The Importance of Capital Allocation

"The lack of skill that many CEOs have at capital allocation is no small matter: After ten years on the job, a CEO whose company annually retains earnings equal to 10 percent of net worth will have been responsible for the deployment of more than 60 percent of all the capital at work in the business."

- Warren Buffett

A surprising number of CEOs are failing at their most important responsibility: capital allocation.

A good capital allocator makes intelligent decisions with each dollar that comes into the business. That could be investing in new plant and equipment, acquiring an outside business, closing down a struggling line, paying off debt, or buying back shares in the open market. Where you allocate your resources determines the goods and services you're capable of providing your customers. A thoughtful approach creates tremendous value at a firm, and that value creation eventually leads to investment returns for the owners of that business.

How do we know CEOs are struggling? A 2016 McKinsey study of 1,600 large businesses found the average resource reallocation from year-to-year amounted to only 8 percent of their capital. A full one-third of companies surveyed reallocated a trivial 1 percent. Said another way, 1 out of 3 companies leave 99 cents of every dollar of their budgets unchanged from year-to-year. How does a business adapt to a dynamic environment when the budget is so ossified? It doesn't.

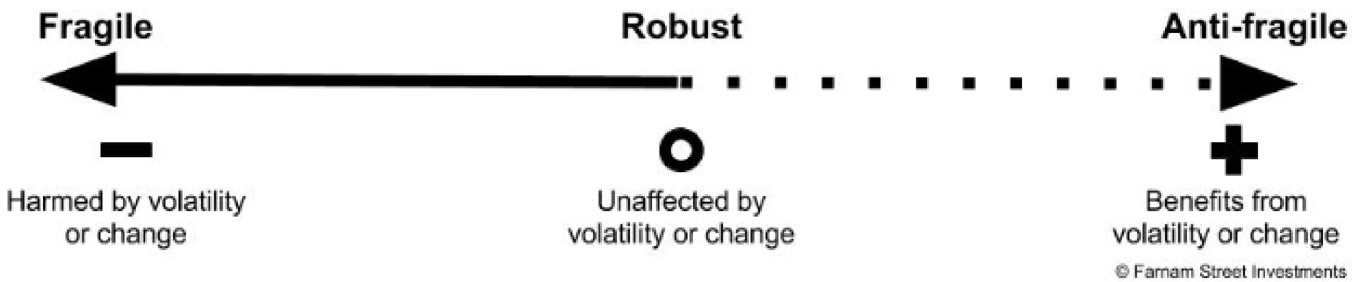
We're all familiar with the December phenomenon of departments spending down any remaining budget, lest they lose it for next year. Who doesn't need 10,000 paperclips, just in case? This harmful behavior obviously wastes money. Those misallocated resources could have gone toward other ways of delighting the customer, instead of a mountain of paper clips. It's a difficult job for CEOs to prevent this type of hoarding, but it's worth the effort. Making sure each expense moves your customer's needle should be a primary goal of every CEO. We frankly don't see that kind of discipline often enough.

Let's next consider share buybacks. When the CEO of a public company buys back shares, they are effectively cashing out one group of the business's partners and increasing the ownership percentage of those remaining. If the price paid by the CEO is well above the intrinsic value of the business, the departing partners benefit at the expense of those who didn't sell. If the price paid by the CEO is below what the business is worth, the remaining shareholders benefit. Price versus value is all-important. Warren Buffett's quote rings true, "The first law of capital allocation--whether money is slated for acquisitions or share repurchases--is that what is smart at one price is dumb at another." Having a CEO who understands the value of the company and executes buybacks effectively adds massive value for owners.

On Fragility

"Some things benefit from shocks; they thrive and grow when exposed to volatility, randomness, disorder, and stressors and love adventure, risk, and uncertainty." – Nassim Taleb

What's the opposite of fragile? Strong, robust, firm? Incorrect, that only accounts for half of the spectrum. The other half constitutes what one of our favorite authors, Nassim Taleb, coined as "antifragile." This describes anything that benefits from volatility. The greater the change, the more it improves. A herd of gazelles culled by a lion is left as a stronger group. Cut off one head of the mythical hydra and two more grow back. The human body is antifragile, up to a point. Exercise stresses our bodies, but makes us stronger. Variety of food provides us vital essentials that we wouldn't get eating a static diet. Sickness leads to the development of anti-bodies, making us resistant to future disease.



FARNAM STREET INVESTMENTS
1847 Iron Point Rd, Suite 180 Folsom, CA 95630
916.542.2008
www.farnam-street.com

The world is unpredictable. The last five years have been incredibly tame, and are not a representative sample. If you're a regular reader, you know we've been actively looking for antifragile investments which will invertedly *benefit* during the next market panic. A strong capital allocator is an antifragile bet, providing one of the least-appreciated competitive advantages. Naturally, it's a common thread running through our portfolios. When collective pessimism and fear return to depress assets prices, the good capital allocator will be a ready buyer at sale prices. Volatility now becomes our friend. We know the stress on the system will provide the opportunities our capital allocator needs to make the business stronger.

Warren Buffett has described a good business as having a "moat" that protects it from competitors. Moats are generally a wonderful thing for an investor. Unfortunately, a moat's existence is usually fleeting. Most advantages are lost to technological disruption, changing consumer tastes, competition attracted to high returns on capital, or even managerial bungling. It's rare the business that can maintain its moat for any extended time horizon. Metrics for a good business are easy to quantify, so by the time you are aware of a company's advantage, the cat is already out of the bag and it's likely richly price. A good capital allocator is more difficult to identify and measure, providing a hidden advantage for those willing to do their homework. Our task is to keep finding these good stewards and trusting them with our capital.

It was great to see so many of you at the FSI Annual Bash. We had a blast and hope you did too. As always, we're thankful to have such great partners in this wealth creation journey.

Jake & Lonnie

Performance since Jan 2008*

FSI (after all fees)	+73.1%
S&P 500 (w/ dividends)	+78.8%

* Based on auditable track record of our flagship The 5505 Fund formerly named RCM Partners Fund.

FARNAM STREET Investments

FARNAM STREET INVESTMENTS
1847 Iron Point Rd, Suite 180 Folsom, CA 95630

916.542.2008
www.farnam-street.com