Back to Basics: Unveiling Nick Sleep's Investment Strategy: Destination Analysis for Long-Term Value

Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. And welcome back to our back to the Beginner series today. This is a continuing series for those of you catching up, so to speak. We're going to do these once a week, and we're going to talk about different aspects of investing and try to help you get a better sense on how to start building your process and growing your portfolio. So with that in mind, today we're going to talk about some ideas around selling. So, not necessarily selling per se, but maybe some things you could start to look for to consider selling your stocks. And one of the things that we're going to focus on is an investor called Nick Sleep. And for those of you unfamiliar with Nick, he was the prime investor behind a fund called the Nomad Fund, which was based out of England.

Dave [00:00:47]:

And he and his partner Zach were the ones that ran the fund for around 1314 years. And just for reference, they generated around 920% return over that time period compared to the MSCI, which is what they compare to, don't hold my numbers, but it's around 140%. So they beat it quite handily, and they did it based on really three companies that they owned. One was Berkshire Hathaway, the other one was Amazon, and the last one was Costco. And so the idea that Nick talked a lot about in his writings, his papers, I will put a link in the show notes to his shareholder letters. They are for sure something you should read. But anyway, Nick talked a lot about having a destination analysis or having a destination in mind when you're looking at a company. So maybe we could talk a little bit about stock analysis and why something like destination analysis would be beneficial.

Dave [00:01:44]:

So what are your thoughts, initial thoughts on that.

Andrew [00:01:46]:

I like it a lot. If listeners remember, Dave talked about a book called Seven Powers maybe a month ago or something like that, and I finally read it and it was awesome. And one of the takeaways was that even if you do, how valuable is a stock and what are you paying for? What should its price be? And even if you're doing it in the traditional finance kind of formula, what's called the DCF, if you're doing it in that way, more of the value comes from the terminal value or the very long term value of the business, more so than even the next ten years. So I don't care what the business is going to do tomorrow, next year, three years, five years, even ten years, is it still going to be viable over the very long term? And when you put that mindset on the companies you buy it can really change the way you analyze a business and almost make it a lot easier in a sense. If you look at the things that Nick invested in, like you're mentioning Costco, Berkshire and Amazon. Costco and Amazon don't really have much in their industry. That's going to change very much in the sense that they have these membership programs that are very sticky and people will continue to stay subscribed as long as they're getting that value. And so if you can find businesses like that, I think it can give you a huge advantage.

Andrew [00:03:23]:

Granted, all the assumptions of you have that long term in mind. You don't want to be trading in and out of stocks. Some of that why are you investing and what are you trying to do? That we talked about in the first segment of this, back to the basics. But assuming that's all there, if you have the destination in mind when you start, it can help you stay invested in stocks. Even when the businesses become uncertain, you get the headlines that pop up and people start feeling bearish about a company. But if you've already thought that through to me, it becomes a lot easier to hold a stock even when people are selling it. If you've already thought about the destination in mind, it's kind of how I look at it when I think of Nick Sleep's ideas.

Dave [00:04:13]:

Yeah, that's a great takeaway. Let me share a couple of the quotes. So Nick Sleep said that destination analysis is consciously central to how we analyze businesses these days. It helps us ask better questions and get to a firm's DNA. He also said that the only real long term risk is the risk of misanalyzing a company's destination. So I guess maybe we could talk a little bit about that and maybe how an investor could start to apply that idea to analyzing a stock or analyzing a. Like, how would you look at that?

Andrew [00:04:46]:

Well, which part? Because I think you can dive into several different ways there.

Dave [00:04:50]:

Well, maybe we could talk a little bit about trying to uncover a company's DNA, for example. You're trying to uncover the DNA of Costco, for example. How do you do that?

Andrew [00:05:01]:

Okay, so I'll use company that's fresh in my mind. Starbucks, a company that I recently purchased. I think about their DNA, really, it comes down to the brand and the brand experience that they offer. And so the reason why you buy a Starbucks versus Folgers or any other kind of non branded coffee is because Starbucks drinkers have an affinity for the brand, and they're not drinking coffee just to drink coffee, but they're drinking coffee because they like Starbucks. Right. That's to me, like brands, branded companies. Apple, I think is a good example. Coca Cola is a good example.

Andrew [00:05:42]:

Those have easier DNA to understand to me because it's very tangible and I think a lot of people are exposed to it. And so they can kind of conceptualize how a consumer might respond to a business like that. And so to me, the DNA says as long as customers like the Starbucks brand and the Starbucks loyal stay loyal to the brand, then the DNA is intact. That's kind of how I look at one aspect of DNA as far as branding.

Dave [00:06:15]:

Yeah, I think that makes a lot of sense. I think if you think about to use your example of a Starbucks, I think when people buy it, they expect a certain level of quality of the product that they're going to buy as well as the experience that they're going to get when they go to a Starbucks. And they're willing to pay for that, not only quality and experience because of their expectation, they know it's going to be met. And as long as that continues, like you said, as long as that continues to be met, then that brand and that moat, if you will, will stay Modi. It's not going to change much. And that's what lends these companies such buying power or not buying power, but such brand. So I used to work in the wine industry and it's not a public company, but Kendall Jackson's Chardonnay, for example, is ubiquitous. It's everywhere.

Dave [00:07:11]:

It has a certain brand level. It's like Coca Cola of wine, if you will. And I'm not saying that good or bad, but what I am saying is that every time you open a bottle of that or you have that at a restaurant, you expect a certain level of quality and taste. And that's what you're going to get. Because when you're paying for that bottle of wine or that glass of wine from Kendall Jackson, you're paying for that experience that you know you're going to get because you've had it so many other times that that's what you're going to get and you know it. And so you have a confidence level in ordering that, knowing, know, hey, this is what I ordered and this is what I'm going to get. And I think when you think about investments, I think those are the kinds of investments that I think are really, they're certainly something you want to find and strive to find. So I guess when you're analyzing a company beyond maybe the, are there any financial traits to this beyond some of the more, I guess, quantitative parts of it.

Dave [00:08:12]:

Is there any qualitative parts of it that really tell you, okay, this is somebody that has an expectation I should cook for.

Andrew [00:08:19]:

Qualitative or quantitative?

Dave [00:08:21]:

Quantitative. Sorry, my bad. Listed them around. So old person brain, forgive me. Just want to make sure I don't misread.

Andrew [00:08:29]:

Yeah, I don't want to jump into quantitative without getting your consent. So now that I have your consent, I won't dive. Right. Know, in general, you would want a company where sales are going up. Bed, Bath beyond has a brand you could, you know, when I'm looking for a want, if it's a premium brand like Starbucks, I would want pricing power. And so if sales are not going up, they probably do not have pricing power. In the case of Starbucks in particular, pricing power means they're able to charge more for their cup of coffee than somebody like Dunkin'donuts would. If you look at how profitable is a Starbucks restaurant versus how profitable is a Dunkin Donuts restaurant, and what are the profit margins? If Starbucks has a premium pricing power, they should have a higher profit margins.

Andrew [00:09:21]:

And so to answer your question of what is the quantitative, I think you can use some general ideas. Sales should be going up, a company should be profitable, but not always, but really, it depends on the business. And so you kind of have to know, even past knowing the DNA, you have to know the symptoms or the evidence that tells you the DNA is there. And for every business, I think it's going to be different. So a restaurant has certain numbers you look at, which are going to be a lot different from a railroad. So part of that comes from experience or learning the industry, at least for a company like Starbucks. That's how I would think about it. I know I'm missing some quantitative things, so I'd love to have you jump in and talk about other quantitative things that can help when you're looking at this.

Dave [00:10:15]:

Well, obviously, the sales is a big one, but I think I would probably also look at the margins of the company and see if they are stable, growing, or contracting, because those can all tell you different things depending on, again, what kind of industry you're looking at, where they are in the economy, where they may be in a cycle, what they're trying to do. If you look at the margins for Nvidia and you compare those to the margins for Texas instruments, they're obviously going in different directions. And you could extrapolate that and go, okay, this one's doing great, and this one's maybe not doing great. But if you don't understand that Texas Instruments is in the capital allocation stage of we're building a lot of capacity to try to capitalize, when we think the cycle for our business is going to start to improve, then you would look at that and know, and, yuck, I'm stepping away from this. Likewise, Nvidia was like that four or five years ago. I don't know Nvidia as well as I know Texas instruments, so don't hold my feet to the fire on this, but I just recently read somebody was talking about Nvidia five years ago, was setting themselves up for success today by investing in gpus, spending a lot of money to build out the products and systems that they have currently that they're selling. These things don't happen overnight, and so you don't build these things that Mark Zuckerberg is going to buy, 350 of them at millions of dollars apiece. You don't build that on Tuesday.

Dave [00:12:00]:

You do that a while ago. So my point being is that when you look at the business and you see that margins are expanding, growing, then obviously they're developing efficiencies, they're developing pricing power, they're developing distribution systems that allow them to sell things for cheaper. All those things are great things. And likewise, when you see margins contracting, another example from the semiconductor space is a company like intel, where you're seeing margin contraction from them because they're not innovating, they're not iterating on the stuff, they're not doing things efficiently. All those things start to cascade and start to cause the company's destination to be murky. You don't know where intel is going. You know where Nvidia is going. You have a pretty good idea of where Texas instruments is going, but you don't have a great idea where intel is going.

Dave [00:12:52]:

And so their destination is very murky, whereas the other ones you feel a lot more confident about. And based on the numbers, they can help you. Some of those numbers can start to help tell a story. If you see returns on invested capital Ric contracting over a longer period of time, that's also a sign that something is amiss. And I'm not talking about from one year to another, I'm talking like five to ten year contraction, from 25% to 12%, that's not a good sign. If you see it go from 25 to 22 to 27 to 24 over a three or four year period, big deal. But if you see it gradually contract, just like with revenues, you see those gradually contract. Those aren't great signs.

Dave [00:13:38]:

Those are some three easy things that you can look at to start to get a picture of where the company is going and how they're doing currently, as well as how you think they're going to do in the future. Remember, past results are not a guarantee of future results, but they can be a pretty good indicator. So if management is the same, they're selling the same stuff and they still have the same popularity, you shouldn't see drastic changes. But if all those other things I was just talking about are changing, then you would expect to see changes in numbers. And so that's kind of how you can try to use those to interpret them. At least that's the way I try to look at them.

Andrew [00:14:15]:

Yeah, I think it's great. Can you summarize the three one more time?

Dave [00:14:19]:

Yes. One would be revenues, the other one would be margin. So gross margin, operating margin and net income or earnings margin. And then the third one would be ROIC, our favorite return on invested capital.

Andrew [00:14:31]:

Perfect. And as those expand or contract.

Dave [00:14:35]:

Yes, exactly.

Andrew [00:14:37]:

Yeah, perfect. So are there other aspects to. We touched on the DNA and we touched on kind of trying to evaluate a company and its DNA and how it's performing in its strategy. Anything else that stands out to you about this destination in mind idea from Nick Sleep?

Dave [00:14:58]:

I think for like, one of the things to really keep in mind is having a pretty good handle on the industry that the company operates in in particular, and really understanding the dynamics of not only the industry, of the other companies that are in the industry, but also the products and the services that they are selling that people find appealing and really having a good understanding of those. So, for example, if you're a grocer and you sell everything, but then you start to notice that maybe organic foods becomes a big thing and you don't include that as part of your offerings, then that business may start to suffer, especially if that becomes a national trend. It's not just a local thing in the area that you live in, but you start seeing it nationally, you start seeing it in news, you start seeing it globally. All those things start to resonate and then that leads to more demand for those particular items in store. And if the store that you invest in doesn't offer those, then they could suffer. They could lose market share, they could lose branding, they could lose advertising dollars. It could cause them to struggle to expand because they're not generating as many sales because they lose market share. And their competitor, who's really embraced this idea, could really expand.

Dave [00:16:26]:

I'm using this just illustrative. So I'm not saying this is happening, but it's just kind of an illustrative idea of how I like to try to think about it. What are your thoughts on that?

Andrew [00:16:36]:

Yeah, so almost to look at an industry and see if there's any disruption and kind of try to avoid the companies that are not reacting well to disruption, is that kind of how you see? I just, again, kind of recent top of mind kind of thing. But I did just sell a company, so I got more cash for Starbucks, but I did sell them because the industry that they're in is eventually going to be phased out because of all this fossil fuel stuff. We don't know when that is. My sense and when I bought the stock is that it's going to be a lot longer of a transition than everybody tended to think a couple of years ago. Regardless though, you still have disruption. That's somewhere on the time horizon. And I owned this stock for probably two or two and a half years. And it was just exhausting to own this thing because it's like being a guy who's on death row and you're just counting the days down, seriously, you're just looking for positive indicators.

Andrew [00:17:46]:

When I've now sold that position, moved it into Starbucks, and there is no huge disruption anywhere on the horizon that we can know. Sure there can be one sometime in the future that we don't see now that does rear its head and start to challenge the brand, but completely different mentality and reality and investment environment. And so it's a lot easier to hang on to companies where you know the DNA and you're kind of familiar with the risks and you've thought about them for a long time and you've determined that the destination does not have a big disruption somewhere in mean, I have Costco as like that's a good example, I think. I don't spend time every month fretting over if know only has a year to live or five years to live because I know that business. I don't see disruption in the horizon. I didn't see it when I bought the stock.

And so again, it's just a very different way of investing. By having that, trying to eliminate as much of that downhill disruption as you can, it does free you up to being a lot more patient, a lot less emotional, and really able to compound your money at a more uninterrupted rate because you're not thinking about, okay, do I need to sell this now? Do I need to sell this now? Do I need to sell this.

Andrew [00:19:11]:

Now, to me, that's been one way. I've tried to apply the whole disruption theme. As far as, like, disruption down the road.

Dave [00:19:19]:

I think that's a great way to think about it. And the company that you sold, I think is the perfect illustration of this idea of destination analysis, because as you were saying, you felt like you were on death row owning the company because you just never knew when the cliff was going to fall off. You just never knew when it was going to fall off the cliff, when the doomsday was actually going to come. You see it in the horizon, but you don't know when it's going to arrive. And not only does it impact your psychological viewpoint on the company, it also affects the returns that you're going to get on the company, too, because we're not investing in a vacuum, and other investors see that on the horizon as well. And it makes it hard to invest in companies that have to necessarily go on life support, but they might have to make a very hard pivot to stay relevant. And I think that's a hard place to be as an investor. And I don't know that I would want to invest in companies like that that are going through that kind of disruption or potential disruption, because you don't know when it's going to happen.

Dave [00:20:31]:

You also don't know how they're going to react to it and how well that's all going to turn out. Like Warren Buffett likes to say, turnarounds don't turn very often. So that's kind of why I've tried to stay away from them. I have a similar situation where one of the companies that I owned, PayPal, I've started to trim the position because I have felt that they've been fairly rudderless over the last two or three years. And it just feels very kind of, they don't know where they're going. They haven't had a direction. They start down this path, then six months later going down this path, and then six months later, they're going down another path. And it's like, okay, just pick one and go.

Dave [00:21:14]:

And I think it's a really hard place for investors to be, and I think that's partly why the company has been on the struggle bus as far as their returns go. If you look at their financials, they're fine. They're not awesome, but they're also not horrible. But because the market doesn't know where the company is going, they're not really rewarding them for having a direction because they don't really have one. Now they have a new CEO, and we got to give the guy time to see if he can write the ship or get it headed in the right direction. But if you look at the destination analysis for PayPal, none of the things you look at, this doesn't all bode well. I mean, they have a few things in the hopper that could be really great, but until you start to see the company execute on those, you don't know if the DNA is going to allow you to think that this is going to be successful. Whereas if Costco came to us and said, hey, we're going to roll this new thing out, you'd probably have a lot more confidence in their execution of it based on their past history.

Andrew [00:22:16]:

Yeah, for sure.

Dave [00:22:18]:

So I guess when you're thinking about selling, a, like, one of the things that I like to think about is buy slow, sell even slower. And I think I read that somewhere. I'm not smart enough to come up with that on my own, but I think that's a great phrase. What are your thoughts on that kind of whole idea?

Andrew [00:22:37]:

Yeah, I love that phrase. I don't know if I'm the best person to answer a question like this, to be honest, because I feel like the way I've had to manage my portfolio for value spotlight has been very different from the way Nick sleep or Warren Buffett or Joel Greenblatt or even Tom Gaynor. All of these guys, when they're running funds, they're managing other people's money, they're constantly getting new capital, fresh capital. In Warren Buffett's case, he gets a bigger pile of cash every year.

Dave [00:23:11]:

Right.

Andrew [00:23:12]:

And has to put it somewhere. For me with value spotlight, I've been running the portfolio now for ten years, almost ten years. Maybe I give myself like a little cold. I don't like, watch. I'll have to figure something else out. A ten year something, right? And because it's been constrained to $150 a month deposit every month, and it's no more, no less, that's not allowed. So the amount of cash is not getting bigger and bigger every year. So because I have to sell something every time I want to buy something significant, my mindset is a little bit different.

Andrew [00:23:50]:

But I do believe that we should be slower to sell because you can't have these stocks work out in your favor if you're constantly jumping ship. The 1 minute there is like a cloud on the horizon because no business has it perfectly. So there is a lot of nuance, I think, to every business is going to have some sort of storm cloud that they're going to have to deal with. And that's what makes it hard, is determining which ones are actually destination disasters and which ones are just short term bumpiness. And because that problem is so hard, it can make buying those stocks very rewarding. But I think by slowing down, if an investor can slow down, that gives them more time to process the information and think very logically instead of thinking emotionally like the rest of the market. So I think just by being slower, you can give yourself an advantage over the market in that way. How do you look at that quote? Because it's a great quote, and I feel like it has many layers.

Dave [00:24:48]:

Yeah, I definitely feel like it has many layers. I will qualify it by saying if you did your work well prior to buying a company, it should be easier to slow your role, so to speak, before you sell the company. If you bought it as a knee jerk reaction to something, Fomo, for example, if that reared its ugly head and you decided, I got to jump on this bus without really knowing what you were buying, then I think the speed bump probably needs to be shorter. But also I think you probably need to do a little more work to see if. Because to your point, every company is going to experience storm clouds, and some are going to experience more in a shorter time frame than others. And generally probably the more flashy, more cyclical, more, what's the word? Shiny. The object is probably the more reactionary the storm clouds can cause you to try to be, just because it's going to be volatile by nature. And so I think in that case, you really need to probably think through the storm clouds before you make a decision.

Dave [00:26:05]:

Whereas if you buy something that has, you've done a lot of work on it, it has a longer time horizon, the destination seems to be a lot clearer, and you see something that could disrupt it. I feel like that's maybe not going to happen as quickly. But of course, I could be wrong. I mean, the BlackBerry apple thing wasn't overnight, but it also wasn't a ten year span either. So it can be reactionary. But I think the better you know the company and the better you know the industry, I think the easier it is for you to determine whether a storm cloud is actually something serious or if it's just a passing rain flurry that'll be gone in an hour and a half, relatively speaking. And I think that can have a bearing on it. One of the things that I come back to all the time is when you think about selling a company, you have to ask yourself, has the thesis changed? Has it fundamentally changed the business and what's going on with the business? Has that all drastically changed? And if it has, then you probably need to consider getting out.

Dave [00:27:07]:

If it hasn't, then you need to do some more work and determine whether these headwinds, rain, clouds, storms, whatever you want to see, stormy seas, if any of those analogies are really playing out or if it's something maybe less serious.

Andrew [00:27:22]:

Yeah. Do you feel like there's a good recent example of that in the market today? That's kind of a bigger name that people can relate to as far as.

Dave [00:27:31]:

Like a more volatile idea or something that's maybe more steady, either or, but.

Andrew [00:27:38]:

Just something that's maybe going through a storm cloud. And so it can provide good context to kind of what we're talking about.

Dave [00:27:48]:

With this idea that's a good know, honestly, the one that kind of sticks in. Well, the couple that kind of stick in my head are two that I own is PayPal and intel.

Andrew [00:27:58]:

Okay, well, we've heard about them, right?

Dave [00:28:01]:

We've heard about those enough. Right?

Andrew [00:28:03]:

What about Apple? Can we talk about them?

Dave [00:28:06]:

Yeah, we could talk about them. I think in the recent news, there have been a few things that could potentially disrupt the company. Not disrupt them, but cause some bumps. One is the rigor morole that they're going through partly with Europe with them and the App Store. And then the other one is Epic, the company that makes Fortnite. They have had an on again, off again contentious relationship to say the least. And it's all kind of based around the App Store and how Apple exercises their power via the App Store. And that kind of applies to epic games as well as Spotify and how Spotify has been using the Apple app to allow people to download their app, but they're charging on another platform.

Dave [00:28:57]:

And so Apple doesn't generate any revenue from that. So they're upset about that. And Europe has fined Apple for some what they feel like are unfair business practices. And so this has been an ongoing fight for a while. So there's that part of it. And then there's also in China recently, they released information that 2020, 5% less smaller iPhone sales in China over the last quarter, six months, something along those lines. So it appears that iPhone sales are slowing in China. And so that is not great news.

Dave [00:29:33]:

So those are some things that if you don't know Apple, I think could be very disheartening. So you know it way better than I do. So what are your thoughts on it?

Andrew [00:29:42]:

Those are good examples. I think it goes back to if we were to reframe the question based on everything we've talked about. Know, what's Apple's DNA? What's the destination in mind if you're buying Apple stock and then have all of these different events that have occurred changed that destination? To me, that's what comes down to now. If it's short term swings of you know what, for the next two, three years, the company is not going to be as profitable. So the stock price needs to come down to reflect that. Sure, that's one thing, and that's kind of beyond my skill set as it comes to stocks. But to me, the bigger question is if the stock is down 5%, 10%, 20%, whatever, is that indicative of their long term strategy is deteriorating, or is it something else?

Dave [00:30:38]:

Right.

Andrew [00:30:38]:

I don't think it's the easiest answer, particularly when some of these events can be kind of emotionally charged. In the case of Apple, I look at them like Starbucks, right? I feel like they have built a brand that commands a premium price, and so they have a premium pricing power because of the brand. And so if these events permanently damage the brand and make it so people are buying less iPhones or make it so the brand power no longer commands pricing power, then yes, I would say that would change the destination. But if these things do not change that and do not alter that DNA, then to me, they're more speed bumps in the short term than they are a problem with the stock for the long term. So that's kind of when it comes to Apple. I feel like Apple's always in the news. That would be an example of how I tried to use what I've learned about Apple and the things I've thought about Apple and try to use as a lens for looking at all these different events, I think that's a great.

Dave [00:31:43]:

Way to frame it. That's awesome. All right, folks, well, with that, we will go ahead and wrap up our show on back to the basics and some of the ideas about potentially selling a company. So with that, I'll go ahead and sign us off. You guys go out there and invest with a margin of safety. Emphasis on the safety. Have a great week, and we'll talk to you all next week. Bye.