Hosking Post
Taking Time

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TAKING TIME

"It's waiting that helps you as an investor, and a lot of people just can't stand to wait. If you didn't get the deferred-gratification gene, you've got to work very hard to overcome that."[1]

Charlie Munger, 2014

In his essay "Of Bamboos, Cicadas and the Economy of Adam Smith",[2] the scientist Stephen Jay Gould tells the story of a species of bamboo *Phyllostachus bambusoides* that flowers and sets seed once every 120 years, a remarkable length of time. What is even more remarkable is that all plants of the species do this simultaneously, so that wherever in the world they are, they wait 120 years and then all flower in the same year. This combination of infrequency and synchroneity can be understood as "predator satiation" - the long time interval between flowering means it occurs at most once during the life cycle of its predators, and the synchronous setting of seed increases the likelihood that at least some representatives of the species will survive. The bamboo's strategy is taken a step further by certain members of the insect order *Homoptera* in the eastern half of the United States, known as periodic cicadas. These live underground as nymphs for 17 years (or 13 years in the case of some species) and then in the space of a few weeks they all emerge from the ground, become adult cicadas, mate, lay their eggs and die. Gould points out that these cicada cycles are prime numbers, non-divisible by any other integer except 1, which has the effect of minimising the coincidence of the cicadas' life cycle with that of any predator.

Giving yourself a structural advantage that reduces the threat from others recalls Amazon founder Jeff Bezos' finding opportunity in projects whose longer paybacks put off the competition. "If everything you do needs to work on a three-year time horizon, then you're competing against a lot of people", he is quoted as saying in 2011. "But if you're willing to invest on a seven-year time horizon, you're now competing against a fraction of those people".[3]

Adopting a seven-year horizon to exploit richer opportunities sounds eminently sensible, but is easier said than done, whether by a chief executive making capex decisions, or by an investment manager constructing a portfolio. There are plenty of reasons why the prospect of a more immediate payback is often preferred, mostly to do with lower perceived risk. However, where a longer-term approach does not involve a commensurate increase in risk, the reward from allowing duration to compound superior returns for longer is highly attractive. At Hosking Partners, our diversified portfolio creates

[1] https://www.wsj.com/articles/the-secrets-of-berkshires-success-an-interview-with-charlie-munger-1410543815
[2] Ever Since Darwin: Reflections in Natural History, 1978
[3] https://www.wired.co.uk/article/ceo-of-the-internet

more capacity to invest in companies with a longer investment horizon. If, following Bezos, the forecast three-year returns are unexciting but there is the reward of an exciting payoff after seven years, we are very happy to exploit the potential mispricing on offer. The long-dated returns are rightly more difficult to value, but the large number of stocks in the Hosking Partners portfolio (currently in the region of 350) means that single-stock risk can be accommodated more easily. If others with a more concentrated strategy find that harder to do, then the likelihood that those stocks will be underpriced increases even further.

A diversified portfolio is necessary but not sufficient to exploit this opportunity to invest in long-horizon companies. Among other things, a high-quality and patient investor base is key. We are judged by the company we keep, and it is important that our clients share the same long-term approach as we have. A long-term performance fee is designed to reinforce this shared vision. Career risk arises from the mismatch between an investment manager's horizon and their investors' horizon, so closing that gap is essential not only to avoid the herding of more myopic investors, but more importantly to take advantage of the exaggerated short-term price movements which their behaviour creates.

Hosking Partners' capital cycle approach helps too: it reinforces contrarian thinking with its focus on supply rather than demand, on the capital cycle rather than the business cycle, providing a rational justification to support the decision to be different. Whether our long holding period (currently averaging circa 10 years) is a function of this approach or vice versa is moot - the two go hand in hand. It is important to note in passing that not all positions in the Hosking Partners portfolio are necessarily long-term – we are happy to pick up opportunities with short-term paybacks, recognising also the benefit from the diversification they bring to the portfolio.

Unfortunately, just as we are able to exploit Mr Market's manic pricing to increase our exposure to the shares of long-sighted companies, so too can private equity by means of a takeover offer, with the result that we public market investors are sometimes forced to sell our most attractive holdings at precisely the wrong moment. The one-off premium paid by private equity to delist a company is scant compensation for the foregone years of compounding returns which Hosking Partners' investors are deprived of.

One way in which we can address the risk that some stocks in the Hosking Partners' portfolio are confiscated at a cheap price by private equity is to ask our investors for the ability to continue to hold shares even after they have been delisted, so we can stay on the longer-term journey. In practice,

we use this ability sparingly, as the majority owners of the most attractive situations unsurprisingly find ways to squeeze out minorities just when the opportunity is most exciting.

There is, though, another way, which is to invest alongside an owner who has a sufficiently large stake to prevent the private equity privateers from boarding the ship. The aforementioned Jeff Bezos at Amazon is one example: although his ownership of the company has been diminished by consistent share sales over the years, as well as by divorce, it stood at more than 40% immediately following Amazon's IPO in 1997 and until fairly recently was above 20%. Elsewhere, the presence of fellow long-term investors such as Berkshire Hathaway with its mantra that its "favorite holding period is forever"[4] provides some protection to minority shareholders, although Berkshire's privatisation of the BNSF railroad in 2009 at a 31% premium demonstrates that minority public shareholders can never be totally confident they will not be dislodged from the registers of companies of which they are owners.

"If you can't beat them, join them" can be a pragmatic response when the odds are not right, and Berkshire Hathaway is currently a top 20 position in the Hosking Partners portfolio. Investing alongside the management who control the company allows us to retain long-term exposure to assets such as BNSF, and rather than paying for this advantage we get to invest with minimal drag from fees and management overhead. We also benefit from the liquidity of listed shares.

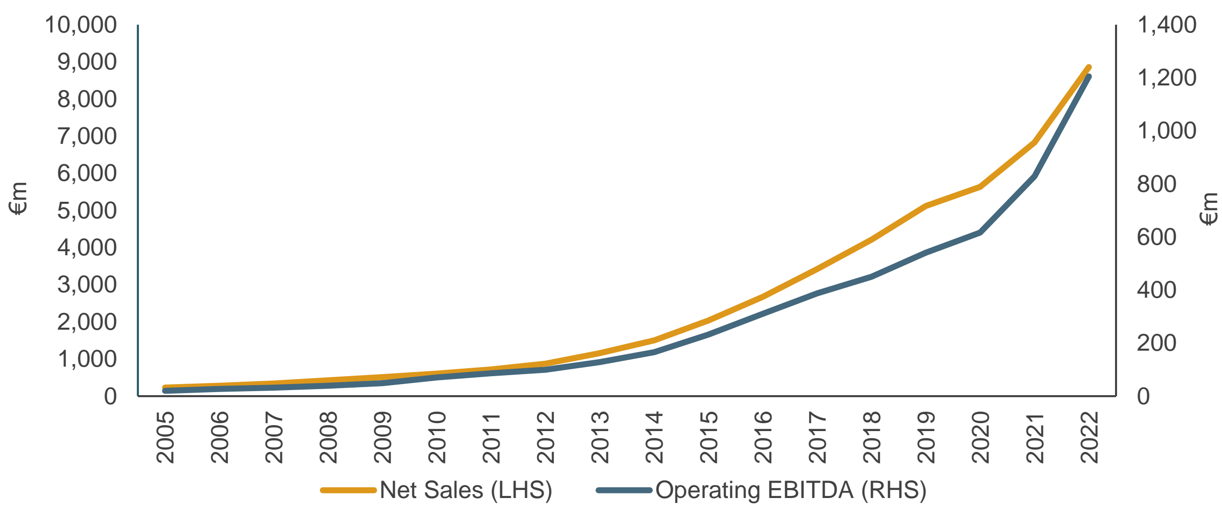
Incidentally, since its acquisition by Berkshire Hathaway, BNSF has stood out with a different strategy from the other Class I railroads, all of which are listed. While the rest of the industry has pursued the practice of "precision scheduled railroading" (PSR), based on pursuing operational efficiencies to generate a higher return from their assets even if at the expense of customer experience, BNSF with the support of its Berkshire Hathaway parent has instead accepted greater redundancy in its operations, for example in terms of track length and yard numbers, in order to be able to accommodate longer-term growth. The jury is out on which approach is the right one, but the consensus among the sell-side analyst community is that PSR is the only way, and much of its commentary consists simply of breathless reporting of the latest job moves by PSR's leading exponents from one railroad to another. BNSF is sheltered from such short-term distraction by its parent Berkshire Hathaway. The fable of the hare and the tortoise may be an appropriate metaphor as we wait to see which strategy prevails.

[4] Berkshire Hathaway 1988 shareholder letter - https://www.berkshirehathaway.com/letters/1988.html

Berkshire Hathaway is by no means the sole representative of a long-duration approach in the Hosking Partners portfolio. Other examples include the insurer Fairfax Financial, as well as our basket of royalty companies of which PrairieSky Royalty and Altius Minerals are the most prominent. Occupying a top 10 position in the portfolio currently is listed private equity investor 3i, whose model was previously to raise limited-life private equity funds to invest alongside its own balance sheet but is now more similar to a holding company such as Berkshire Hathaway. After a near-death experience during the global financial crisis which came about due to the combination of debt at holding-company level as well as investee-company level, 3i has eschewed raising any more third-party private equity funds. Possessing its own significant balance sheet rather than simply being a capital-lite manager of other people's money, the company realised that if it is an above-average investor (an important caveat), then it should generate a better return for its shareholders by earning a multiple on its own capital rather than clipping a fee on the profits enjoyed by investors in funds it managed. Furthermore, much of that fee income would anyway get diverted into the pockets of its own managers in the form of carried interest, and therefore would not reach 3i's own shareholders. The switch from agent to principal brings with it an important shift in time horizon: it is easier to earn a higher IRR for investors (a key input into the calculation of carried interest) by holding an asset for a short holding period, while a focus on a multiple of money encourages a longer-term hold. Notably, in one of our first meetings with 3i's chief executive Simon Borrows in 2016 (Borrows had been at the helm since 2012 and still leads the company), he remarked that if we ever saw 3i raise another private equity fund we should sell our shares as it would be a sign the pirates had taken over the ship!

Deploying permanent capital (i.e. its own balance sheet), 3i enjoys structural advantages relative to private equity peers. Not only does it avoid the risk of procyclicality, whereby funds are raised and investments are made when markets are hot and prices are high, but also its unlimited time horizon means it is not compelled to sell investments at the end of a fund life even when the opportunity remains to continue to compound growth for years into the future. An example of this is its investment in Action, which is the fastest growing non-food discount retailer in Europe with more than 2,300 stores across the mainland continent. 3i acquired Action in 2011, contributing £106 million of equity, and today 3i's investment in Action has a valuation of £12.0 billion, despite Action having returned over £1.7 billion to 3i in the intervening years.

Action net sales and operating EBITDA (2005 – 2022)



Source: 3i Action Capital Markets Seminar. https://www.3i.com/media/apblwd2j/2023-action-presentation.pdf. Chart has been reproduced and reformatted.

At our most recent meeting with chief executive Simon Borrows earlier this year, he told us that the model for Action's strategy was privately owned retailers such as IKEA, Aldi and Lidl, who are undistracted by the need to achieve short-term performance targets for outside shareholders and can instead focus on the achievement of long-term value creation. The retailing business model, where the retailer leases rather than owns its stores and is paid by its customers before it pays its suppliers, means that very little capital is required for a retailer to grow. For those retailers who happen to be listed, this combination of growth and cash flow generation means that the risk of delisting by private equity, depriving public shareholders once again, is particularly acute. Ownership of Action by 3i not only provides far-sighted stewardship of the business (echoing BNSF's ownership by Berkshire Hathaway), but also allows public market investors continued exposure to an asset that benefits from extremely strong like-for-like sales growth and a store rollout with many years ahead of it.

There is another feature of 3i which particularly appeals to a global investor such as Hosking Partners. Despite being dominated by Action (which accounts for 63% of the 3i investment portfolio's valuation), 3i is a London-listed company, and although it is familiar to UK-based investors, continental European investors are underweight a stock which is the owner of one of Europe's fastest growing and most successful retailers. The upside which should materialise as European investors' awareness of the stock increases is a bonus on top of the runway of future revenue and profit growth that lies ahead. Being an unconstrained global investor, Hosking Partners is indifferent to arbitrary

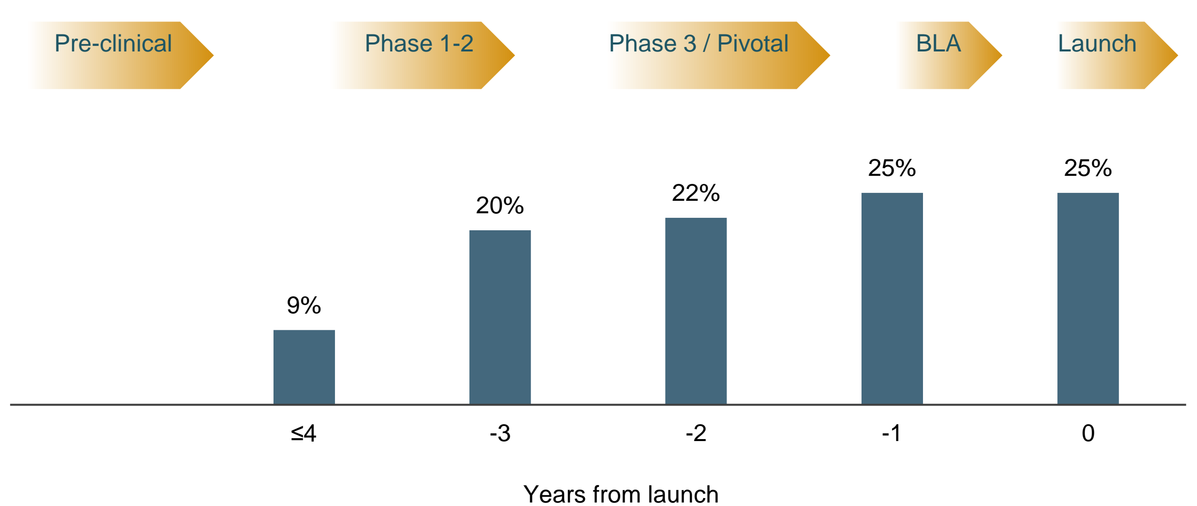
classifications and merely happy to exploit the opportunities which lie in the cracks between other investors' silos.

Finally, a recent addition to the Hosking Partners portfolio provides one further example of the benefits of a longer time horizon. Syncona is a holding company which invests in healthcare companies, benefitting from close ties with leading UK research institutions as well as its 28% shareholder the Wellcome Trust which is the leading charitable funder of life sciences in the UK and was itself founded in 1936. In a sector which is notoriously difficult for investors owing to the vagaries of drug discovery, Syncona already has the distinction of being behind two of the ten largest biopharma exits in the UK.

Interestingly (for us at least), the Wellcome Trust founded Syncona in 2012 using the profits arising from its successful 1995 acquisition of a £283 million portfolio of property in London's South Kensington district, which took advantage of the charity's greater appetite for duration risk arising from its permanently endowed status. The assets it acquired generated little income, being freehold properties let on long-term leases, but by taking a 15-year view the charity was able to capture significant value which had been beyond the reach of investors with a shorter horizon.

Successful biopharma exits mostly happen in the years immediately before clinical stage commercialisation. This means that returns are heavily weighted towards the later years of a venture capital investment. The length of time between the scientific research which leads to a biopharma venture investment and the date it comes to market is difficult to predict and may be long, and the 10-year life of a typical biopharma venture capital fund (a structure carried over from tech venture capital) is not ideally suited to bridging this interval. Venture capital investors tend therefore to avoid the earliest stage investments as they are not certain they will be able to last the journey, and they tend to crowd around later-phase opportunities where the path to clinical success is clearer.

During the last 18 years, 90% of biopharma exits greater than $1 bn have occurred less than three years before commercial launch



Source: Corporate presentation, September 2023. https://www.synconaltd.com/media/sy3dduuz/syncona-corporate-presentation-august-2023.pdf. Chart has been reproduced and reformatted. BCIQ, global data, Syncona analysis. BLA = Biologic license application

Syncona's permanent balance sheet capital and the long-term horizon enabled by this gives Syncona a structural advantage over the venture capital funds it competes with. It invests in early-stage opportunities where its access is unrivalled, competition is less fierce and valuations are sensible, in the knowledge that it can continue to hold the investment through to exit. Meanwhile in the intervening years, its investee companies can access the funding they need more cheaply from venture capital investors keen to deploy capital closer to clinical success, enabling Syncona to deploy its own capital more efficiently.

Despite this unique advantage, Syncona shares trade at a roughly 30% discount to net asset value, and when this is adjusted for the circa £610m of cash equivalent on its balance sheet, the discount expands to almost 60%. As a generalist investor with no greater biopharma expertise than any other generalist, Hosking Partners has little edge in terms its knowledge of molecules or gene therapy, however as a capital cycle investor we do see an advantage in paying attention to industry structure, competitive dynamics, capital flows and likely returns on capital. Deloitte publishes figures annually on likely returns on investment in drug discovery by large biopharma companies. Over the last ten years the projected return on investment in pharma R&D has fallen from 6.2% to 1.2%, owing to ballooning R&D spend and the lengthening time required to take drugs through trial to market, as well as lower forecast revenues. One way to compensate for this falling return on investment is for

large biopharma companies to acquire commercially proven drugs from earlier stage investors. Syncona is therefore well placed both at entry and exit.

Return on large-cap biopharma’s late-stage pipeline, 2013-2022

Source: Seize the digital momentum. Measuring the return from pharmaceutical innovation 2022. January 2023. https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/life-sciences-health-care/deloitte-uk-seize-digital-momentum-rd-roi-2022.pdf. Chart has been reproduced and reformatted.

Like Stephen Jay Gould’s bamboos and cicadas, at Hosking Partners we seek to use a long-term, unconstrained approach to give ourselves an edge. This is based on the support of similarly minded clients, the use of the capital cycle approach and the capacity created by our diversified portfolio. It should therefore be no surprise that the Hosking Partners portfolio features a number of companies which likewise pursue a structural advantage, allowing them to exploit long-term opportunities neglected by others. We have written about Berkshire Hathaway, 3i and Syncona in this piece, and they are just a selection from a much larger number of such companies in the Hosking Partners portfolio.

Joe Robillard said that “successful investing is about having everyone agree with you … later”.[5] The longer you can wait, the better. Time will tell…

LUKE BRIDGEMAN
September 2023

[5] Grant’s Interest Rate Observer, 28 October 2016

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