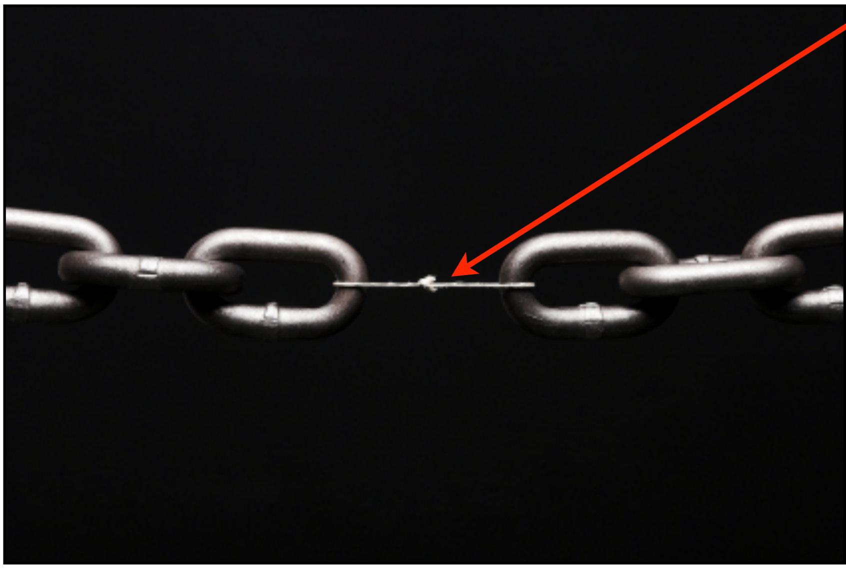
BFBV NEWSLETTER

A Chain Is Only As Strong As Its Weakest Link. Or Is It?



Imagine that for an investment operation to be successful, four events must happen. Imagine further that you know what are the chances of each of those events happening.

You reckon that there is a 95% chance of the occurrence of *each* of the first three events. But the fourth event is not very likely to happen. In fact, it is highly unlikely and has a probability of only 5% of its occurrence.

How should you think about this investment operation?

Elementary probability theory, which you read in school, taught you that the chance of achieving a success in this investment operation is very small. Indeed there is only a 4.29% chance of success (0.95 x 0.95 x 0.95 x 0.05). Of course this does *not* mean that you should not invest. To judge that, you also need to know the outcome in this very low-likelihood scenario, which must be weighted against the outcome of the operation's failure.

Life is full of very unlikely-to-succeed operations, but ones with huge potential payoffs in the event of success. So merely because the chance of success is low does not have to mean that you turn down such opportunities.

But you should think about weak links — they are very important. In the above example, the weak link is the low-probability fourth event. Which brings me to the title of this newsletter. *"A chain is only as strong as its weakest link"* should, perhaps, be re-stated as *"A chain cannot be stronger than its weakest link."*

Hi,

Metaphors are important and as you know I use metaphors in class to better illustrate some ideas. Remember "Boiling Frogs," "Pavlovian Dogs," "Ostriches with Heads in the Sand," and "Burning Bridges?"

When it comes to chains, I like to use *two* metaphors.

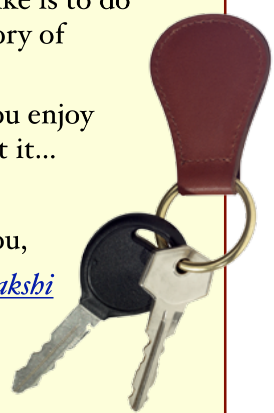
The first one is to do with *bias from commitment & consistency*. Old habits die hard (its difficult to teach an old dog new tricks) and its better to develop good mental habits early in life. "Chains of habit," Mr. Buffett says beautifully, "are too light to be felt until they are too heavy to be broken."

The second chain-metaphor I like is to do with the theory of Probability.

I hope you enjoy reading about it...

Thank you,

-Sanjay Bakshi



The *weak link* metaphor is a very important one in the investment business. Let me illustrate...

Some businesses are what I like to call as *"accidents waiting to happen"* because they have many *weak links.*

These *weak links* could arise from a variety of sources. My favorite example to explain this is the airline industry. Let's just think a bit about this industry. We will expand the discussion of *weak links* after that.

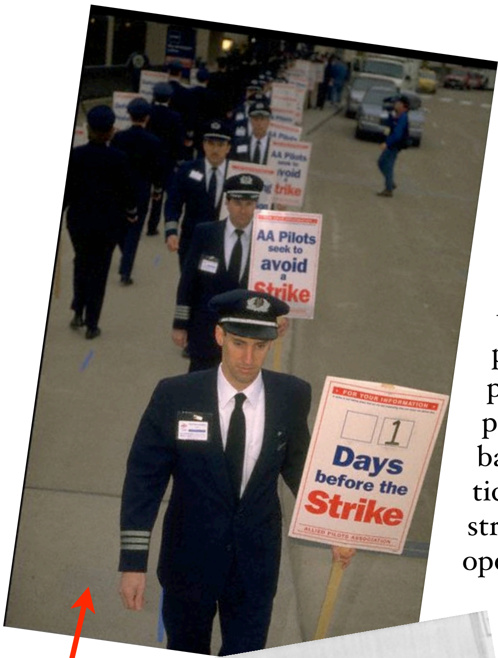
Here is one very interesting fact: there are more bankruptcies in the airline business worldwide, than in any other business. Now I find that very fascinating and I want to know why that happens.

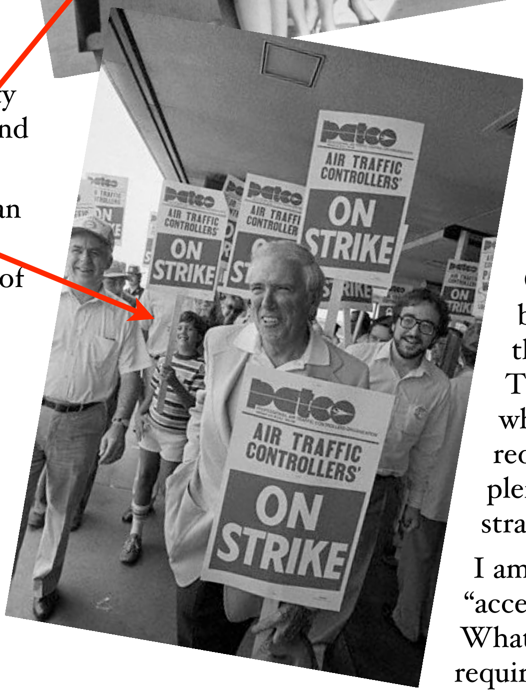
Why is the airline business an accident waiting to happen? What are the *weak links* in the airline business?

There are many and if any of the *weak links* breaks, then the business falls down to its knees. And it happens again and again in the airline business.

So what are those *weak links*? Strikes, Cost Structure, Commodity Product, Excessive Competition, and Leverage.

Let's just focus on strikes. For an airline to make money its planes must fly. For the planes to fly, a lot of things must happen and if any one of those things don't happen the planes won't fly: You would need willing Pilots, willing flight stewards, willing baggage-handling staff, willing ticketing staff, willing aircraft maintenance staff, willing air traffic controllers etc... If any of these guys (or girls) don't show up, the planes can't fly. And if the planes can't fly, it makes the passengers very upset. Not only do they ask for compensation, they also decide to never fly that airline again.





It has been estimated that given the airline industry's cost structure (very high, and largely uncontrollable, fixed costs as a percentage of revenues), and the possibility of long strikes from pilots, or flight stewards, or baggage-handling staff, or ticketing staff etc, even the strongest airline (low-cost operator, debt-free balance sheet etc.) will be brought down to its knees if its planes can't fly for just six weeks.

There are other problems with the airline business which you can learn about by reading Mr. Buffett's comments on USAIR in his letters from 1989 to 1996.

Let's return to the metaphor of *weak links*. When evaluating any investment opportunity, I think it makes sense to do some thinking about the *weak links* in that opportunity. While I won't bore you with a long list of possible *weak links*, let me give you a few examples.

One *weak link* is what I call businesses which depend on the *"kindness of strangers."* There are a few businesses which, by their very nature, require for their survival plenty of "kindness of strangers."

I am, of course, referring to "access to capital markets." What kinds of businesses require frequent access to capital markets? There are many but ones which come immediately to mind are investment banks which use huge amounts of leveraged capital, low-return businesses with insufficient internal cash generation to fund their operations, high-growth businesses which require huge amounts of incremental capital to fund their growth, and businesses which have embedded ponzi schemes in them — the "robbing Peter to pay Paul" type of businesses.

As we move ahead in BFBV, you'll see how easy it is for these businesses to be brought down on their knees because capital markets have shut their doors on their faces. You are already seeing what investment banks are going through right now as an example of weak links in a business which cannot refinance debt or raise equity capital for even short time periods.

Another *weak link* could be over-dependence on a single customer. Many auto-ancillary companies come in this category, as do many suppliers to big retail giants like Wal-Mart.

Dependence on a single product, is also a *weak link*. What if someone built a better mousetrap leaving you exposed to the risk of the going extinct?

High margins earned by companies in cyclical a industry are also a *weak link*. Investors get over-optimistic about the prevalence of high margins and value them based on the assumption that they are more-or-less permanent. Frequently this assumption turns out to be wrong. Paying even moderate multiples of near-term earnings and near-term cash flow for stocks of companies experiencing cyclical booms, represents a *weak link* in the investment thinking in my view.

Its always a good idea to think about weak links in the idea *before* making an investment. How should you do that? One trick is to ask this question: *"What three or four things can destroy this business?"*

We discussed this idea when I introduced you to *confirmation bias* — the human mind seeks confirmation for decisions it wants to take and does not automatically look for information which could prove the decision wrong. So you have to kind of de-program yourself from what you've be programmed to do by evolution. So my suggestion is to always ask that question because it will then force you to find the *weak links* you are not programmed to be looking for.

After you've spotted the possible *weak links*, then what should you do? You should think about how important is the *weak link* in the totality of the situation. Coca-Cola is largely a one-product company so it has a *weak link*, but that does not mean that you should not invest in the company.

As a deep value investor, you can do one very smart thing. You can hunt for opportunities in areas where the *weak links* of businesses have already been exposed causing their stock prices to crash. While hunting in this field, you might find opportunities produced by an overreactive, semi-psychotic Mr. Market.

Many banks, for example, are now selling for far less than their conservatively-estimated liquidation value because the *weak link* in banking is there for the whole world to see. I do not think that conservative banks will die — although I cannot rule it out. This means that I must look at bank stocks *after* their stock prices have fallen by 70% or more from their peaks, *because* of possible over-reaction of Mr. Market over the *weak links* in the banking business model.

So, in a sense, *weak links* could be your enemies because they could destroy your business, or they could be your friends, because they produce mouth-watering opportunities for thoughtful investors like you.

Happy Hunting!