July 14, 2023

Through the second quarter, Banyan's equity composite's year-to-date return was 12.6% compared to the S&P 500's total return of 16.9%. Over the trailing three- and five-year periods, our equity composite compounded at 15.1% and 11.9% per year, respectively, compared to the S&P 500's return of 14.6% and 12.3% per year over the same periods (click here for details).

The Ideal Investment

Ideal (adjective): 1.b: conforming exactly to an ideal, law, or standard: perfect.
2.a: existing as a mental image or in . . . imagination only. [1]

Charlie Munger and Warren Buffett say the secret to a life well-lived is to work backwards. "Write your obituary," they say, "and then live up to it." This sage advice reveals a useful mental trick. Rather than reason forward, reason backward. Define an ideal, and then avoid anything inconsistent with that definition. Or, as Charlie likes to say, "Invert, always invert."

Putting this advice to work in our business, we set out to define the ideal investment. To us, the ideal investment is a business with seven attributes. The business is:

(1) understandable;
(2) well financed;
(3) earning a high return on tangible capital employed;
(4) producing a superior product with durable competitive advantages;
(5) serving a growing market so earnings can be reinvested within the business;
(6) managed by smart and honest people who wisely allocate capital; and
(7) available at a bargain price that provides an adequate "margin of safety."

The ideal investment, like any ideal, is a concept of perfection, and perfection is rare in the real world. It would be unwise, then, to make the ideal investment our minimal standard. We would never invest if it was. Rather, the ideal investment is our North Star. It is our aim. Alarm bells ring if an investment deviates too far from it; our hearts race when an opportunity approaches it.

From this perspective, prudent investing is the prudent weighing of trade-offs. To get a bargain price, for example, a sacrifice must be made on another attribute. If no other attribute is sacrificed, then a sacrifice must be made on price. Occasionally, a truly ideal investment requiring no sacrifice does present itself, and getting your hands on one will make the cash register really ring.

[1] *Ideal*, Merriam-Webster, available at: https://www.merriam-webster.com/dictionary/ideal.

As bad as we hate it, however, ideal investments cannot be identified with certainty *ex ante*. To believe otherwise would be the definition of hubris. Too many smart people spend their lives looking for such opportunities for them to be lying around in plain sight. The best an investor can hope for is a deep suspicion. It takes years for an investment to prove whether it was ideal.

Apple (AAPL) offers a prime example. When we first bought AAPL in 2016, its innovation engine, iPhone franchise, and CEO were in question. We felt these concerns were overblown, and AAPL offered investors a 13.6% pretax enterprise yield at the time.[2] This provided a wide "margin of safety" if we were wrong. AAPL proved us right, thankfully, and our cash register really rang.

AAPL was an ideal investment, but we did not *know* it at the time. We merely *suspected* it. The same was true when we purchased Markel (MKL) in 1994, Berkshire Hathaway (BRK) in 1996, and Danaher (DHR) in 2011. Like a barrel of fine whiskey, a business with all the right ingredients can still age poorly. Only a taste test years later will reveal if the product is top- or bottom-shelf.

Hence the need for patience. An investment that "tastes" mediocre today may taste much better in the future. Do not toss it out prematurely. If the business has the right ingredients and is aging well, let it continue aging. It may prove ideal at a future tasting. American Express (AXP) and Parker Hannifin (PH) come to mind. Although not *yet* ideal, they taste better year-after-year.

We will sell a business even after a good "tasting," however, if it no longer has the right ingredients or is aging poorly. Examples here include Discovery (DISCK) and Post Holdings (POST). Both were very profitable investments, but the businesses were declining in quality as time passed. The sacrifices we were making were growing rather than shrinking. We sold them both as a result.

Some investments "taste" outright awful and must be tossed out. We have examples here, too. Wells Fargo (WFC) and Altice (ATUS) come to mind. Interestingly, both share a common theme. We never even *suspected* they were ideal investments. They lacked the right ingredients from the start. We *knowingly* sacrificed on quality and relied on a bargain price to compensate.

And herein lies the lesson. The ideal investment is not made; it emerges. Like the artisan of fine whiskey, the wise investor assembles businesses with the right ingredients and patiently watches as they age. Most will age into mediocre investments. Others will age poorly and must be tossed out. Only a few will age into ideal investments, but a few is all it takes to ***build permanent wealth***.

Sincerely,

Drew Estes, CFA, JD
Portfolio Manager

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[2] Apple's fiscal year 2016 cash enterprise earnings were $57.8 billion. Its fully diluted market capitalization at a split adjusted price of $26.43 was $574.7 billion, but Apple's net cash and investments totaled $150.6 billion. Thus, Apple's cash adjusted enterprise value was $424.1 billion. Therefore, Apple offered a pretax enterprise yield of 13.6%.