Seeking Protection from Nature

November 30, 2019
By: Direk Khanijou

I'm a fan of Bear Grylls and his show Man vs. Wild. Each episode begins with Bear being dropped into a remote terrain – usually a mountain, jungle or desert. His mission is to survive and find a way back to civilization. My main takeaway from the show – nature is brutal, tough and unforgiving.

One of the things I have learned as an investor is to seek protection from nature. This means avoiding investing in companies that deal with commodities that can be taken out of the ground – gold, precious metals, minerals, oil, natural gas, sugar, corn, etc.

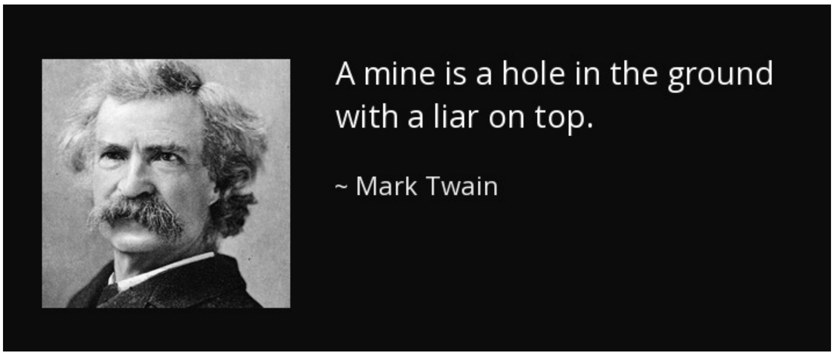
Take a look at the price range of any commodity over the past 30-years. You will see very wide and volatile swings.

Examples of cyclical and commodity-like industries are shipping, steel, and mining. During good times, they take on enormous amounts of debt for expansion, have excellent margins and show high profits. But because of the inherent cyclicality in the industry, when the tide turns, they are left with fragile balance sheets, high interest payments, and no free cash flow.

"The short-term solution is money and the long-term solution more money."

Many analysts try to deal with the unpredictability of a natural resource company by doing scenario analysis. This is a type of financial modeling that requires assigning subjective probabilities to the worst case and best scenarios and then computing the weighted average value.

We know that the value of an oil company will be different if we use a $10/barrel future oil price scenario vs. a $100/barrel oil price scenario. But the way to handle this variability is not through scenario analysis. Doing so would be the functional equivalent of the six-foot statistician who drowned crossing a stream that was on average four feet deep. He forgot that the range of depth was between one and seven feet.



I have read about investors who have lost significant capital by making big, concentrated bets on cyclical companies. We should all learn from what happened to Mark Sellers. At one point he had 80% of his fund in a natural gas company called Contango. For a while, it played out beautifully. His fund delivered solid returns from 2003-2007, Contango's stock kept going up and there was a signed deal for the company. Then everything fell apart. The global financial crisis struck, the deal broke and the price of natural gas tanked.

Another example is Bhushan Steel in India. The company was formerly run by Neeraj Singal. In a race for capacity creation with his brother Sanjay, Neeraj borrowed heavily to build state-of-the-art steel plants. But, falling steel prices and a high debt load, did him in. The company has been acquired by Tata Steel and renamed to Tata Steel BSL.

The tricky thing with investing in commodity companies is that you have to be right twice – when to buy and when to sell. However, if you buy quality businesses, you only have to be right once – buying at the right price.

Furthermore, commodity companies have poor business economics. They are generally price takers, cyclical, capital intensive, lack product differentiation and have returns governed by macro factors. As a result, their stocks are usually bad long-term investments.

One way an investor can seek protection from nature is to invest in companies that "buy commodities and sell brands." Well-known examples that come to mind are Hershey, Coke, Wrigley, Tiffany, and Brown-Forman.