

Uncertainty (An Investing Parable)

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Long ago in a small farming village, lived Sophie and John. The village is blessed with four crops that will grow, depending on the weather. They are: Droughtie (drought resistant), Pestie (pest resistant), Sugarie (one the Queen enjoys, hard to grow but high profits) and Cerealie (a basic staple that grows in all conditions).

At the start of the growing season, Sophie is uncertain about the growing conditions. She decides to plant three crops: Droughtie, Pestie and Cerealie. John wants certainty about the future before he acts and seeks out Prognosticus, the village forecaster. “What is the weather forecast?” asks John. Prognosticus, counts the number of frogs in the pond and proclaims that this season will be hot and dry. John ambitiously plants his entire field with Droughtie to maximize his profits.

The season unfolds exactly as foretold. A long hot and dry season favours Droughtie. Sophie produces a moderate profit as Droughtie does well, Cerealie does satisfactory, while Pestie yields no results. John, with his entire harvest of Droughtie, realizes large profit. Other farmers take notice of John’s quick success in just one season.

At the start of the next growing season, Sophie is uncertain about the growing conditions. She again decides to plant three crops: Droughtie, Pestie and Cerealie. Other farmers realize that they need certainty about the future and join John in seeking out Prognosticus, the wise forecaster. “What is the weather forecast?” asks John. Prognosticus counts the number of frogs in the pond and warns that this season will be tough with locusts descending on the village. John and the other farmers ambitiously plant their entire fields with Pestie to maximize their profits.

The season does not unfold as forecast. It rains for almost the entire season ruining all crops except for Cerealie. Sophie produces a moderate profit as Cerealie does satisfactory, while Droughtie and Pestie yield no results. John and the other farmers’ harvest yields no results. In a precarious financial position, they pledge their lands and borrow funds from Sophie for capital for the next growing season. At the start of the next growing season, Sophie is uncertain about the growing conditions. She again decides to plant three crops: Droughtie, Pestie and Cerealie. Other farmers and John realize that they need certainty about the future, more than ever, but question Prognosticus, “Your forecast was wrong causing us misfortune. Why should we believe you?” Prognosticus, replies, “The last season was an anomaly. My methods have improved!” Convinced that they still need certainty about the future they ask, “What is the weather forecast?” Prognosticus proceeds to count the number of frogs in the pond and counts the length of seven butterfly wings. He proclaims that this season will be a glorious mix of sun and rain, perfect for growing Sugarie. Word spreads throughout the village that the Queen will be visiting. John and the other farmers ambitiously plant their entire fields with Sugarie to maximize their profits and pay off their debts in short order.

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The season does not unfold as forecast. The village is beset with locusts, eating all the crops except for Pestie. Sophie produces a moderate profit as Pestie does well, while Cerealie and Droughtie yield no results. John and the other farmers' harvest yield no results and unable to repay their debts, are forced to surrender their lands to Sophie.

The visiting Queen asks Sophie, "How did you accumulate all the land in the village? Can you predict the weather better than Prognosticus?"

"No." replied Sophie politely, "I just know that there is going to be weather."

What is a 'quality' investment strategy?

Our investment process at Cidel focuses on companies with the resiliency to withstand and survive when the inevitable 'drought', 'rain' or 'locusts' arrive. We assemble portfolios to generate wealth with companies we deem to be durable cash flow compounders (like 'Cerealie') over the long term. We recognize the investing environment is complex and uncertain, therefore we do not seek out Prognosticus to provide us with macro-economic forecasts. Rather we choose 'crops' by seeking companies with the following characteristics: attractive growth prospects based on sustainable competitive advantages with a high degree of predictability. These business models produce recurring cash flows and high returns on capital and, when combined with solid balance sheets, form the basis of eligibility for the portfolio. Attractive valuation is the final gate. The wider the margin of safety the better to handle the "unknown unknowns". And like Sophie's approach, the portfolio is a diversified collection of 'crops' designed to perform in all 'weather' conditions.

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