Twitter Thread by Thomas Chua

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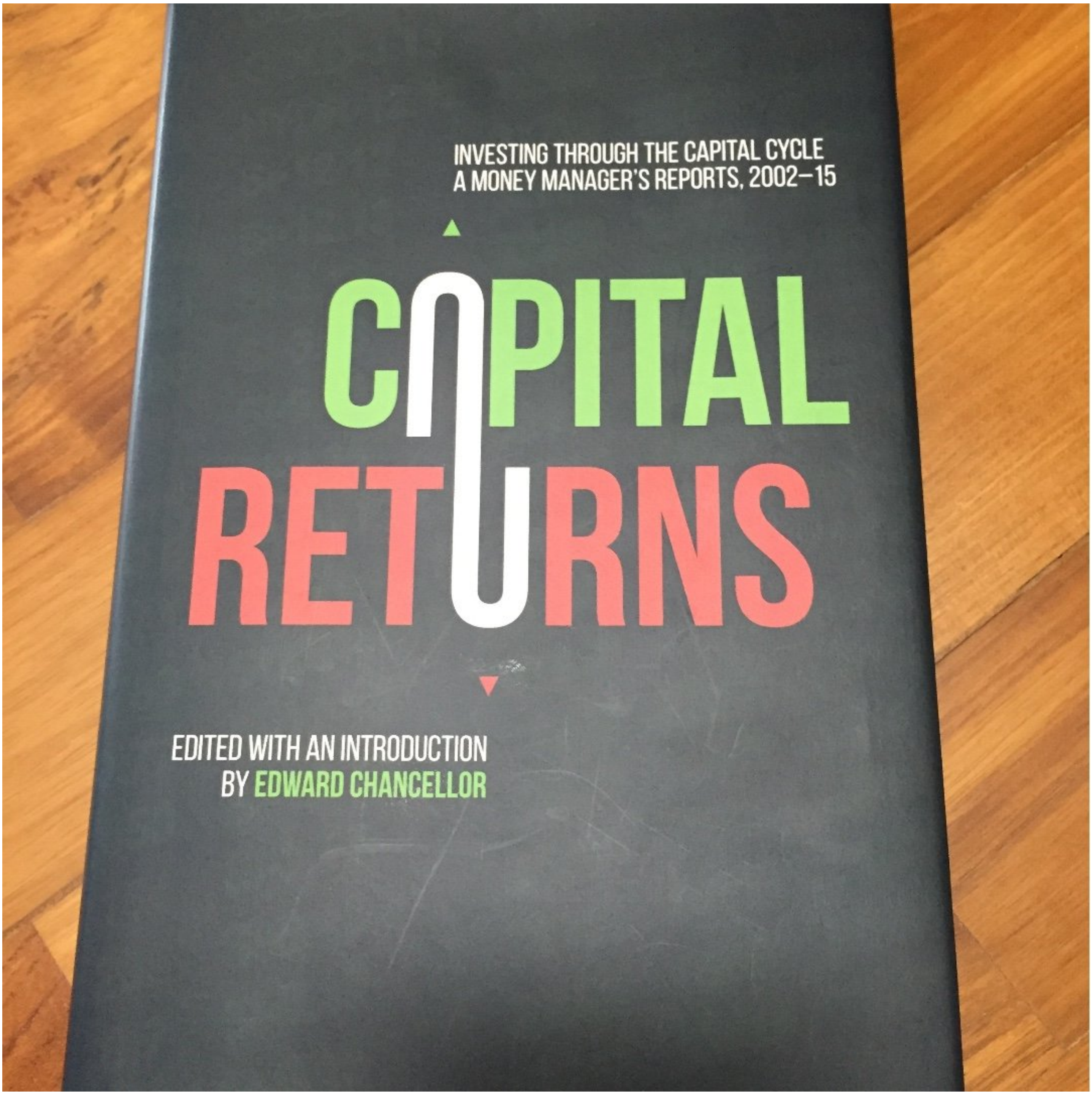
Marathon Asset produced several iconic investors such as Nick Sleep and Jeremy Hosking.

Their letters from 2002 to 2015 provided a treasure trove of insights into their investment frameworks and how they look at the capital cycle.

Here are my main takeaways:



1/ Periods of high profitability leads to reckless investments.

When profits are high:

-Boost CAPEX with little regard for ROIC
-Competitors will follow suit to avoid losing market share
-CEO's incentives aren't aligned with shareholders

It's a race to the bottom.

High profitability loosens capital discipline in an industry. When returns are high, companies are inclined to boost capital spending. Competitors are likely to follow – perhaps they are equally hubristic, or maybe they just don't want to lose market share. Besides, CEO pay is often set in relation to a company's earnings or market capitalization, thus incentivizing managers to grow their firm's assets. When a company announces with great fanfare a large increase in capacity, its share price often rises. Growth investors like growth! Momentum investors like momentum!

2/ The capital cycle will swing down when investments are taken too far.

Forecasts that were reasonable will now look overly optimistic.

Profits collapse, management teams are changed, CAPEX is cut, and consolidation begins.

This will pave way for a recovery of profits.

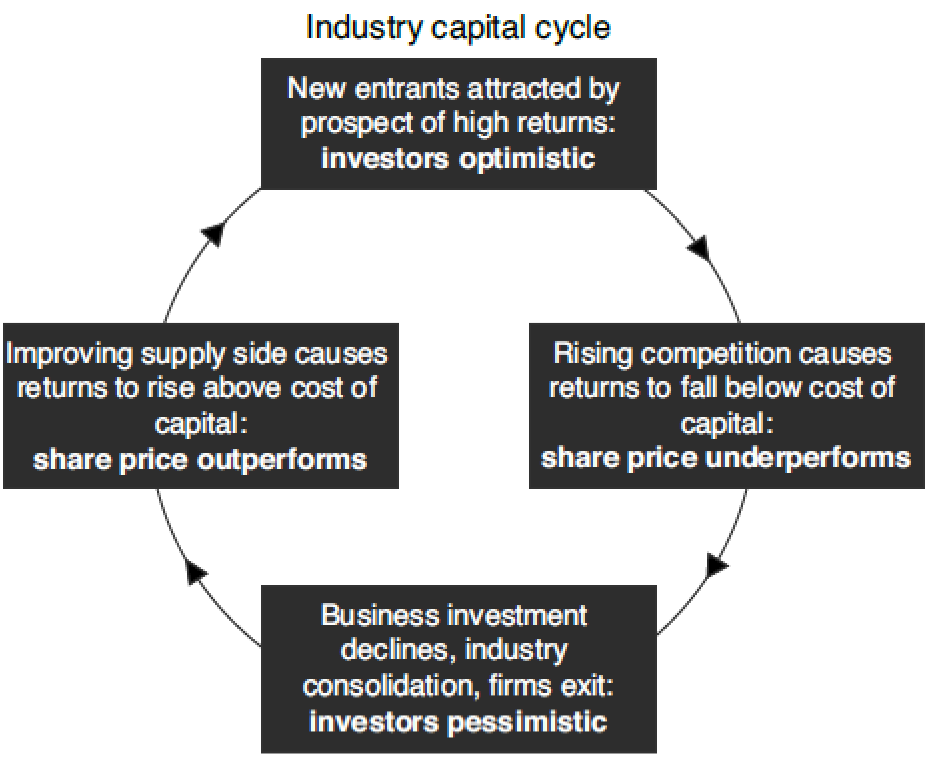


Chart I.1 The capital cycle

Source: Marathon.

3/ Asset growth matters

Consider both asset growth at the company and industry level.

Avoid industries where assets are growing rapidly.

In short, recent research is edging towards the conclusion that the excess returns historically observed from value stocks and the low returns from growth stocks are not independent of asset growth. This leads to a key insight of the capital cycle investment approach: *when analyzing the prospects of both value and growth stocks, it is necessary to take into account asset growth, at both the company and the sectoral level.* One researcher goes so far as to claim that the value effect disappears after controlling for capital investment.[19]

4/ We tend to extrapolate

When overdone, investments that appear logical at first can become disastrous.

We have a tendency to forecast linearly when many things are cyclical.

Examples: trade cycles, credit cycles, etc

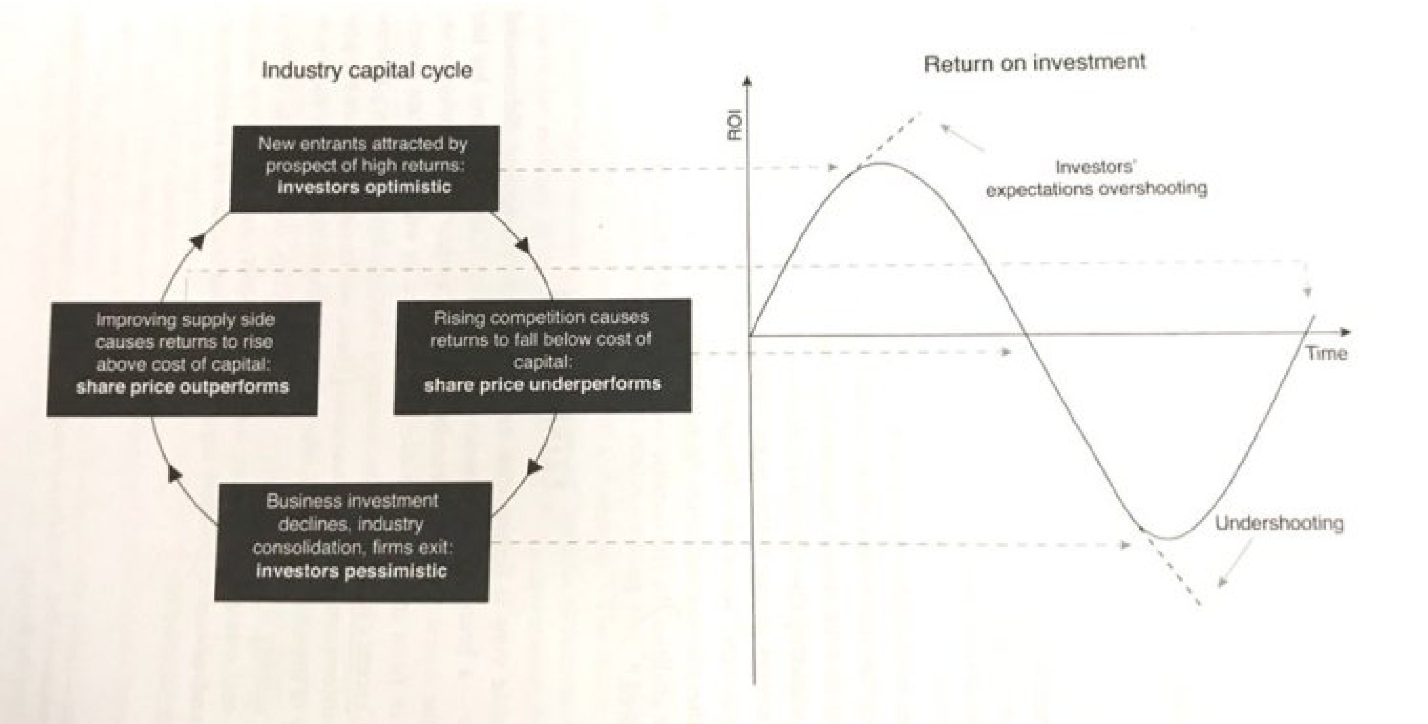


Chart I.3 Investor overreaction and the capital cycle

Source: Marathon.

5/ Overconfidence

In making forecasts, investors and corporate managers are prone to be overconfident.

The overinvestment behavior is reinforced when many players in the industry do the same.

OVERCONFIDENCE

Why do investors and corporate managers pay so little attention to the inverse relationship between capital spending and future investment returns? The short answer is that they appear to be infatuated with asset growth. Corporate expansion fires the imagination of both managers and shareholders. This mistaken fetishism for growth is reflected in the historic poor performance of stocks with higher growth expectations (higher valuations). Behavioural finance suggests that investors (and corporate managers) are prone to overconfidence when it comes to making forecasts. As Yogi Berra says, "It's tough to make predictions, especially about the future." As we shall see, this is especially the case when it comes to predicting future levels of demand.

COMPETITION NEGLECT

Overinvestment is not a solitary activity; it comes about because several players in an industry have been increasing capacity at the same time. When

6/ Focus on supply when making forecasts

Supply is far less uncertain than demand.

Since most analysts focus on demand, stock markets rarely price in supply shocks.

FOCUS ON SUPPLY RATHER THAN DEMAND

Given that the future is uncertain, why should Marathon's approach fare any better? The answer is that most investors spend the bulk of their time trying to forecast future demand for the companies they follow. The aviation analyst will try to answer the question: How many long-haul flights will be taken globally in 2020? A global autos strategist will attempt to forecast China's demand for passenger cars 15 years hence. No one knows the answers to these questions. Long-range demand projections are likely to result in large forecasting errors.

Capital cycle analysis, however, focuses on supply rather than demand. Supply prospects are far less uncertain than demand, and thus easier to forecast. In fact, increases in an industry's aggregate supply are often well flagged and come with varying lags – depending on the industry in question – after changes in the industry's aggregate capital spending. In certain industries, such as aircraft manufacturing and shipbuilding, the supply pipelines are well-known. Because most investors (and corporate managers) spend more of their time thinking about demand conditions in an industry than changing supply, stock prices often fail to anticipate negative supply shocks.[33]

THE TENETS OF CAPITAL CYCLE ANALYSIS

The essence of capital cycle analysis can thus be reduced to the following key tenets:

- Most investors devote more time to thinking about demand than supply. Yet demand is more difficult to forecast than supply.
- Changes in supply drive industry profitability. Stock prices often fail to anticipate shifts in the supply side.
- The value/growth dichotomy is false. Companies in industries with a supportive supply side can justify high valuations.
- Management's capital allocation skills are paramount, and meetings with management often provide valuable insights.
- Investment bankers drive the capital cycle, largely to the detriment of investors.
- When policymakers interfere with the capital cycle, the market-clearing process may be arrested. New technologies can also disrupt the normal operation of the capital cycle.

8/ Hunting for growth & value

When seeking growth, they look for businesses whose returns are more sustainable than what the market expects.

When seeking value, they look for companies whose improvement potential is generally underestimated.

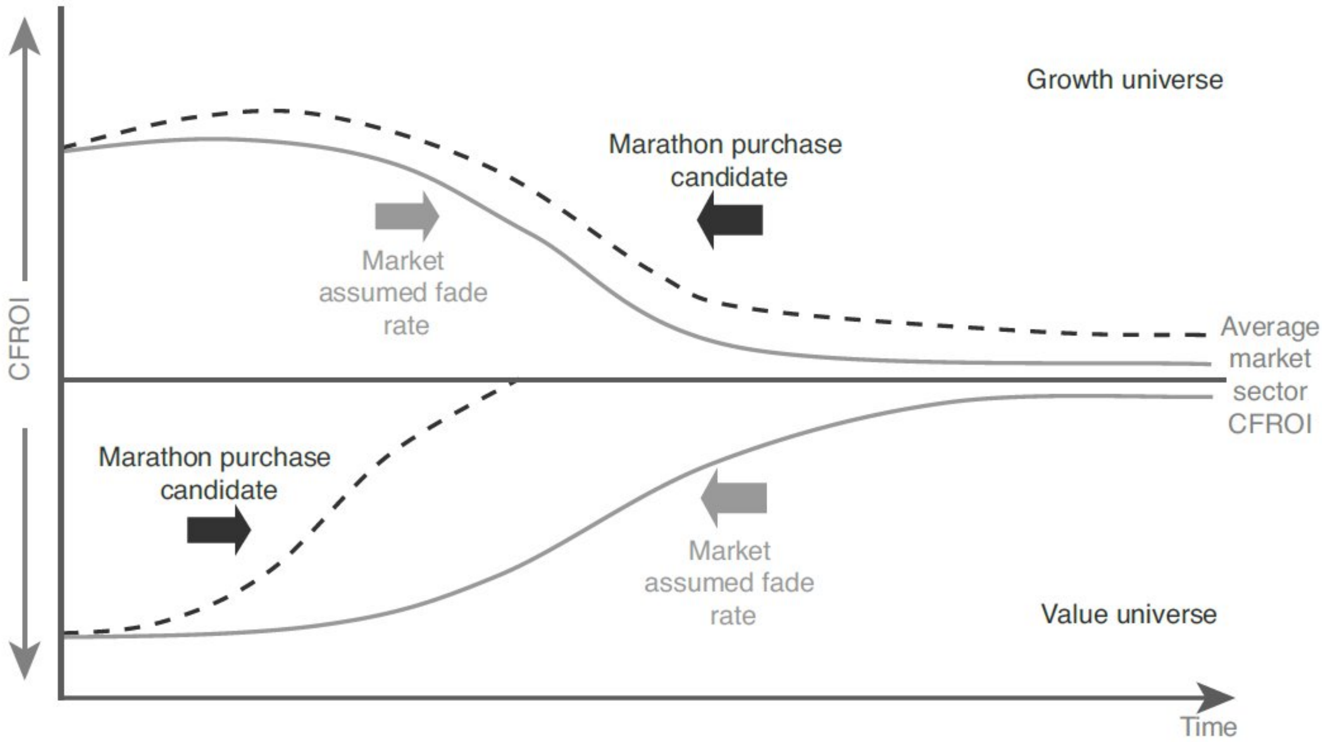


Chart 1.7 The fade rate

Source: Marathon, Credit Suisse HOLT.

9/ Primary driver of value is a favorable supply side.

In fact, a strong demand may destroy value as it triggers the industry to invest excessively.

The concept of the capital cycle provides a broader explanation as to why corporate profitability lags GDP. The primary driver of healthy corporate profitability is a favourable supply side – not high rates of demand growth. Hence, it is possible for there to be rapid growth in an industry which brings little or no benefit to investors. In fact, strong growth in demand is often the direct cause of value destruction as it encourages a flood of capital into the industry, eroding returns.

10/ Look at where capital has withdrawn

When competition exits, it is when profitability and valuation start to rise.

Capital cycle analysis, as it originally evolved at Marathon, looked to invest in companies from sectors where capital was being withdrawn and to avoid companies in industries where assets were increasing rapidly. The insight being that both profits and valuations should generally rise after capital has exited an industry and decline after capital has poured in. In other words, capital cycle analysis was all about the drivers of mean reversion. Yet the same mode of analysis can be used to identify companies which, for one reason or another, are able to repel competition.

Companies with such strong competitive advantages, possessing what Warren Buffett calls a wide "moat," are able to maintain profits, often for longer than the market expects. Mean reversion is suspended. From a capital cycle perspective, it can be observed that a lack of competition prevents the supply side from shifting in response to high profitability. Acquiring stocks in companies which defy mean reversion has been a particularly fruitful investment strategy for Marathon over the last decade.

11/ Companies with pricing power generate durable returns

It usually comes from:
-Oligopolistic market structure
- "Intrinsic" pricing power embedded in the product.

I.e. Branding of consumer products or mission-critical products.

Pricing power has arguably been the most enduring determinant of high returns for these investments. It has come from two main sources. The first is a concentrated market structure, closely associated with effective management of capacity through the demand cycle which encourages a rational approach to pricing. The second is "intrinsic" pricing power within the product or service itself. Intrinsic pricing power is created when price is not the most important factor in a customer's purchase decision. Most often, this property is generated by the existence of an intangible asset. There are several classes of intangible assets, examples of which can be found among Marathon's holdings.

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