Memo to: MCJ Capital Partners

From: M. Carter Johnson

Re: Fishing In The Right Pond

Date: 2/15/2020

As a young boy, I spent many summers creating fond memories fishing with my grandfather. One memory stands out in particular. I was around nine years old and despite my persistence, I wasn't having much success at the local fishing ponds. It just so happened that my grandfather knew of a small fishing pond about 45 minutes away that was hard to get to and rarely fished. I remember waking up earlier that morning, loading our gear and making the trip to that isolated fishing pond. It was no sooner that I casted out my second line, that I had hooked my first fish of the day. That was the start to a day I'll never forget. By sunset I had caught more fish than I could count. My forearm ached from reeling in so many catches. Driving home I was sure the success of the day was a result of my persistence and superior fishing capabilities.

What I know now was that day's success was directly because I was simply fishing in the right pond. Today that same principle can be applied to investing. There are certain structural characteristics of the investment world that create difficulty for larger firms with larger capital bases to "fish" smaller ponds stocked full of high quality smaller capitalized companies. For investors willing to limit their capital base, fishing these areas of the market offer a number pristine advantages. We could spend quite a bit of time discussing all of them in detail but in this memo I will focus specifically three:

1) The advantageous ability of small companies to swiftly compound absolute levels of capital.
2) The unfair playing field that limits heavy competition in this area.
3) The specific difficulties of replicating the strategy passively.

As an investor I spend most of my time looking for opportunities in these capacity constrained areas of the market. These areas are full of quality businesses, smaller in size that offer great asymmetrical opportunities. Let's explore these advantages in more detail...

Compounding Absolute Levels of Capital

Perhaps the most attractive advantage held by small companies is their ability to rapidly compound absolute levels of capital. To understand this, envision the trajectory of a hypothetical small but successful service company, with only two locations. If the small service company adds one additional location, it has grown its operational footprint 50% in size. If the company adds two additional locations, it now has doubled its size. This is an oversimplified example that removes a lot of underlying fundamental finance, but you likely understand the point. On the contrary, large companies do not have the luxury of compounding capital with such ease. As a business successfully matures, it begins to saturate its own market, slowly shrinking the overall remaining runway enabling its growth. Practical limitations of how much more the large company can expand (and how fast) set in. The way economics take over, size creates a drag that makes it increasingly more difficult for the large businesses to compound capital. Put differently, it is much easier to grow a company from $150 million to $300 million, than from $20 billion to $40 billion.

To our benefit, discovering a small and growing company early creates the opportunity to ride a winning horse for a long time. As opposed to agonizing over where to reallocate capital, a small company with a long runway offers a great place to park capital and let the nature of compounding take over. In addition, investors can benefit not only from the growth of earnings produced by the business but also an overall expansion in the valuation multiples applied to those earnings. These factors create a two-fold rise to the overall value of the enterprise. Take a look at the earnings growth and valuation expansion for Costco from 1995 to 2020:

Costco		
	1995	**2020**
Store Count	200	785
Earnings Per Share	0.34	2.47
P/E Multiple	24.11	35.69

In 1995 Costco opened store number 200. The company was publicly traded and producing $0.34 earnings per share. Those earnings were valued at 24.11x, bringing the per share value to roughly $8.20. Had an investor parked capital in this small and growing company, they would have benefited from owning an operation that grew store count from 200 to 785, fueling earnings per share growth from $0.34 to $2.47 and an expansion of valuation multiples from 24.11 to 35.69x. As of early February 2020, a share of Costco trades north of $300. In 1995 Costco had a great business model with a long runway to keep reinvesting earnings internally. The growth of earnings and expansion of valuation rewarded investors quite handsomely.

Less Professional Competition

Most investors understand the economics that create advantage one and welcome the idea of finding opportunities of this nature. Knowing the underlying advantage exist (coupled with the historical return premiums on small cap equities), you would think the area of the market devoted to small cap companies would be crowded with competition from sophisticated high caliber professional investors, and thus flushing away any opportunity for excess returns. However, this does not happen for a simple reason. As active professional investors enter the market, many begin by plucking the low hanging fruit of this area. As their success increases they begin to experience an influx in capital. Eventually their capital base reaches a point where allocations in this area of the market are no longer feasible.

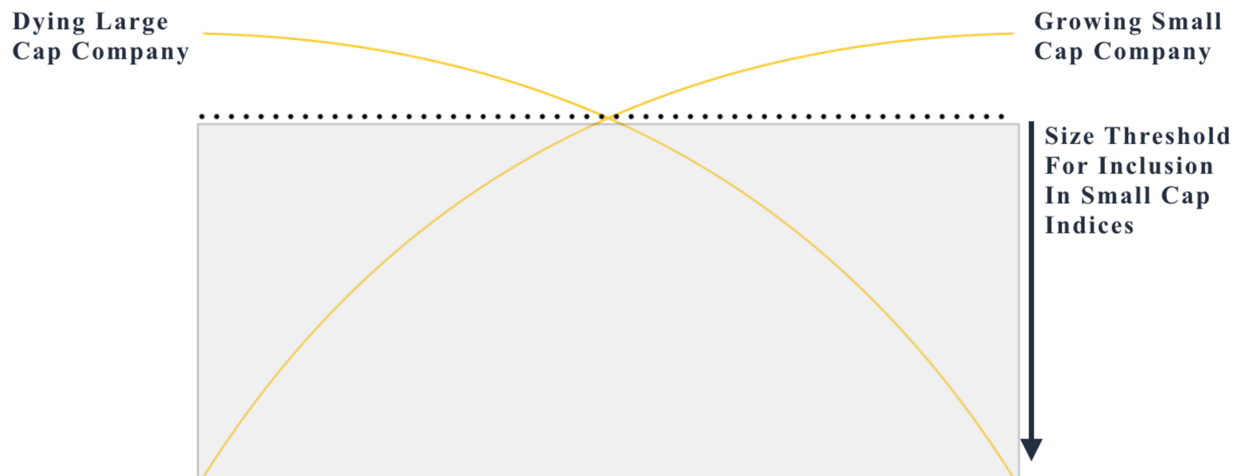
To illustrate this phenomenon think of a hypothetical portfolio manager with starting assets of $10 million. If our portfolio manager were running a concentrated strategy, investing equally across 10 positions, they would allocate $1 million per a company. Investing in a company with a market capitalization of $500 million would be a breeze. The manager could hypothetically invest in companies well below $100 million in market capitalization even going all the way down to nano cap companies without encountering capacity issues. Now, let's say over the years that portfolio manager had success and kept taking on capital growing their asset base to $300 million. All of a sudden, a 10% position would mean allocating $30 million to a single idea. $30 million to a $500 million company would equate to a 6% position of the overall company, making it much harder to execute. Should the manager like the prospects of a company with a market capitalization less than $100 million, the challenges and tradeoffs climb. If the manager could only allocate $1 million in a single idea, they would be allocating just 0.33% of their total AUM, meaning approximately 300 similar allocations would need to occur to fully invest the entire asset base. This is unlikely in an active strategy built on bottom up investing. The manager with $300 million must decide between more companies with allocations to lower conviction ideas, or a similar number of companies but larger in size (and routinely priced by the broader market thus hypothetically more efficient).

The result of this structural component in the investing world creates a vacuum where there is less overall active (and seasoned) competition in these areas of the market. Investors with smaller capital bases benefit from both pricing inefficiencies and more reasonable valuations when market prices are pressed to speculative levels.

Difficulty to Replicate Passively

Knowing small capitalized companies have a fundamental economic advantage, and knowing less active competition exist within the market for these companies, you are probably asking yourself the question I too had at one point... Why not just purchase a passive index fund focused on small cap equities? At first glance, doing such would seem to capture the benefits outlined above. However, something strange happens with small cap index funds…

The threshold for small cap index funds is based on market capitalization. These index funds consistently recalibrate their holdings to passively include and abandon companies of a preset market capitalization size. This means, large failing companies with shrinking market caps eventually drift into range and are included in these small cap index funds. Occupying the small cap index fund, they weigh down the performance of the entire index, on their way down to zero (ie bankruptcy). Perhaps even worse, the small cap companies that are proven winners, with growing market caps, are abandoned by the small cap index funds as they grow in size pass the upper threshold of inclusion. Passively, small cap index funds cut the winners and double down on losers. This can be seen visually in the exhibit below:



Overall, the advantages of fishing for opportunities in smaller ponds number well beyond those listed in this memo. However, the absolute compounding advantage, less professional competition, and difficulty to replicate passively are a few reasons why I believe this will remain a fertile hunting ground well into the future.

Until next time,

M. Carter Johnson

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