Increasing the surface area of luck

By Michael Brown, Vice President, Portfolio Manager, Investments

"Luck is where opportunity meets preparation" – Seneca
"You know, Hobbes, some days even my lucky rocket ship underpants don't help." - Bill Watterson

Luck. Most of us rarely discuss or even admit the role that luck plays in one's life, either personally or professionally. What is luck? Do we live in a probabilistic world or are things preordained? Perhaps there is only bad luck, where despite our best efforts, events conspire against us and deliver a negative outcome. Or conversely, perhaps we are too quick to pat ourselves on the back when fortune shines its light on us, and we claim it was our intention, our own efforts that resulted in our success. In this case, there is no 'good' luck, just our hard work delivering results as it should. On one hand, the bad outcome was the result bad luck and was out of my control, and on the other hand, control over events was fully maintained, there was no luck involved and I am responsible for the positive outcome. Which is it? Or, more practically, can we increase our (good) luck? We first need a definition of luck. We will turn to Michael Mauboussin distinguished financial strategist, author and professor, renowned for his profound and practical insights into the complexities of investment philosophy, behavioral economics, and the interplay between psychology and markets. His working definition of luck is[1]:

1. Operates for an individual or organization
2. Is either good or bad
3. It's reasonable to expect that a different outcome could have occurred

We at Cidel subscribe to the worldview of a probabilistic reality. Simply put, the world, including the investible world, is a very complex system with a vast number of interdependent connections. Random events happen. There are many alternative outcomes rather than the apparently single narrative documented in history books. Perhaps this is what makes life interesting.

First, an examination of the role of luck in business. Have some businesses just been lucky? More importantly, is it possible that high quality businesses 'generate' more good luck than their average or below average counterparts? Do high quality businesses have a larger surface area to capture good luck? Or said inversely, do low quality businesses increase their propensity for 'bad' things to happen to them? It hardly needs saying, but assuming the world is a complex system of interdependent connections and random events, forecasting business outcomes in these conditions can be a rather arduous endeavour. Furthermore, a large historical variance in business results (as measured by cash flow) makes assessing management's stewardship of capital nearly impossible. We have written in the past about one of the four elements that helps us define a high-quality business: predictability of results.* Said differently, do we, as investors, have a reasonable chance of forecasting the range of potential outcomes? Or, is the range of potential outcomes so vast as to make any work on valuing a business almost meaningless and therefore not actionable? (These situations are better labelled as something else. It starts with "g" and ends with "ambling").

October 2023

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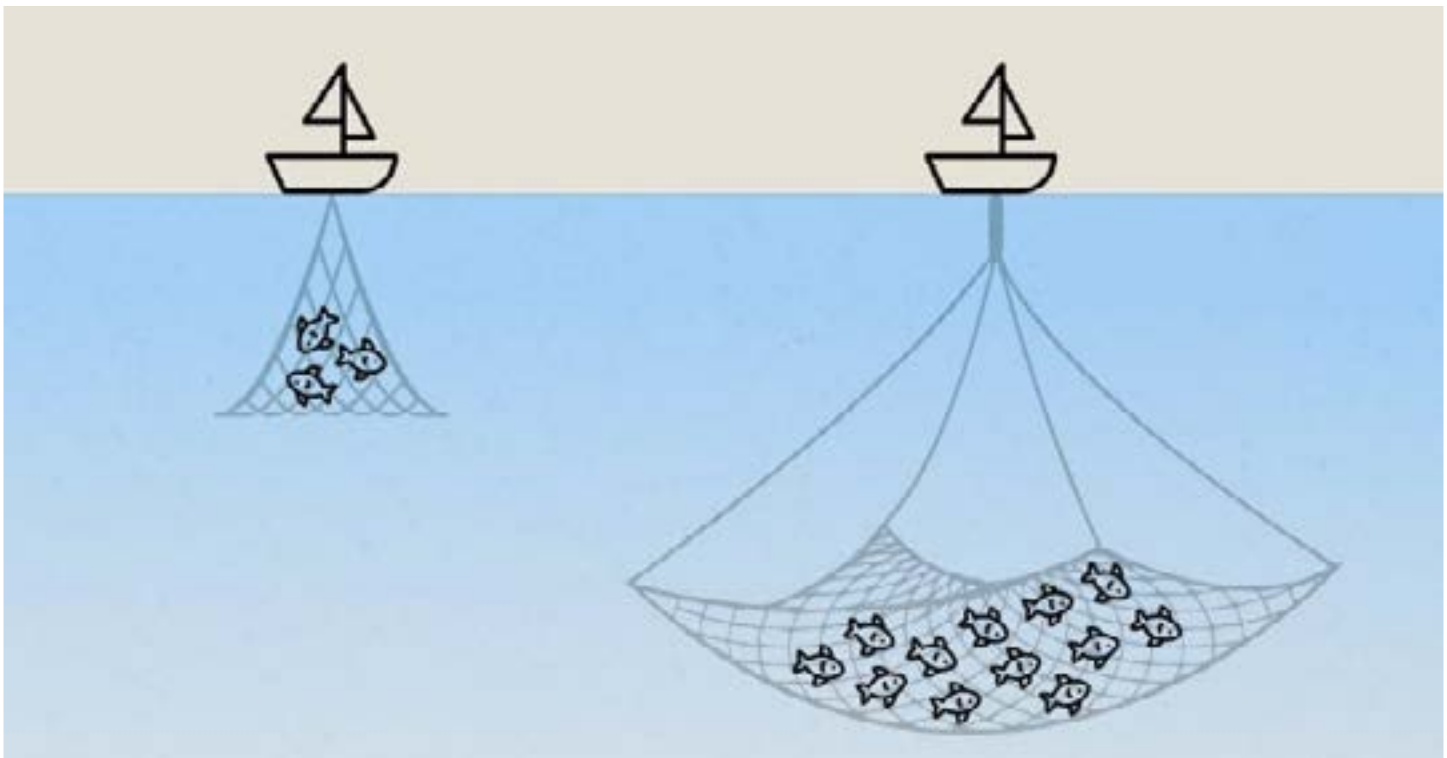
Bear with me, as we tread the path on the role of luck and examine whether one can apply the self-help 'insights' on luck to businesses, and whether businesses can increase their "surface area of luck". When we talk about "surface area" a simple analogy can help explain. We think of a large surface area of luck much like the surface area of a fishing net. The larger the net, the more fish can be caught.



Bookstores, social media and the Internet are plum full of clichéd self help 'truths' that, indeed, can increase your 'chances' of good luck landing in your lap just by getting out there and meeting people. The objective here is to identify some practical insights, perhaps for ourselves, but more importantly for the investment process of identifying high quality businesses. As a reminder, at Cidel, the equity team is focused on investing in high quality businesses at attractive valuations. Let's turn to some of the luck focused 'self-help' literature and explore whether they apply to businesses. Most blogs and articles about luck trace their roots back to two books. Dr. James Austin's 1978 "Chase, Chance, & Creativity" and the 1980s book by Max Gunther appropriately titled "How to Get Lucky". Dr. Austin identifies four varieties of chance: 1) Blind Luck, 2) Luck from Motion, 3) Luck from Awareness, and 4) Luck from Uniqueness. We will not address Blind Luck, as we are not interested in completely random events.

October 2023

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Dr. James Austin's Concepts of Luck Applied to Business

Concept	Meaning	Example	Example
Luck from Motion	Being active can generate opportunities.	**RB Global.** Operating in geographies where there are multiple and high uses of heavy equipment. As auctioneers with scale uniquely positioned to benefit from the business activity of others.	**Boyd Group.** Literally capitalizing on the bad luck of others by providing efficient auto collision repair services.
Luck from Awareness	Deep understanding of the field one operates in	**Dollarama.** Scale and merchandising expertise (deep knowledge of their retail operations) allows them to create new products at price points not typically in the market.	**Constellation Software.** Very active in acquiring Vertical Market Software companies. VMS are great businesses because of predictable results with high cash flow margins. The more deals and 'verticals' that CSU enters the more opportunities they become aware of and can take advantage of.
Luck from Uniqueness	Luck comes to you because of your unique set of characteristics	**CGI Group.** Highly successful organizations will attract the best talented employees, who in turn create, and deliver high quality services, attracting more clients	**Altus Group** has a suite of commercial real estate valuation tools driven by a deep dataset. This unique offering attracts more clients and therefore more data, which increases the dataset making the product better for all users. Better product attracts more users and so on.

Similarly, Max Gunther offers 13 techniques by which we can discover and take advantage of life's good breaks, while minimizing the effects of the bad ones. Here are the first three (and most important) techniques applied to several Canadian businesses.

October 2023

Increasing the surface area of luck

Max Gunther's Concepts of Luck Applied to Business

Concept	Meaning	Example	Example
Finding the fast flow	Like Austin's Luck from Motion. Be around activities and people – the more the better. More connections the better – network!	**Boyd Group.** Knows the North American auto collision industry very well. Boyd knows which small repair shops can be acquired and integrated profitably into their network. Expansion across North America has allowed them to become more efficient and the partner of choice for insurance clients.	**TMX Group** operates Canada's largest equities and options trading exchanges. As the definition of a network, TMX Group is well positioned to benefit from any capital formation or trading activity in Canada. There is no better place to benefit from luck, than by connecting people with capital to those that need capital and to match up buyers and sellers.
Risk spooning	Take a measured approach to risk. Small risks are ok. Large risks are not.	**TC Energy.** High debt levels were normally fine given cash flow profile. Then unlucky construction cost overruns from pandemic sets the company back financially. Debt levels become a major risk where they are forced to raise equity (dilute shareholders) and sell off key assets. An example of high leverage increasing the propensity for a bad luck (COVID and related cost inflations, and now rising interest rates) event to become a major issue.	**Dollarama.** Being active and successful in dollar store retailing in Canada allowed them to take a small risk (through a JV) to expand successfully into Latin America.

October 2023

Increasing the surface area of luck

Concept	Meaning	Example	Example
Making the Luck vs. Planning Distinction	Plan, but recognize that luck can play a role in success. Be ready to capitalize quickly on an opportunity	**OpenText.** Studying and knowing the business of MicroFocus. Effort went into carefully planning of the acquisition as far back as 2016-2017 yet valuation was not attractive. Fast forward, and as luck would have it, the pandemic created the window to acquire at very attractive valuation. Planning and patience increased the surface area of luck.	**Couche-Tard.** Experts in both operating and acquiring convenience stores. They carefully plan their expansions including patience on price paid. This expertise allowed them to seize the opportunity to expand into Europe when Statoil decided to sell off its Fuel and Retail division.

To summarize, high quality companies actively increase their surface area of luck by:

- Being **uniquely positioned** with products and services in active growing markets
- Having **success at scale:**

    - Customers want to do business with the best value proposition for products or services

    - Top suppliers want to do business with success at scale

    - Highly successful businesses will attract the best talented employees – these 'top' performers then create an internal 'flywheel' as their energy, ideas and creativity makes the company even more successful attracting even more top talent.

- **Generating high margins** creates optionality to capitalize on a 'lucky' break for capital redeployment.
- **Minimizing the use of debt** as it reduces the chances that a minor bad luck event turns into a major company ruining event.

Pulling it all together, successful investment outcomes for our clients require that we have skill in allocating capital to the best risk-reward opportunities. However, despite what you may constantly hear and read, investing is not a pure skill endeavour but rather, sits on a continuum of pure skill (chess) on one end, and pure luck (bingo), on the other end. While sustained investment success requires skill (a necessary condition), unfortunately it is not a sufficient condition. Why? The world is a complex system of interdependent connections and random events.

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Without sounding too promotional, let's safely assume the equity team at Cidel is highly skilled. Unfortunately, (or fortunately for the CFA Institute) the general skill level of equity investors is quite high, meaning competition for returns is high. So, at the margin, what should a rational equity investing team that focuses on business fundamentals do to increase their surface area of luck? ***Properly identifying and, investing in, high-quality businesses that have positioned themselves to have a large surface area of luck***. Due to the role of luck in the world, and therefore investing, we remind our investors that we hold ourselves accountable to our investment process first** (what we can control - the application of our analytical skills) and not to the outcomes (what we cannot control – the results).

Notes:

1. The Success Equation: Untangling Skill and Luck | Michael Mauboussin | Talks at Google https://www.youtube.com/watch?v=1JLfqBsX5Lc

* The other three elements of a high quality business are a 1) sustainable competitive advantage, 2) high return on capital with opportunities for reinvestment and 3) financial strength.

** "What makes a decision great is not that it has a great outcome. A great decision is the result of a good process." – Annie Duke from "Thinking in Bets". She reminds us: do not fall into the trap of "resulting" – one of the largest single problems in decision making. For sports fans, a real-life example of 'resulting' is the criticism of Pete Carroll's 2015 Super Bowl decision.

October 2023