# Trade-offs - Opportunity costs vs. Opportunities lost!

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**Framing the question**

Value investors differ widely in how they attempt to strike the balance between opportunity costs and opportunities lost! The essence of an opportunity cost is well summed up by Prof. Mankiw: "the cost of something is what you give up to get it." As investors who allocate a fixed quantum of resources we routinely face situations in which we need to consider trimming a great business to add a recently discovered one. As a follow up to our investment principles note we highlight this tradeoff while sharing our thoughts for dealing with what at times can seem like quite a *dharamsankat* (conundrum). While there is no optimal approach, a process well adapted to one's philosophy and psychology helps deal with alternative outcomes with equanimity as they arise.

As a value seeker you may often stumble on an interesting, relatively undiscovered and seemingly undervalued, great business. One which makes you wonder how you hadn't come across it earlier! As you go through your research you think about the seven or eight other great businesses you own (if you are a much more diversified investor assume you have to fund the purchase from your top 5 holdings). Are any of them worth trimming to fit this one in? It's excruciatingly painful to sell a franchise you think might be worth 6-7 times more in a decade if you have even the mildest discomfort about who you are enlisting into your dream team. Conversely, if you were to abstain from making the purchase, seeing the new idea worth 15 times more in a decade, and every expert business commentator still heaping praise on it, would make you really forlorn. Of course, part of being an emotionally balanced investor is learning to live with these decisions and the outcomes that follow decades after the fact.

**How much do you value certainty?**

For us a large part of assessing the investment-merit of a business is certainty. We like businesses which are likely to do well in a wide variety of alternative outcomes. Not just their resilience, but their ability to thrive, should be a function of just a few determining factors. We grow less comfortable with a potential opportunity as its prerequisites for success increase. Given this high threshold of certainty, as full-time capital allocators, we have reconciled to the fact that we may spot far more compelling ideas than we would be willing to invest in. Some "abstains" will turn out to be exceptional investments. Our peers may partake in them and routinely remind us of our folly. However, we try to hold ourselves accountable to our responsibilities, not our peers! We have no qualms about looking like fools for passing up on "multi-baggers". In fact, we expect to find ourselves in that situation quite often. We do not strive to be perpetual ideators, spotting every new opportunity (It would be presumptuous for us to believe that we are even capable of it). Instead we would rather have very few beliefs which are seldom misplaced. It is difficult for us to gain that sort of conviction in many businesses which is why we tend to be concentrated. Most often, it's not that we do not like them enough, it's just that we simply do not know enough about them. Intertwined with our need for certainty hence is our high threshold for *understandability*.

It is far more emotionally painful for us to dilute a holding in a great franchise which is very likely to compound our capital over decades than to deal with the regret of not investing in a newcomer despite spotting it in the early years. We gain solace from the fact that if something is not worth doing well (building a meaningful position), it is not worth doing at all. The exception, of course, is when we are dealing with a new idea which is worthy of a similar dose of our conviction. At such occasions we would not be hesitant to weigh the potential returns of our holdings over a decade and as a first option, meaningfully trim positions which may have run up substantially ahead of their time, and may risk subjecting our capital to less than optimal returns, and thereby accommodate an idea of similar conviction which may post more lucrative returns over time. In closing, we are far more likely to bet on second serves being "in", than on first serves being "aces".

**I invite your comments** (soumil@dmzpartners.in)

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