GUEST INTERVIEWS

Guest Interview, Joe Frankenfield at Saga Partners

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Investment Talk
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> ***Guest Interviews***

In today's edition of the Investment Talk Guest Interview series, we have the co-founder and lead portfolio manager at Saga Partners, Joe Frankenfield.

I first stumbled across Joe, and the Saga team, in early 2020 after reading one of their quarterly letters (*see here*) and found that their style resonated with my own. I have been an avid reader ever since.

In today's interview, we cover a broad range of topics including some great insight into the dynamics of launching and operating a fund with respect to everything from the mentality required, the pressures, the importance of investor alignment, and some mistakes made along the way.

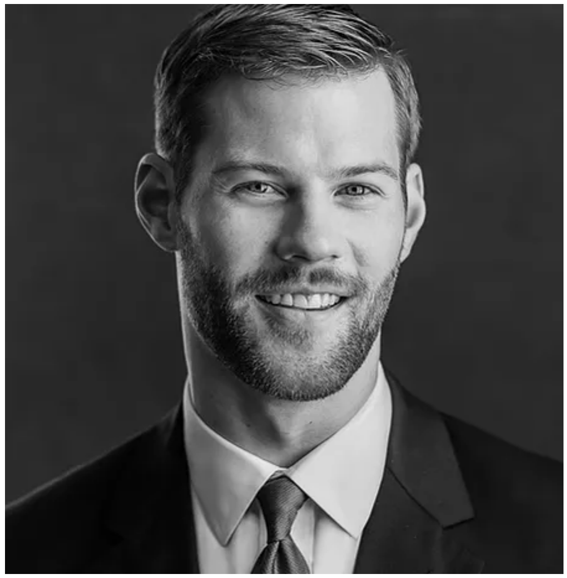
We also touch on what it really means to be a 'long term' investor, when to approach selling decisions, and concentration, as well as whole lot more.

Joe Frankenfield at Saga Partners

After founding Saga Partners in 2016, with fellow Co-Manager Michael Nowacki, Joe currently acts as the lead portfolio manager for the fund which describes itself as having a *"fundamental, long-only, public equity investment strategy"*.

After spending his post-graduate years in roles across corporate banking and the sellside, Joe began to search for a role that would better align itself with his own ideas about managing capital.

> *"Most sell-side analysts are compensated on getting their clients to trade with their brokerage as much as possible. The more clients traded, the more money they made. It creates a very short-term outlook and my philosophy has always been focused on the long-term."*



Saga's approach to investing is refreshing, focussing on a concentrated basket of high-quality *"forever investment",* companies that the fund would ideally like to own for decades.

We dig deeper into Saga's strategy and outlook for portfolio construction in today's interview.

> *"We don't manage the portfolio based on price volatility or standard deviations.*
>
> *I think the whole exercise of defining risk as a single quantifiable number, especially if that number is based on past price action, leads to a lot of mis-thinking. When a prospective investor asks for our standard deviation or Sortino ratio it's a clear sign the Saga Portfolio wouldn't be a good fit for them."*

You can find everything you need to know about Saga Partners, including their history, their strategy, quarterly letters, and the team *here*.

The Interview

Question 1

> **Investment Talk:**

Good morning Joe, thanks for taking the time to be here today and answer some of my questions.

First off, I think it's usually a great idea for the readers to get some context on who you are, and what you are currently doing.

So, if you could maybe take us through your background, what sparked your interest in investing, and then perhaps walk us through how your journey evolved from that inception point and concluding with what you are currently doing at Saga Partners.

> **Joe Frankenfield:**

I really didn't discover my passion for investing until after I graduated from college, but I've always loved history, solving puzzles, and trying to understand how the world works which aligns pretty well with investing. I ended up studying business in college because I liked the strategy aspect; trying to understand what made certain companies succeed and others fail. Also studying finance/business seemed like the best route to securing a good job right out of school.

After graduating I got a job in corporate banking, underwriting the risks for all different types of companies. It was great exposure to working first-hand with real businesses and learning how they made financing decisions and dealt with competition from all sides of their value chain (suppliers, customers, direct competitors).

It was at that time when I started to make decent money that I wanted to start actively investing it.

I obviously learned about Warren Buffett from studying business in school, but it wasn't until I read Robert Hagstrom's book, The Warren Buffett Way, the summer after I graduated that really got me started down the "value investing" rabbit hole. I was attracted to Buffett's midwestern folksy character (I'm from Ohio). Everything he wrote just seemed so logical and straightforward and he had such an amazing track record that went back decades.

Like many others who had a similar experience, it just clicked for me and I was hooked. I poured over the Berkshire Annual letters and anything else I could find on Buffett and Munger, then moved on to Phil Fisher, Peter Lynch, and other related investors. I couldn't get enough as I spent all my nights and weekends studying this stuff.

While I initially started investing with the goal to grow my savings, it quickly became one big puzzle for me to solve. It was an intellectual game/exercise. Investing to me was like a murder mystery. At first, you can't quite see the full picture, but you pick up all the different clues you can find, try to understand the different motives of each character from each angle, and then put all the pieces together to form an overall thesis of who the murderer was, how they did it, and why.

Investing became more of a complex puzzle for me to solve versus simply a way to grow wealth. Trying to find anomalies available in the market which could provide tangible results in excess returns, i.e. beating the market. While I liked my corporate banking day job, I knew pretty early on that this is what I wanted to do for the rest of my life.

In an attempt to get real-world experience within the investment industry, I was fortunate to get an opportunity to work in sell-side equity research. I really believed that equity research might be a perfect place for me, turning my passion for researching the value of public companies into a full-time job. Although I quickly realized it wasn't the best fit.

A lot of time and effort was spent modelling a company's quarterly earnings per share to the exact cent and trying to guess how shares would trade around those quarterly earnings. This really clashed with my longer-term philosophy. Most sell-side analysts are compensated on getting their clients to trade with their brokerage as much as possible. The more clients traded, the more money they made. It creates a very short-term outlook and my philosophy has always been focused on the long-term.

We also had to write a research note every week. I am one who really likes to dig deep and think long and hard about different topics. There was little time to just sit and think about a subject when you only could spend a day or two gathering/analysing data, a day or two writing, and then publishing your note on day five while balancing time answering investor calls and emails throughout the day about why a certain stock was trading up or down 5%.

I knew pretty early on that I wanted to get into the business of actually making the investments. The thing is when I looked for opportunities there really wasn't anything available for exactly *what I was looking for. Most of the buyside roles were with large asset managers that managed widely diversified mutual funds that rarely if ever beat the market over the long-term.*

There were a few (very few) smaller niche investment managers/hedge funds that appeared to have a similar investment philosophy as me, but they never seemed to be hiring. Smaller unconventional strategies that managed money the way that aligned with my philosophy typically didn't need dozens of investment analysts to manage large amounts of money.

While the lack of available buyside opportunities was frustrating, I was gaining greater confidence in my ability to beat the market over the long term. I started to think that I could break out on my own, manage my personal portfolio based on how I believed money should be managed, and then let anyone else who may be aligned with that philosophy/strategy to come along for the ride.

I knew that if I were to start out on my own, it would be years of building a track record before anyone besides my very close family and friends would invest. I knew I needed to be able to live off my own savings so I wouldn't have the pressure of trying to convince people to invest. Plus, I didn't want to try to persuade people to invest if they weren't truly suitable or for me to feel pressure to change how I invested in order to make the portfolio more sellable. It's not uncommon for people trying to start a fund to adapt their strategy and pitch to what they think potential investors want to hear.

It was in 2016 when I thought I reached the point where I felt comfortable being able to leave my corporate job, manage my portfolio the way I thought it should be managed, and having confidence I could do it successfully for others as long as they were aligned with the strategy.

Question 2

> **Investment Talk:**

Thank you for that backstory Joe, really fascinating.

So, you are currently the Lead PM at Saga, the investment advisory firm you founded, with fellow Co-Manager Michael Nowacki, back in 2016.

I have a few questions on this front.

Firstly, what is the meaning behind the name, Saga?

Secondly, I am wondering if you could share the story behind the founding of the firm, and then perhaps dive into what Saga Partners stands for, and what the mission is there?

Joe Frankenfield:

Right after I left my job, I was connected through a mutual friend with Michael Nowacki. Michael was already managing money at his own investment advisory that he started a few years earlier. We met and immediately clicked. We were both big Buffett fans and shared a long-term fundamental philosophy. He was actually writing a book at the time about the investment strategies of some of the greatest investors titled, Forever Investing.

We began exchanging emails about different investments, thoughts surrounding investing in general, and his advice on starting a business/fund. It was obvious that we shared a very similar philosophy. As I was working on setting up my own fund, we eventually decided that we would make a strong team by partnering together and manage a core strategy surrounding the idea of focusing on owning a portfolio of a few "forever investments." Companies that you would like to own for decades. We started working together in late 2016 and officially launched the Saga Portfolio at the beginning of 2017.

One of the first things Michael and I did when we started working together was come up with a name for our new company and portfolio. We were looking for something that was simple, clean, and reflected our investing philosophy.

After brainstorming for a while and not really having any great ideas, one of us just said, "how about saga?" A saga is a word for a long epic story/journey. It fit the criteria we wanted in a name, and we liked to think that we were about to start on a long, hopefully, multidecade epic journey. It reflected one of our core tenets which is thinking long-term. We bought the domain name that night.

I already spoke about the story leading up to starting Saga Partners, but really the motivation behind starting the Saga Portfolio was to invest money the way I believed it should be managed. I wanted to turn my passion into a full-time job. Essentially, invest money how I managed my personal portfolio and then if anyone else who may be aligned with that strategy and philosophy would be more than welcome to join our niche group of investors.

There was a recent Twitter thread that asked, "if you weren't managing money professionally, how would you invest differently?" The most common answers in the many responses were, *1. Care less about market/price volatility,*

2. Trade less,

3. Diversify less/concentrate more in the best ideas.

Everyone has their own style but my hunch is people who manage their personal accounts typically own fewer stocks and for longer periods of time than a typical mutual fund. Professionals feel like they always have to be doing something which translates into feeling like they have to constantly find new investments and trade more frequently. At the end of the day, it's the long-term returns that matter and that is all we are focused on with the Saga Portfolio regardless of whether it looks like we aren't "doing" anything.

On a similar note, much of the investment management industry sells products in an effort to control volatility. People naturally only want the value of their portfolio to go up and hate to see it go down. To give people what they want, investment professionals try to limit volatility by diversifying extensively. I've come across so many people's brokerage accounts that were managed by an investment advisor that had somewhere between 10-15 different mutual funds in it across all different types of asset classes. Each mutual fund typically owned about 100-200 stocks.

Overdiversifying would be fine if it wasn't for the investment fees. Mutual funds typically charge about 1% management fees (assuming it's a no-load fund) and then the investment advisor will typically charge ~1% of assets managed. Because mutual funds are so diversified and charge management fees, they typically underperform a simple market index like the S&P 500. Over 90% of mutual funds underperform the market over the long term and people pay investment advisors a fee to put them into these funds that underperform.

It's a double whammy.

People feel more comfortable outsourcing important investing decisions to a professional because it provides a false sense of security.

There is definitely value for investment advisors to educate clients about investing and help to make important financial decisions. One just wants to make sure they are paying a fair price for that service. The thing about investing is a perfectly ok option is essentially free by just buying an S&P 500 ETF which will beat 90% of "professionals" over the long term. If you are going to actively manage an investment portfolio, you need to beat that free alternative over the long term in order to justify your efforts and fees.

So back to the question on the mission behind Saga Partners. At the end of the day, the purpose of Saga Partners is to beat the general market over the long-term after fees. I tell our investors to judge our results over five-year rolling periods at the minimum. If we aren't doing that then we aren't earning our keep.

However, the reason why I invest is because I love the activity of investing. The market is one big puzzle and intellectual exercise to me. I wouldn't manage money for others if the only way to invest was using Modern Portfolio Theory, standard deviations, capital asset pricing models, or betas. None of that stuff was very interesting to me when I studied it in school. Even if those things did work, I would choose to do something else for a living. I simply want to solve puzzles and grow with a niche group of investors who align with our philosophy.

Question 3

Investment Talk:

Just on that note, whilst we are on the subject, I am wondering what have been some of the challenges, learnings, lessons that you have absorbed over that 5-year life of Saga?

Perhaps you could share some of the challenges (or blessings) that came your way that was not expected by yourself when founding the firm?

Joe Frankenfield:

I think some of the bigger challenges in building Saga Partners was getting the foundation right and staying focused on our long-term goals. For a relatively young, impressionable person trying to become an independent investment manager, it is very easy to receive bad advice or face certain pressures that can potentially get you off track.

As I said, my original goal for starting my own portfolio was to manage money for others the way I managed it for myself. Having that kind of investing freedom is something uncommon in the investment management industry.

While seeking advice early on from others in the industry, several suggested we define our strategy into a certain box (by market cap, industry, value/growth, etc.) They warned that no one wants to invest in a generalist long-only portfolio because it is impossible to bucket the strategy *into a certain box. This of course conflicted with my original goal of just investing in the best opportunities we could find. However, at the time the Saga Portfolio was mostly invested in small and mid-cap companies and that is where we thought we would most likely find future opportunities so it would be unlikely to hurt long-term returns if we called ourselves a small and midcap (SMID cap) portfolio.*

I had a lot of cognitive dissonance with this decision during our first year because on a few occasions we passed investing in an attractive opportunity simply because it was above our self-imposed midcap threshold. We would focus a lot of our time and energy looking at small cap companies that were under the radar thinking we'd uncover some hidden gem. Although we were more often than not coming up short in our search while passing on potentially attractive larger cap opportunities.

We finally made the decision in 2018 that our current investors, while a relatively small group at the time, only cared about getting the best long-term returns possible, and it ultimately hurt potential long-term returns by limiting our investing universe. Starting in the middle of 2018 we, fortunately, corrected this temporary lapse in judgment and would invest in the best opportunities regardless of market cap, industry, or geography. That is how I would manage my personal portfolio and that is what is best for our investors.

Another thing we had to better figure out was how to make decisions managing the portfolio. Michael and I were co-portfolio managers of the Saga Portfolio in the beginning. We think very similarly and generally see eye-to-eye on probably 99% of decisions. Despite being aligned most of the time, it's pretty difficult for there to be two CEOs of a company or in our case two final decision-makers for an investment portfolio.

The way the Saga Portfolio was originally managed was that we both had to agree on every decision and if either of us disagreed it would be vetoed and result in the status quo and therefore inaction. This worked pretty well for a long-term philosophy since portfolio inactivity is typically the best course of action. However it did lead to some decision-making confusion, ownership of certain responsibilities, and we found that the current structure probably wasn't the best way to manage an investment portfolio.

Additionally, before Michael and I started working together he was already managing several separate accounts more tailored to specific investors. Not all of those accounts were suitable for a concentrated, volatile investing strategy like the Saga Portfolio. Therefore, in addition to the Saga Portfolio, Michael had to manage a more diversified strategy that was slightly less concentrated and more tailored to their suitability.

After some reflection, we rearranged our roles at the beginning of 2019. I would solely focus on the Saga Portfolio as the Lead Portfolio Manager. Michael would continue to help manage the Saga Portfolio as Co-Portfolio Manager but also manage a separate strategy that was a little more diversified, continue doing some consulting advisory work, as well as take on a few other outside accounts. This new structure was more aligned with each of our long-term goals and has worked out great ever since.

I think another challenge that we faced was this pressure to grow assets under management while also trying to stay true to what we really wanted to do. While I had saved enough by living frugally and investing to "retire" and live off my savings by my late 20's, in order to make that possible I had to have a pretty modest lifestyle. It was somewhat difficult trying to balance my initial plan of not selling the Saga Portfolio and letting investors self-select into the strategy as we built a track record while also feeling some pressure to grow AUM to better cover my cost of living and business expenses.

In our first two years of managing the Portfolio, the only investors we had were our close friends and family and then maybe a few referrals outside of that. As time went on some of our investors would forward our letters to friends and we started to get an increasing amount of interest. It was probably sometime during the third year that we reached the point where I felt like the whole concept that we didn't have to sell ourselves through push marketing and that prospective investors would self-select in more of a pull marketing effort would really work. I still remember the day that someone who had no connection to us came upon our stuff online, liked what they read, and decided to invest.

During those first few years, it is so easy to potentially get side-tracked. Potential investors would say, we like you, but we are looking for this and we may consider investing if you did that. Or third-party marketers would come across our performance and say they could sell us to certain institutions for a fee share arrangement. Or a seed investor might offer to help you grow by taking some equity in your company. We came across all these different situations and when we barely grew our investor base the first few years there is more pressure to be open to these offers.

The thing that I always went back to is thinking about what I wanted to be doing when I am 80 years old. Perhaps we purposefully slowed our growth during our beginning, but in my view, we were building a strong foundation, philosophy, and aligned investor base that would support us to manage money the way we thought was best. In the whole scheme of things, the first few years are just a blip on the multi-decade journey we are hoping to be on. I believed that if we explained how we think along the way, got strong results over the long-term, that the right *investors will eventually find us and it would make us more successful in the long term. It just takes time.*

The early blessings were our first investors that believed in us without having a proven track record. It was really our close friends and family that knew how we were passionate about investing, supposedly had success investing in our personal accounts to then feel confident to do it for others, and then believed in our yet to be proven investing philosophy.

My dad is one notable example.

He originally invested $1 million which was essentially his entire IRA at the time. I explained to him how it was a fairly concentrated and inevitably volatile strategy. He said he understood and still wanted to invest. I'd like to think he believed in the strategy itself since he knew how obsessed I was over the prior decade with investing and I did well in my personal account. However, I think it was more of a fatherly gesture of support versus his conviction that the Saga Portfolio would provide strong returns. Now that it's about five years later, he has been pretty happy with the results so far and continues to be one of our largest investors to this day.

Question 4

> **Investment Talk:**

Then, lastly, I know that there are a plethora of readers at Investment Talk who wish to follow the same route, eventually launching their own firm.

What would your advice be to someone who wishes to follow a similar path?

> **Joe Frankenfield:**

I basically just gave the story of the ups and downs of starting the Saga Portfolio, so readers can take what they can from that.

My general advice to those interested in becoming an independent fund manager is to read Robert Vinall from RV Capital's letter he wrote in 2014. I probably came across this letter about a year after starting Saga Partners and it essentially provided the playbook for what I wanted to do. I wish I would have found it earlier.

That advice isn't for someone whose goal is to raise a lot of institutional money as fast as possible by doing what is more sellable and fitting exactly what certain institutions are looking for. It also isn't for someone whose underlying motivating factor is to make a lot of money.

If someone simply loves investing and wants to become an independent fund manager then I completely empathize with them. There's usually this chicken and egg problem that you need a track record to help raise money but need money to build a track record.

My general advice is that it is not easy. It takes a relatively long time before there is a chance for things to take off if they ever do. There are a lot of things that can go wrong or side-track you. Any success that might be attributed to Saga Partners so far is partly due to hard work but also due to a huge amount of luck and serendipity.

However, there are things you can do to help increase your chance of success.

First and foremost, you must be obsessed with investing. You live, breathe, and sleep thinking about investing. You absolutely can't do it primarily for the money which is very counterintuitive because those typically attracted to investing or investment management are often pretty motivated by money.

Second, you must have confidence in your ability/skill to outperform the benchmark over the long term. Contrary to popular belief, beating the market over the long term is not easy. If it were, then everyone would do it which then becomes a self-defeating paradox. Managing other people's money is a privilege not to be taken lightly. You need to have the conviction that you can add value to your investors over time.

Third, have enough personal savings to not have to raise outside assets. This may be hard to do for those just starting out or have families and bigger financial obligations. However, the stress of needing to make ends meet could impact your portfolio decision making if you are worried about paying the bills. Nothing impacts your thinking or shortens your time horizon as much as stress.

It may drive you to cut corners by accepting investors who might not be aligned with your strategy. It might also take a few years to reflect if you are a good investor and therefore convince others to invest with you. Even the best investors of all time have had periods of underperformance that may have lasted for several years. Be prepared to have a slow start to make sure you can make it over the long term.

Basically, live cheap and save. If you are truly a skilled investor, you will eventually grow your savings to the point that you can safely not have to rely on outside income. You will get to the point where you don't need outside investors.

The ironic thing about investment management is if the product is truly great, eventually you don't really need customers. I think that is one of the reasons why there are so few investment managers with very long track records of outperformance. First, it's very difficult to outperform over multiple cycles, but second managing other people's money can be stressful. For those who are great investors, they eventually reach the point where they don't like the stress of managing other's money and close down to simply manage their own money. I think the best route is viewing your investors as family. It creates this self-reinforcing relationship/culture of mutual trust that is important to long-term success.

My suggestion is to wait until you are financially independent, meaning you can cover your living costs with your savings before breaking out on your own. That may be hard to hear for those who want to get started as soon as possible. Let compounding work for you. Compounding may take longer than one would like but its impact is much more powerful than one can really comprehend initially.

If you have the passion, ability/skill to outperform, and enough savings to provide a long enough runway to show your ability to outperform, then my advice is to go for it!

Question 5

> **Investment Talk:**

I wanted to ask you about something that plagues many investors, which is deciding when to sell.

I know that you, specifically, as well as the ethos of Saga, place emphasis on the idea of being a true long-term investor. Thus, we can ignore the tangents of differing mindsets for this one.

What I want to know is, as a long-term investor, what triggers that decision to sell?

For me, it's the case whereby I buy (based on criteria) and will hold, so long as (based on other criteria), the core thesis for my holding remains intact.

Then, as a follow-up, what do you think about the “never sell” mental model?

> **Joe Frankenfield:**

This question gets into the much bigger topic of general investing philosophy and how I view “long-term” investing.

Our goal as investors is to compound capital over the long-term, therefore we have to think long-term because we have to be able to survive all the chaos that will inevitably occur in the market from time to time. My hope is that 50 years from now, the Saga Portfolio will have provided a strong track record for our investors. It doesn’t matter how you performed in any single year if a strategy can’t survive. Anything multiplied by zero is always zero.

The question then becomes how do we go about trying to build that strong long-term track record?

The one law of investing that will always be true is that an asset is worth the net cash that it returns to owners over its remaining life. For us to make a sensible judgement on the value of any asset, we have to have a view of the cash it will generate over its entire life.

Unlike investors, speculators are more concerned about what the price of an asset will be. They are trying to make a guess for what others will guess the price of something will be at some random point in time which then devolves into a game of mass psychology. Some people may be very good at guessing what other people may guess in a certain situation, but I’ve learned that is not something I can do with any degree of consistent accuracy.

However, investing rather than speculating doesn’t mean we have to invest in every asset forever, just that when we own an asset, we need to have an opinion of its intrinsic value, not what the market will value it at some point.

For example, if a one-year bond had a yield to maturity of 100%, we had conviction the coupons and principal would be paid over the remaining year, then we would invest in the 100% one-year bond.

Similarly, if we believed a company was going to go out of business in one year from now, it was selling for $1 million today and was going to return $2 million in cash to equity owners over the next year as they liquidated the business (100% IRR), we only need to have a one-year outlook to invest.

Just because we may only be invested for one year does not mean we are short-term investors. So rather than consider us "long-term" investors, I would just say we view ourselves as investors rather than speculators because we are not trying to play a game of greater fool theory.

The thing is when you look across the investing universe, most bonds don't provide very attractive returns, companies going out of business or liquidations rarely return much cash to equity owners, and some of the best potential opportunities we can find are in owning businesses that have bright futures. Since those companies will be around for a very long time that forces us to think about what will happen over the long term.

For every asset, I am trying to picture the stream of cash in and out of the asset and then compare that stream of cash to its current price. If we own companies that we believe will be around in 10+ years, we have to have a general idea of what their earning power will likely be.

Most of Wall Street, at least when it comes to the public market, is focused on predicting quarterly stock price moves, some are looking out 1-2 years and then put a price target or multiple on those expected fundamentals. A few may think out 3-5 years, but it is rare for someone to think out 10+ years when analysing a company, but that is exactly what you have to do if you are analysing a company's intrinsic value.

For companies not paying dividends today or in the near term, most of the intrinsic value is concentrated in the terminal value, the farther out cash flows. If you overvalue that terminal value number because you don't consider the risk of competition or disruption to the business, the investment isn't going to work out very well over the long term.

Like I said, we aren't trying to play a game of greater fool theory by hoping other investors will also misanalyse the value of the company and bail us out at an artificially inflated price.

It's important to understand that more likely than not, the typical company will get disrupted. The average half-life of a public company is <10 years. Roughly half of companies provide negative long-term returns to shareholders and nearly 70% don't even beat the market. Gaining conviction about how a company will be positioned in 10 years is essential to public equity investing, not just extrapolating recent results over the next year or two. Alternatively, there is an opportunity if Wall Street is significantly undervaluing that terminal value because they are anchoring to recent fundamentals. When investing in public equities, both the opportunity and the risk management is in playing the long-term game and very few truly play that game.

Your question was how we determine when to sell considering this long-term philosophy. I have learned that the only rational way to allocate capital is to always think in terms of opportunity costs.

If I sell a position in the portfolio, then I have to buy something else to replace it. Whether that potential new holding is relatively more or less attractive, based on my analysis, is what determines whether I sell.

I only focus and care about what the best opportunities are available going forward from today, regardless of past decisions, prices, performance, etc. I am only interested in long-term future results. I don't care if a stock is up 10x or down 90% from recent prices, I only care about what I expect it will return over the next 10+ years from today's prices.

Many investment managers will typically say they sell based on hitting a price target, finding a better idea, or discovering they made a mistake. All those reasons are based on opportunity costs.

I've found calling something a mistake is more painful than simply saying you readjusted your long-term expectations. If new information materially lowers your long-term expectations for the worse and the current expected returns are no longer attractive relative to the current price, it would be a second mistake to not reallocate the portfolio.

Let's go back to the example of a company going out of business in one year, selling for $1 million, and is expected to distribute $2 million of cash to equity owners over the following year (100% IRR). If I buy the equity for $1 million and then the next day someone offers to buy that same equity for $100 million, my expected return would then be 2%. Assuming I had more attractive opportunities to invest $100 million, it would make sense to sell my holding and allocate to more attractive investments.

Alternatively, what if the expected cash distribution was lowered to $50 thousand over the following year for whatever reason (5% IRR). If I had more attractive opportunities to invest in, then it would make sense to sell my holding and allocate to more attractive investments. It doesn't matter whether I had to realize a loss or a gain (with the minor consideration for tax consequences). All that matters were my revised expectations were going forward from current prices. That doesn't make one a short-term investor, it makes them a rational investor based on one's intrinsic value expectations. The key is having a good understanding of the intrinsic value of the assets you own or plan on owning.

Opportunity costs are what drives all behaviour. It's the cost-benefit analysis everyone does while making decisions. Deciding to spend time to read one book is a decision to not read another, or to not work out, or spend time with family. That is how I approach portfolio management. There is only 100% in any unleveraged portfolio. Deciding to invest in one company is also a decision to not invest in another. I am simply trying to allocate the Portfolio to the best opportunities available.

There is a reason why many have struggled with the concept of selling, particularly with selling companies considered "high quality." Historically, many high-quality companies have outperformed the market over the long term. As in, the market undervalued their future performance for much of the company's history. That was because the market expected a company's strong operating results to revert to some economic mean because the competition was expected to eat away at any excess profits. That intuitively makes sense in a competitive market because all companies will eventually get disrupted.

However, companies that actually have a durable competitive advantage have been able to defend against the competition for longer than the market may price in. Even when these truly rare winners sell for what appear to be higher multiples than the average when compared to peers at a similar part of their life cycle, they can still be significantly undervalued based on their even brighter than expected future. As the company continues to provide stronger than expected operating results, its share price outperforms.

Really high-quality companies that have durable competitive advantages do not have infinite value, just as lower-quality companies with no competitive advantage have some value. However, the value of high-quality companies is often much higher than the market believes, and the value of lower-quality companies is much lower than the market typically believes.

In summary, we sell an investment if there are relatively more attractive opportunities available based on our long-term return expectations.

Given that lengthy answer, it is probably obvious that I do not agree with the whole ethos of "never sell." Buying an asset and then refusing to sell it regardless of whatever its price is not logical. No asset is worth infinite value.

However, I understand where the "never sell" concept comes from. If there is anything wrong with investing in public equities, it isn't that people trade too little, it's that they trade too often. The ability to buy or sell stocks any day causes people to do so and it's often in reaction to fight/flight or fear of missing out responses which is more likely to hurt returns than help them.

I think applying "never sell" to investing in the general stock market can make more sense if people dollar cost average into the market throughout their life and refuse to sell during panics or periods that some may believe to be overvalued. Over the long term, U.S. corporations will likely do very well, and the market index will be tied to corporate performance over the long term. There will be periods of panic and times when stocks may look expensive. However, if someone just dollar-cost averages into an index over 40 years, I'd expect that they would do very well, especially if they don't have to pay fees to advisors along the way.

Question 6

> **Investment Talk:**

I know (and you say so yourself in the quarterly letters) that your team operates under a fairly concentrated outlook.

How do you reconcile the trade-offs between concentration versus the potential for reducing the portfolio standard variation via additional diversification?

Do you feel there is a cut-off point whereby additional positions begin to exhibit diminishing returns with respect to 'added protection'?

> **Joe Frankenfield:**

We don't manage the portfolio based on price volatility or standard deviations.

I think the whole exercise of defining risk as a single quantifiable number, especially if that number is based on past price action, leads to a lot of mis-thinking. When a prospective investor asks for our standard deviation or Sortino ratio it's a clear sign the Saga Portfolio wouldn't be a good fit for them.

We generally define risk as a less-good outcome than we initially expected. It is the risks we don't account for in building our expectations surrounding future outcomes. For a company, a less-good outcome would be if the actual intrinsic value were lower than our initial estimate for whatever reason, which may have led us to pay a price for the company that was too high relative to the actual intrinsic value and therefore earned a lower than expected return or even potentially a loss of initial invested capital.

In the short term, we do not necessarily care what the market prices the value of a company on any random day unless we can use it to our advantage at its extremes. When a stock crashes for whatever reason, we have to determine whether it is just the manic mood of the market or if it is a revised and more accurate reflection of the company's intrinsic value. If it's the former it could be an opportunity. If it's the latter we may have to reallocate if it makes sense to do so. The only thing that will guide us is if we, and we alone, have a good understanding of the company's future prospects and its value because the market will not give us the answers.

In terms of portfolio management and concentration, it all goes back to my last answer surrounding opportunity costs. We weigh our expectations surrounding long-term returns and relative conviction in those expectations, then allocate the portfolio accordingly to provide the highest risk-adjusted returns.

If you had the most amazing investment opportunity of all time and no other opportunities came close, it wouldn't make sense to invest in anything other than that single opportunity. Of course, the future is inherently uncertain, especially when investing in the equity of companies, so it really isn't prudent to go all-in on a single investment. You have to account for unknown risks that may not even be on your radar, the black swan type events.

I do think the typical investment industry's view on concentration/diversification does not make much intuitive sense, or even practical sense, assuming the actual goal is to beat the market.

If you look back at the long term returns of the stock market and what drove those returns, like many other things in life, it follows very closely to Pareto's 80/20 Principle.

Very few companies provide a disproportionate amount of total stock market returns. In fact, you can reapply the 80/20 rule to the 20% of companies that provide most of the returns, resulting in 4% of companies provide 64% of the market returns.

This general principle actually turns out to be pretty close to reality where historically anywhere between 4-9% (depending on the testing period) of available stocks provide nearly all of the market's returns.

I think there are two main takeaways from this reality, you either want to widely diversify to make sure you don't miss owning the rare big winners or you want to focus all your energy on trying to pick a few of the big winners since they are rare and hard to spot without the benefit of hindsight. Therefore, you either want to index or if you are actively managing a stock portfolio, concentrate on these far-right tail opportunities.

If you are actively managing a portfolio, managing it based on opportunity costs (not based on tracking a benchmark), and successful in finding the few winners, your portfolio will just naturally concentrate on the best ideas over time. The more you study market history, the more you will realize how rare the truly great investments are and when you have a lot of conviction that you found one, then it makes sense to concentrate on it.

However, I'd recommend to those who are just learning how to invest to start slow and not overly concentrate. You will make mistakes, learn, and figure out if you have the knack for valuing companies and finding attractive investments. As you invest longer, you will figure out what type of strategy makes sense for you. The future is a very uncertain messy place and you don't want to put all your eggs in one basket until you have a lot of conviction what the value of that basket truly is.

For investment professionals, such as mutual funds which typically own 100+ different stocks, it's hard for me to understand how investing in their 100th best idea really makes sense. It probably reflects they are either pursuing a much different type of strategy than one based on fundamentals and intrinsic value analysis, or they don't really know the relative attractiveness of their 100th best idea versus their 1st idea.

John Keynes said it best when he wrote, "To suppose that safety-first consists in having a small gamble in a large number of different companies where I have no information to reach a good judgment, as compared with a substantial stake in a company where one's information is adequate, strikes me as a travesty of investment policy."

Diversification is really just a hedge against being wrong about your best ideas. It's also a hedge against being right about your best ideas. It makes sense to diversify to a certain point depending on the opportunities at hand and the conviction surrounding those opportunities, but the benefits of diversification decline pretty significantly after holding just a few different opportunities.

For example, assume one could find five separate companies that were expected to provide 20% IRR over the next 10 years.

If they invested equally in each of them and each company met expectations, the portfolio would provide a 20% IRR. However, if they messed up and one of the companies went bankrupt and the others provided the expected returns, it would provide a 17% IRR.

If they really messed up and three of the companies went bankrupt, the portfolio's IRR would then go down to 9%, which is pretty in line with the market's historic average. It is crucial that no single investment, risk, or variable can potentially blow up your portfolio, however, even in an equally weighted portfolio of the best investment opportunities that one could find in the world, you could be wildly wrong with three of the five going to zero but still get a pretty ok result.

However, the world doesn't work like that. It is more likely that you may expect your very best idea to have a 30% IRR (extremely rare), the second idea return 20% IRR (pretty rare), the third idea return 15% (somewhat rare), so on and so forth. It is extremely rare for a stock to return 30% IRR over the long-term, for many more stocks to return 10% IRR, and for roughly half of the stocks to actually have a negative IRR.

It is our job as investors to analyse different expected outcomes and then place probabilities on those expected outcomes. You want to diversify appropriately in case you are wildly wrong about your best idea or any other idea. If you are consistently wrong in picking winners, then returns will be lacklustre and it probably makes more sense to invest in the index.

Of course, you don't concentrate for concentration's sake, you do so if you believe you found one of those rare big winners where the risk-reward makes sense. One thing I know is that there are not a lot of opportunities that provide very high returns over the long term and in order to have the conviction to hold on to the winners you have to really understand the value of those companies.

I think there is a much better chance of decreasing risk in a concentrated portfolio than in a diversified one if it means it increases the intensity with which one thinks about a business and its prospects before buying into it. A smaller number of investments and infrequent trading allows more time to study a company before investing, or more importantly, not investing.

I also think the ability to concentrate should also be considered based on how one manages the total portfolio. If you concentrate in a few ideas, it inevitably leads to greater volatility, hopefully on the upside over the long-term but certainly on the downside at times as well. That means one has to have the ability both emotionally as well as structurally to endure the volatility, particularly on the downside. The Saga Portfolio is an unleveraged, long-only equity strategy. It does not have to worry about margin calls, options expiring, or short squeezes. The only thing we have to do is be able to hold on or potentially take advantage if prices move to extremes, assuming the long-term outlook in the investment thesis remains intact.

Question 7

Investment Talk:

Something that I like to ask a lot of guests who are frequenters of Twitter now.

Obviously, having a digital presence for a firm is uber important today, but for up-and-coming investors, it can be just as important.

I recall back in August 2020, you hired Richard Chu (an excellent analyst, and equally kind gentleman).

You don’t have to go into the specifics behind that decision but I am interested, as someone who has been afforded life-changing opportunities through having a digital presence, what your thoughts are on that?

I guess I am looking for a holistic take on the dynamics you are witnessing (and are active within) now that great research is being shared so publicly, especially by a younger batch of engaged investors?

Joe Frankenfield:

The internet is such a powerful tool. It really has lowered the barriers to entry in so many different fields. You can connect with people all over the world, share ideas, information/research, and learn like never before.

If you have a great product or service, it has become increasingly easier to find demand for that product/service. That could be whether you are Dollar Shave Club or a smart analyst writing research. We were fortunate to find Richard by finding his research online and then starting a real-world offline relationship that turned into hiring him full time. Richard has been a fantastic member of the team and we are lucky that something like the internet made it possible to find him.

For Saga Partners, we are a relatively small investment manager located in Cleveland, Ohio which provides an unconventional investment strategy that is not necessarily suitable for many people. By having a digital presence, explaining how we think and manage the portfolio online, potential investors all across the world can more easily find us online and initiate a relationship *if something like the Saga Portfolio is what they are looking for. It is part of that self-selection I described earlier. Having an investor base that is truly aligned with our philosophy improves our ability to succeed so we are better able to manage capital for the long-term and do not have to worry about short-term performance or volatility of the market.*

The connections, networking, and exchange of information from the internet really democratise many parts of the economy. However, like with any technology, it can have both pros and cons. Some cons might include that the internet does increase the amount of noise. Access to information is no longer an advantage, but the ability to filter information is. People aren't programmed to handle the constant release of dopamine in your brain whenever you check your email, texts, social media updates, stock prices, etc.

Overall I think the internet and the digital world is a huge net benefit that improves the lives of so many on average, but it's important to be able to consider, control, and filter the constant access, distractions, and potential noise that it creates. It's also important to remember that what you say and do on the internet is forever saved out there. I imagine many adults are very happy that pictures from their youth or any past mistakes aren't easily accessible by Google, Facebook, or Twitter.

Question 8

Investment Talk:

Which investors would you say have had the most influence on your current investing style?

Then, as a follow-up, have you always been geared to invest that way, or was this something that developed over time?

Joe Frankenfield:

Warren Buffett and Charlie Munger are obviously the most iconic fundamental investors that many look up to, and without question, they truly have had the most influence on how I think about investing. I've grown a lot as an investor since first coming across them but my core fundamental philosophy on how to think about investing, valuation, and portfolio management all were initially and significantly influenced by Buffett and Munger.

I've always tried to find and learn about investors that had strong long-term track records and then attempt to deconstruct and understand how they were able to do it. Investors like Phil Fisher, Peter Lynch, Shelby Davis (written about in the Davis Dynasty), John Templeton, Phil Carret, Chuck Akre, and Li Lu, all really resonate with me. I've heard about Nick Sleep and his philosophy before, but his past investor letters just became available last year. It was crazy reading his letters and seeing how he evolved as an investor in nearly the same exact way that I did, resulting in owning a very few high-quality companies that he believed were perpetually undervalued.

Investors like George Soros, Stanley Druckenmiller, or Jim Simons have had stellar track records but their methods never made a lot of sense to me. I guess it's just not how my brain is wired. I like to listen to what they say but follow a much more bottom-up Buffett-like approach.

While Buffett and Munger heavily influenced my investing philosophy, my understanding of business and the economy have been heavily influenced by people such as Clayton Christensen, Brian Arthur, and Michael Mauboussin. I love studying business history, looking at all different types of case studies. Trying to understand why certain companies succeeded and others failed is so important to becoming a better investor. I think what's important is to study the greats in any field. Take the few key aspects that resonate with you to form your own style. It's important to never stop learning and improving.

I think I've always been pretty wired to invest in this fundamental, long-term, intrinsic value type philosophy. The most significant change in my investing process is that I used to start my research focusing much more on quantitative analysis and am now much more focused on starting with qualitative analysis. Originally, I would try to bottom fish for stocks trading at 52-week lows or ones that looked statistically cheap. That worked about half the time. Through trial and error, qualitative analysis became the first step in my investing process. It's obviously the quantitative outputs that determine returns but in order to really get those outputs, you have to really understand the qualitative inputs that drive them. Only after a company passes the qualitative filter do I potentially consider moving on to the valuation/quantitative part.

Question 9

> **Investment Talk:**

There is a big difference between 'noise' and 'sound' in the investing world.

With such a proliferation of day-to-day mainstream financial media, focussing on the very things that people like Graham taught everyone to ignore, how do you block out noise?

> **Joe Frankenfield:**

I mentioned earlier about how there is an increasing amount of noise because of things like the internet and having access to so much information. The internet has opened up access to so much supply of a constant flow of information, digital social interactions, etc that the problem is now filtering the infinite supply. Access to information is no longer an advantage in investing, it's being able to filter the information and decipher what is important, figuring out what is noise and what is signal.

One filter I use is to ask myself, in five or ten years from now, will this information have impacted the outcome in a material way? Sometimes the answer is yes and that probably means it's something worth paying attention to. Most new information is noise. What's important is understanding the big things.

Another tool I use to help not get distracted is not checking the market until after lunch (if at all). I also typically try to not keep my phone in my office, check the internet, or schedule meetings in the morning. I really try to reserve mornings for my deep work/deep thinking. I do a lot of my reading in the mornings. People really only have about 3-4 hours of being able to truly focus and be able to think hard each day, so you don't want to spend your most productive hours replying to emails or doing busy work.

In an investing sense, the ability to check stock prices by the second, read opinions of thousands of bulls or bears on a stock, makes people shorten their time horizon more than ever before. Increasing speculative behaviour only increases the relative advantage to truly long-term investors if they are able to maintain their focus and not get swept up in the noise.

Question 10

> **Investment Talk:**

I am an avid reader of Saga's blog and quarterly letters.

As part of Saga's H2 2021 Letter you had a segment which was titled 'Evolution of the Digital Economy'.

I have shared links to that letter and discussed the contents in previous writings of mine, so I am sure a few readers have read them.

But, if you could break down what excites you most about the evolution of the digital economy into just a few key points, what would they be?

> **Joe Frankenfield:**

One of the key effects of the digital economy is the rise of intangible assets in the economy and how that impacts the economics of businesses.

The microprocessor has made processing and distributing infinite data very cheap and easy. Combined with the networking connectivity of the internet has turned the value chains of businesses upside down. It has increased the importance of the platform business model and increasingly commoditizes suppliers.

We are now living in a world where access to supply is opening up. Barriers to entry are being lowered. Competition, price transparency, and more options are available to customers. Historically some of the best businesses were the ones that we're able to control access to supply and distribution. Now the best businesses are the ones that provide the best customer experience by helping filter the increasing amount of supply.

Smaller suppliers who didn't have the legacy economies of scale have easier access to customers and are able to better compete with the Procter & Gambles of the world. That means that customers will have access to better products/services or the higher margins of certain products will be competed down in the face of increased competition.

The world is just beginning to see the impact of the digital economy. It's not an exaggeration that the internet is one of the most significant inventions since the printing press. We are just scraping the surface of the implication of being able to store, transmit, process, rearrange, and combine all the data in the world.

Understanding this new digital paradigm is extremely important for both businesses and investors. What was believed to be durable moats are starting to get filled in. This reality is already obvious in areas like newspapers, music, media, taxi drivers, hotels, etc. You don't want to be the horseshoe blacksmith when the Model T Ford was hitting the inflection point of its S-curve.

Question 11

> **Investment Talk:**

I ask this question a lot, but I like to get a range of answers on the topic.

Investing styles are often attached to the investor's personality.

What about your personality, do you feel resonates with your desired form of investing, if at all?

> **Joe Frankenfield:**

An investment portfolio is definitely a reflection of the portfolio manager's personality which is evident in the Saga Portfolio in several different ways. I also think it generally takes a unique personality to enjoy the activity of investing.

I have always been pretty comfortable marching to the beat of my own drub or going against the grain. To do really well actively investing, one needs to be comfortable feeling uncomfortable much of the time. You don't want to be contrarian just to be contrarian, but whenever you buy or own a stock, you are essentially telling the world you think it is wrong and you know better. The thing is that the market is generally efficient most of the time. To find the big winners you need to be contrarian and right. Investing is a weird balance between having the confidence/arrogance to tell the world it is wrong but also the humility to be open to potentially being wrong if the evidence starts to disconfirm your thesis.

Additionally, I've always valued having autonomy and control of my life. I think that is apparent in how I structured Saga Partners and is also reflected in my investing. I don't want to have my hands tied behind my back whether that is limiting how I can invest or forcing my hand with no alternative options. There are certain things you can control when investing in the public markets and certain things you simply can't. I am generally agnostic/ignore the things I can't control, focus on the things that I can, and avoid the things that could potentially make me lose control of the things I can.

There are ways to potentially boost results such as using leverage in the form of margin debt or options. I have no idea what the market will price my stocks on any given day, but I want to be in the position to either ignore the market or take advantage of it if the opportunity presents itself. Getting a margin call, trying to time price movements with options, risk of a short squeeze, are all lessons I prefer learning vicariously through the many unpleasant experiences of others. No matter how small the chance of one of the above scenarios, I prefer to not even tempt fate, especially when managing other people's money. I like to reference Buffett's quote, "if you are smart you don't need leverage and if you are dumb you shouldn't touch it." You must be able to play out your hand if you want to succeed long-term.

Lastly, I've always tried to keep things as simple as possible, "but not simpler," as Einstein once said. The great thing about investing is that simple is often more than enough to get great results and complexity often gets a lot of people into trouble. There is a big benefit of being long-only and not trying to time the market. It leads to an increased focus on what is important and the natural progression to being able to concentrate on the best ideas.

I don't think my investing approach is the only way or even the best way for everyone. It simply makes the most sense to me for how my brain is wired. There is more than one way to skin a cat and many different ways to manage an investment portfolio. The Saga Portfolio is not suitable for someone who looks at their investment account each day and would be happy if the value is higher than the day before or upset if it is lower. Some people are not wired to not care about short-term stock price movements or may have greater risk tolerance surrounding leverage. Everyone has to do what makes the most sense to them based on their personality and how their brain is wired.

Investment Talk:

What have been some of the most influential books that you have read in your life, and why?

Joe Frankenfield:

Tough to answer because there are so many different genres but I'll give a few of my favourites. I think one of the most impactful books on life was Viktor Frankl's book Man's Search for Meaning.

It was fascinating how certain people were able to find purpose and meaning in life despite their surrounding circumstances.

I also love reading about nature, evolution, and trying to understand why things are the way they are. Richard Dawkins The Selfish Gene is one of my favourites. It shifts the point of view of animals making conscious decisions to one where genes simply "want" to copy themselves which then leads to certain outcomes based on natural selection. It was really eye-opening and applies to every living ecosystem whether in biology, language, culture/ideas, or business. Similarly, Matt Ridley has many great books on similar topics such as The Evolution of Everything, The Red Queen, and The Rational Optimist.

One fantastic book that gives a history of mankind is Why the West Rules—For Now by Ian Morris. It's a book I read last year and is now one of my favourites for explaining how human civilization came to be the way that it is. Another favourite history type book more geared to investing is Engines That Move Markets by Alisdair Nairn, which discusses the most significant technological innovations over the last 200 years. It includes case studies of the businesses related to those innovations and helps one learn about past technological paradigm shifts throughout the economy from an investor's perspective.

Everything Brian Arthur writes is a must-read. He has his research papers available online. I love his book, The Nature of Technology and his paper, Increasing Returns and the New World of Business, which really influenced my understanding of technologically focused businesses. Related to Brian Arthur and others associated with The Santa Fe Institute studying complexity theories, Geoffrey West's book Scale is fantastic.

From a business/strategy focus, Clayton Christensen is probably one of my biggest influences. His books The Innovator's Dilemma and The Innovator's Solution are a core foundation for how I think about investments. Related books on competition that are also great are 7 Powers by Hamilton Helmer and Competition Demystified by Bruce Greenwald.

One book I rarely hear about but think truly describes the essence of investing (at least how I've come to think about investing) by tying it in with all the different sciences is Robert Hagstrom's book Investing: The Last Liberal Art. I sort of came to Hagstrom's view of investing as a liberal art, thinking much more qualitatively than quantitatively, through a lot of trial and error. I wish I would have read this book much earlier in my journey.

Psychology is such an important part of investing and one of the best books discussing behavioural biases is Daniel Kahneman's Thinking Fast and Slow. Robert Cialdini's book

Influence is well-known but is also a must-read.

On all topics related to investing, I highly recommend reading everything that Michael Mauboussin writes. He is able to explain complex topics in a simple, logical, and straightforward way. His papers are available online but his books are fantastic, Expectations Investing, The Success Equation, More Than You Know.

Question 13

> **Investment Talk:**

Lastly, I always conclude these interviews with some quotes. My favourite will always be Graham’s weighing machine analogy. So, to finish this off, what are some of your favourite quotes, and why?

> **Joe Frankenfield:**

That quote by Ben Graham is a great one that I always like to reference when thinking about the market. To keep it investing related and along the same lines I’ll go with Buffett’s famous quote, “price is what you pay, value is what you get.” It’s short and sweet and sums up how to think about the market. Similarly, Munger says, “value investing is always wanting to get more value than you pay for when you buy a stock, and that approach will never go out of style.” Couldn’t agree more with what those three legends think about the market and investing.

Questions from Twitter

In this segment, we collected questions from the Twittersphere, and present them to Joe.

Question 1

@h_varma14: "How do you judge the quality of management apart from capital allocation decisions and skin in the game factors?"

> **Joe Frankenfield:**

Great management isn't necessarily a requirement for all successful investments. Buffett says the best businesses are the ones that an idiot can run. However, those great businesses where management doesn't matter are extremely rare. They are essentially monopolies. If a company is the only option for customers to get a certain product/service that they either need or highly desire, then that company will still do very well despite some mismanagement.

For the Saga Portfolio, great management is a requirement and one of our investing filters. The CEO is essentially the coach of a basketball team. They allocate resources, create the culture, and have to think about the big picture.

I think the qualities we look for in a manager is similar to what one would look for in a good friend or spouse (except for the physical aspects). When we invest in a business, the CEO becomes our business partner. We are giving them our capital and trusting that they will allocate it successfully. Trust is key. Managers have to be aligned with outside shareholders so it helps if they do have skin in the game.

Passion and love for the business are essential. They have to be mission-driven. A common trait among the managers of most of our companies is they either started the business or have been there for most of their career. We aren't looking for an institutionalized career CEO where the person in that seat may change every 4-5 years. We are looking for CEOs who view the company as a reflection of their life's work. They have to be thinking about growing the company's competitive advantage (moat) over the next 5-10+ years, not trying to meet short-term Wall Street consensus expectations each quarter in order to maintain the stock price.

One way to gain that trust is to look at the CEO's track record. What did they do throughout their life before leading the company and then while leading the company? It really helps to go back as far as you can. See what the CEO said 5-10 years ago and then what happened subsequently. How did they react to the inevitable ups and downs that occur when managing a business? Do they tell it like it is? Frugality is typically a good sign though not always essential and the importance of that often depends on the type of business they manage. We are not looking for managers who try to enrich themselves at the expense of shareholders, though the managers of the companies we own are often very wealthy since they typically own a significant stake in the company they have grown over time.

Over the long term, the numbers eventually matter. It's a judgement call to decide if the qualitative inputs such as putting your money with a manager will eventually lead to the desired quantitative output.

@h_varma14: "How do you decide how much to allocate to one company (Kelly formula)?"

> **Joe Frankenfield:**

The concept behind the Kelly Formula is along the same lines as to how we generally like to think about portfolio allocation, but in reality, our process is not as formulaic as that. The Kelly Formula focuses on the expected returns in excess of other opportunities and then the probability of that payoff, which then provides how much you should allocate to that position.

Those two variables are essentially what we consider when allocating the portfolio; expected returns and then conviction surrounding those returns. Of course, those returns are really just a general estimate based on the company's current price and where we think its earnings power will generally trend over the next decade. It goes under the principle that it's better to be approximately right than precisely wrong.

It's all about the return versus the risk. If a bond and a stock were both expected to return a 15% IRR over the next 10 years, we would allocate more to the bond because of the greater certainty surrounding its return relative to the stock.

Sometimes rare opportunities present themselves that look much more attractive than all other opportunities. If there's no close second option, then we will allocate a lot more to it depending on its relative attractiveness and conviction in that outcome.

I always like to consider a scenario of potentially being completely wrong. What if a single investment goes to zero? Weighing that possibility sort of puts a ceiling on how much we are willing to invest in any single position, although that ceiling is much higher than almost any other actively managed portfolio.

There are typically between 8-10 separate holdings within the Saga Portfolio with the top five historically making up anywhere between 60-80% of the Portfolio. We have a cap of 40%

allocation to any single investment and currently, the largest allocation in the Saga Portfolio is about 20%. Figuring out whether 18% or 22% is the right allocation to that position is not important. What is important is whether that specific investment is actually the most attractive opportunity relative to our other opportunities available. There's not a precise formula for determining the exact allocation to each position at any given time because the future is unknowable. It's more important to be approximately right.

I went through the math earlier about if you were to equally invest in the five best opportunities you could find in the entire market and what happens if you are wrong. You would still get a great result if 1/5 went to zero and even an acceptable result if 3/5 went to zero. If you are getting to point that you are wildly wrong on 4/5 of the best investments you can find, then you may want to reconsider picking investments for a living.

This being "approximately right" philosophy has worked well for us versus coming up with an overly quantifiable formula that provides a false sense of security that investors desire. Finding very attractive investments that you have a high level of conviction in is very difficult. There are not dozens of amazing opportunities in my wheelhouse at any given time. There are typically only a few I am able to wrap my head around with any level of conviction. Therefore, it makes sense to only invest in the few that make sense to me. Over the long term, the results will reflect whether past decisions were generally correct on average.

Question 3

@CoalemusGuy: "How do you find quality companies and what do those companies have as qualities?"

> **Joe Frankenfield:**

The two questions I always ask when evaluating a company is "what is the problem it is trying to solve?" and "why can't others solve this problem today or in the future?"

The first question involves the demand. Will there be demand for this product/service far into the future?

The second question involves the supply for that product/service. It determines whether a company creates value customers are willing to pay for. Can this company do something that *other's aren't able to do to the same extent?*

Customers value the ability to fly across the country, but many companies are able to provide that undifferentiated value. Customers don't necessarily care which airline they use because the service is largely viewed the same. They are generally not willing to pay a lot more to fly Delta versus United therefore the price the airline is able to charge is competed down to pretty average returns.

A competitive advantage is simply some reason why a company can offer a better product/service for the same or even higher price, or the same product/service for a lower price. These advantages could be due to economies of scale, a network effect, access to some key resource (location, land, patent, etc), switching costs, a brand, or a superior process.

To help determine why a customer picks a company, put yourself in their shoes. Why did they choose that product/service? What is important to them? What is the job they are trying to get done and why do they outsource that job to a particular company and not another? Understanding the answers to those questions is key to understanding whether a company provides value or is more of a commodity.

Question 4

@CoalemusGuy: "How do you think about the future of companies?"

> **Joe Frankenfield:**

This is along the same lines as the last question. It goes back to Clayton Christensen's Law of Conservation of Attractive Profits which states, "when commoditization cause attractive profits to disappear at one stage in the value chain, the opportunity to earn attractive profits with proprietary products will usually emerge at an adjacent stage."

Products and services are in a continuous cycle of commoditization and de-commoditization in an effort to improve the performance of what is "not good enough." When the functionality and reliability of a product or service become more than "good enough" the basis of competition changes.

If an end-customer values a certain product/service then some player in the value chain for making that product/service will be able to earn attractive profits. So when I think about the *future of a particular company I am trying to understand all the different players within a value chain, how they are related/interact with each other, where the value is being created, who has the bargaining power to earn the attractive profits, and how that might change or get disrupted far into the future.*

@CoalemusGuy: "Would you rather fight 10 piranhas (in water without weapons except for the ones you can find underwater) or 2 bald eagles?"

> **Joe Frankenfield:**

Tough question because I would probably lose at either fight. I'll go with fighting 10 piranhas in water. I have more confidence in my swimming ability since I was on the swim team for most of my youth. I'd also feel like I was doing something wrong if I were trying to fight the United State's national bird.

Concluding Remarks

As always it's the guest who makes these interviews so insightful and informative.

As such, I'd like to say thanks to Joe for pouring so much attention and energy into his answers for this edition of Investment Talk.

I hope that any readers who have goals of opening their own fund learned a lot from this today. I certainly did.

You can find Joe on Twitter over at *@SagaPartners*, and learn more about the Saga team and their portfolio *here*.

Moreover, you can access Saga's quarterly letters *here*, which I personally find to be a great resource.

> *Reminder to readers that you can access the full archive of Investment Talk Guest Interviews using this link.*

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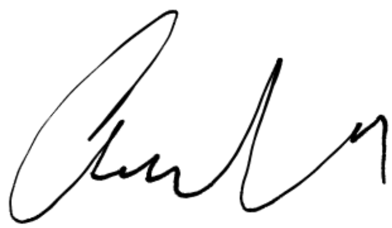
If you have any ideas related to the information you'd like to see each week, or perhaps where you feel it could improve, please reply to this email, or drop me a DM on Twitter @investmenttalkk.



Conor,

Lead Analyst at Occasio Capital Ltd

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Loved reading this! It's a dream of many investors to start their own fund; glad Joe was able to succeed and share his story.

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