DMZ
PARTNERS

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18th October, 2023

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Semi-Annual Letter to Partners

Financial Year 2023-24

Epigraph

"When I wrote my book, "How to be rich", the publishers wanted to change the title. They wanted to call it "How to get rich". Well, I told them, getting rich is easy; I mean any fool can get rich… Any number of fools do. But being rich; That's something else. ***When a man becomes wealthy, he has to deal with the problems of freedom****. All the choices he could possibly want. An abyss opens up. I've watched that abyss. I've watched it ruin men…"*

Attributed to J. Paul Getty in the television show, *All the Money in the World* (2017)

J. Paul Getty (1892-1976) founded Getty Oil and was once considered the world's wealthiest citizen. The scene cited is available on: https://www.youtube.com/watch?v=d3IKQBY03bg

Clients are requested to contact us for an unredacted version of this letter.

18th October, 2023.

This letter is comprised of two sections:

- *Section One: Our Investing Umwelt*
- *Section Two: Our Position Sizing Framework*

I hope you enjoy reading this letter as much as I enjoyed writing it.

Warmly,
Soumil S. Zaveri.

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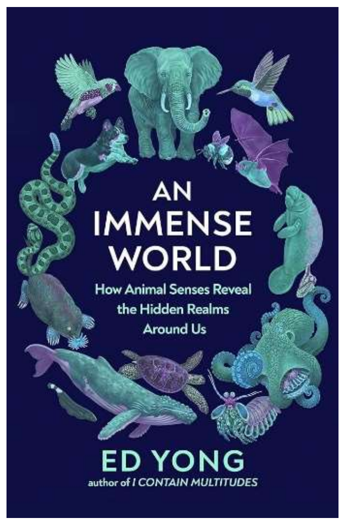
Section One: *Our Investing Umwelt*

In his fascinating book, *An Immense World*, science journalist Ed Yong introduces readers to a fascinating term – *Umwelt*, which was first defined by zoologist Jacob von Uexküll to describe each species' unique sensory bubble. To paraphrase Yong, *Umwelt* does not simply refer to an animal's surroundings, rather it is specific to the part of the surroundings that the animal actually experiences based on the capabilities and limitations of its own senses. In effect, several species could be in the same physical space yet have completely different *Umwelten*. This seems intuitive given the enormous scale of all the sensory data flowing through an environment at any moment of time. Given the sheer sensory overload, if a species were to sense *everything* it would be rendered incapable to meaningfully decipher *anything*.



Back to investing – as patient, decadal investors, we have to recognize that our default *Umwelt* is painfully constrained and deeply flawed. I'm not referring to the obviously irrelevant macro-noise or monthly data here that many of us have consciously desensitized ourselves to. I'm referring instead to the more hazardous kind that wears a cloak of respectability & relevance, fooling our investing instincts to pay attention. For example, it would be difficult to find an investor who does not "read into" the consecutive quarterly market share loss of their company especially when it coincides with strongly-opinionated narratives on why the company's prospects have soured. The narrative accompanying weak data is what leads to the seed of doubt. Alex Honnold, one of the finest free solo climbers in the world, aptly states that "doubt is the precursor to fear". Fear of being wrong over decades leads otherwise patient capital to prematurely abandon good businesses. Hasn't every company that compounded capital over decades had consecutive releases of thesis-threatening data? Invariably, yes. Nonetheless one can feel foolish in underplaying, let alone potentially discrediting, seemingly important information.

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While it is never rational to entirely ignore emerging realities, is it rational to abandon holdings at the first sight of adversity? Obviously not – it would be impossible to have long ownership periods while expecting no discomforting information along the way. Yet this is exactly the wrong expectations that a morphed *Umwelt* sets up. In recognizing this reality, I visualize the image of a jeweller's loupe – a magnifying eyepiece that allows the jeweller to zoom in to see the minute facets of a precious stone with exceptional clarity, a prerequisite to being a good jeweller – but constrains the jeweller's ability to see a broader view, a prerequisite to being a good investor. It's almost as though our overly-rational, data-obsessed, validation-seeking yet bias-riddled minds have been forced to roam around the investing universe with these magnifying loupes firmly fixated on both eyes, deceitfully morphing our *Umwelt* and denying us the full potential of our investing destinies.

By virtue of our patient ownership of a handful of businesses, we must recognize that we are in the business of arduously long feedback loops. Unlike traditional cause and effect scenarios where you can analyse the inputs that created certain outcomes, investing in the same companies over decadal timeframes doesn't yield well to such analysis. It can be of little consequence to know the ins-and-outs of a bad quarterly print – projecting those drivers out into the future may do more harm than good. Yet this compels ill-advised investors to measure whatever they can – even if it has negative utility. It would take a seemingly counterintuitive abandonment of what seems "logical" to take those eyepieces off – why would anyone give up the ability to analyse the nuts and bolts of something they value with exceptional clarity?

The answer lies in age-old principles of trickery – in focussing all our attention in one spot, we deprive attention from where the magic trick actually manifests. For every handful of measures that we ought not to monitor there is likely a qualitative characteristic that we ought to. It is fair to surmise then that the most devastating consequence of a flawed *Umwelt* is misdirection.

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In the context of our discussion on Investing *Umwelten,* I highlight a few situational examples from our portfolio when it can seem like we are forcefully keeping the magnifying loupes on, which materially morph our worldview and introduce doubt and fear, preventing us from clearly seeing the bigger picture:

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All the above, while individually important observations, may deceive patient capital in taking unnecessary actions, especially when the above information is digested in conjunction with resoundingly powerful, strongly opinionated narratives from well-respected peers, the broader investment community and the business media. This may detract patient capital from fully monetizing their decadal aspirations.

Section Two: *Our Position Sizing Framework*

While our ideology defines **how we invest**, our psychology dictates **how much we invest**. Although academic theories on sizing are useful, they erroneously assume that probabilities and payoffs are knowable. Our model aims to bolster one objective, which is inspired by an idea that Bezos mentions in his shareholder letters – regret minimization. Decadal regrets come in many forms – not owning a good business, not owning *enough* of a good business, selling too early, not selling at the top, sticking with a weak business too long, partnering with the wrong people, etc. **Investing can be unforgiving to one's sanity**. Our framework focuses on our investing aspirations – staying invested in really good companies run by really good people for a really long time. It is important to disclose that we do not consider our preference for long holding periods and low turnover to be exalted virtues – others may have gone farther with an inverse approach. Our approach is not didactic – it's simply what works well for us.

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One reason our approach works for us, is that we know what we want – we want to protect purchasing power over decades and minimize impairments in the interim, while remaining largely agnostic to how we stack up along the way. We do not target a specific return and then reverse engineer how we ought to invest. Rather, we design how we should invest and then accept the returns that emerge from rigorous implementation – we try to think of decadal returns of any specific stock in our portfolio with a similar mindset as the founding family of that business would, in long-term return multiples. For example, we would happily accept a 10x even if it took 4-5 years longer. Let's think about what that means – a 10x in 10 years = 26% CAGR; versus a 10x in 15 years = 16% CAGR – a whole ten percentage points slower – this would not inconvenience us one bit! In the second hypothetical scenario note that one is at a ~4x return multiple even after 10 years. It is only the conviction to patiently hold that produces the 10x outcome in 15 years. We don't seek to maximize returns by undermining the certainty. We overweigh certainty and accept the accompanying trade-offs. Our focus is firmly on minimizing decadal error.

These are not return estimates/ projections/ guarantees – we are just framing how we think about returns.

The number of positions we choose to own is guided by our desire to minimize decadal regrets regarding, on the one hand, the opportunities we undoubtedly seek to seize, and on the other, the opportunities we are unapologetically willing to forfeit. Based on these overlays we believe that our decadal regrets are best minimized when we invest with a high-concentration (10-15 positions), stubbornly-patient, ownership-oriented mindset. A maximum of fifteen positions is a hard stop as more holdings would take away juice from our best ideas. A minimum of about ten positions helps minimize the regret of missing out on compelling decadal opportunities that sit well within our comfort zone of understandability.

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In my early years, I would be pained to own anything beyond my few most compelling ideas – adding anything else *felt* deeply dilutive – the opportunity costs felt incredibly cumbersome and the nature of the opportunities seemed truly rarified. In hindsight, this conviction to heavily concentrate was predominantly fuelled by the exemplary stewardship of the leadership, our perceived certainty of the long-term scalability prospects and the ability to lock-in a lucrative purchase price – the stars felt truly aligned. That early mindset is a good reflection of our sizing DNA. Over time, experience and the heuristics it burdens us with, led me to grow increasingly mindful of alternative future outcomes – the reality that the future we perceive as entirely certain today often isn't so. While the benefit of experience may at first seem to dull the flame of courage that engenders some of the most superior investing outcomes, one realizes that left unchecked, those same flames hold the curse to inflate hubris and to set ablaze valuable, irreplaceable resources. While I could envision us reverting to higher concentration, it would be contingent upon that rare alignment of the stars. Having discussed position-count, let's drill down into how we size individual positions (not to be confused with our investment selection criteria). Upfront and ongoing sizing decisions are based on our often-fluidic and evolving business-specific perceptions of the following:

1) **Stewardship** evolution of owners/ managers over time
2) **Certainty** of earnings scalability over decadal timeframes
3) **Longevity** of the reinvestment/ growth runways over decades
4) **Resilience** to survive through a wide range of potential tail risks
5) **Pricing** and return expectations based on comfort/ discomfort of prevailing narratives

Experience has led us away from focussing singularly on expected-returns as this does not help contextualize the long feedback loops and lumpy returns that accompany decadal investing. It also fails to encompass doubt-filled-stretches of dreariness or the sweat-inducing-panics checkered along the way. Pricing is reflexive to the first four vectors – as in, the market-wide perception of the first four factors will inversely impact pricing. A key benefit of a multivariate view to sizing rather than just return maximization is that it narrows what we call the behavioural gap, especially during distress. Morgan Housel expounds the idea of keeping reasonability as an appropriate threshold for investors rather than expecting ourselves to be coldly rational, as that is perhaps a far too unrealistic threshold to hold ourselves accountable to at all times. Building on this idea in our context, we define the behavioural gap as the cost or variance between reasonable and rational actions at any point in time. If we were sizing solely to maximize returns, we would likely be implicitly setting ourselves for failure. Implicit in that behaviour would lie the flawed presumption that we will be able to act purely rationally (rather than reasonably) in any and every possible future scenario. It seems to me then that **investing reasonably is the art of embracing the regrets that you are willing to live with.**

Although our process is more intuitive than formulaic, here we attempt to roughly codify how we think about sizing. To aid our discussion let's boldly presume that we can grade each of our companies based on the five criteria. The tables below are a rough guide for defining our grading scale and the "minimums" we desire based on sizing buckets. In codifying our heuristic, I clarify that grades are non-additive, unequally-weighted and non-linear.

Grade	**1**	**2**	**3**	**4**	**5**
definition	*weak*	*mediocre*	*robust*	*good*	*excellent*

Our larger sizing decisions are predominantly driven by our assessment of the evolution of stewardship (management and founding families), the certainty of profitable scalability over decades, the longevity of runways and the absolute & relative inherent resilience. The key determinants of low sizing are compelling businesses that may have significantly worse pricing (by virtue of high prevailing prices) or marginally lower conviction of certainty, longevity or resilience relative to our larger holdings.

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A gradation based on our perceptions of our companies is presented below. Please read these as rough qualitative approximations. Do note that the finest institutionally-owned companies are capped at a stewardship grade 4 as future stewardship evolution is harder to assess, and even the finest levered companies are capped at a resilience grade 4, due to their reliance on policy during extreme circumstances. For the ease of this discussion, pricing is based on prevailing prices rather than pricing at the time of our initial purchases.

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A reminder - this template is not a precise algorithm; it simply illustrates how we think.

In closing, a potent yet very basic, almost cliched idea in investing is that to do reasonably well one must invest for the long-term. Sounds almost too simple. However, an important iteration of this idea is that if one *must* remain invested over the long-term to have good outcomes, it is only worthwhile investing in businesses that one is capable of *remaining* invested in – not just through good times and bad but also through times of vivid certainty and hazy uncertainty – not just in periods of supportive media narratives and stock outperformance but also through dreary boredom when our prices are stagnant while others race ahead. In essence, I only want to buy what I am confident I will be able to hold – much like I only want to eat what I'm confident I can digest. As Seneca stated, "No wind blows in favour of a ship without direction."

Postscript

"One who sees inaction in action, and action in inaction, is intelligent among men."

The Bhagavad Gita

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