is flexibility. Markets and economic conditions can change quickly. We need stability to survive the initial shock of these changes, but flexibility is the way to recognize how to benefit from a changing market. This requires a broader perspective on how a company competes within its industry:

- The most attractive business is one that operates as a monopoly but does not get regulated as a monopoly. The easiest way to understand this is to think of local monopolies, where one town is not large enough to have two competing businesses. Or a “toll bridge” where the bridge is the only way to get to the other side.
- The next most attractive business is one that operates inside an industry that is difficult for new companies to enter. Economists call this “high barriers to entry.”

These barriers to entry are generally regulatory (things like patents) or simply businesses that require huge investments, such as railroads. This type of industry, where massive amounts of money is needed just to survive, usually has about 3-5 major companies.
- In industries where competition is fierce, or industries that do not have many opportunities to be different, there are still ways to build a durable competitive advantage. This can be made by something as simple as consistently keeping the lowest costs or the best new product development. It is more difficult, but some companies are good at it.

Whatever the industry, our goal is to identify a company that has proven its ability to compete. Preferably, we would also like to see a company that has proven its ability to innovate and reinvest in itself—with many more opportunities for reinvestment.

Beyond that, there is one more aspect to quality that does not show up in any financial screens: the management team's ability to recognize the company's position in the market and take advantage of reinvestment opportunities. If the management team itself is not capable of making the same evaluation as an intelligent outside investor (or if the management team has an incentive to ignore the concerns of the company's owners), then the quality of the overall business is threatened. There are three basic tiers:

- At the very least, we like to have a management team that thinks like owners.
- Or, even better, a management team that has personally invested heavily into the company.
- Or the best, and most rare, a management team that still includes one of the company founders. They will often have special insights on the industry and a unique incentive to preserve and grow the business.

It's a pretty simple analysis. But there is some caution about focusing on high quality companies.

Price is an important factor. Quality alone is not enough to make a great investment. An investment must also be made at a reasonable price that is consistent with the expectations of the company's performance. Even the best businesses can be priced for perfection—and perfection is impossible.

The quality strategy is also an extra-long term strategy. It's not exciting, and it does not guarantee the best investment results every year; it can only increase the chances of having acceptable long-term returns. Short-term returns can be very good for the people using other investment strategies. Sometimes the more exciting strategies will outperform for a painfully long time, and investors in high quality companies might begin

to question the purpose of their patience. It’s a psychological challenge that comes with every investment strategy.

What makes the strategy work is a commitment to following the principles of identifying a high quality business. When those high quality businesses are recognized, it takes conviction and patience to wait for the right price, and even more conviction and patience to wait for business results that prove an assessment of quality. When we look at what we’re trying to do, it’s not about predicting the week ahead or forecasting the next few months. It’s not about hoping that other investors will be willing to pay more. It’s about finding reasonable business stories that can meet our long-term economic expectations, and not paying too much for the potential.

Nobody can be right all the time, or even most of the time. The best case is to make the biggest bets when the probabilities are most in our favor. An emphasis on high quality companies with a long-term view can only serve to increase those probabilities.

This is the benefit of doing the research. Instead of owning everything and getting worried when it moves the wrong way, or making short-term trades based on short-term bets, we can find comfort and confidence in the quality of the businesses that we own. It’s a psychological benefit that is just as valuable as the math behind long-term growth.

That’s why we’ve chosen quality over quantity.

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