



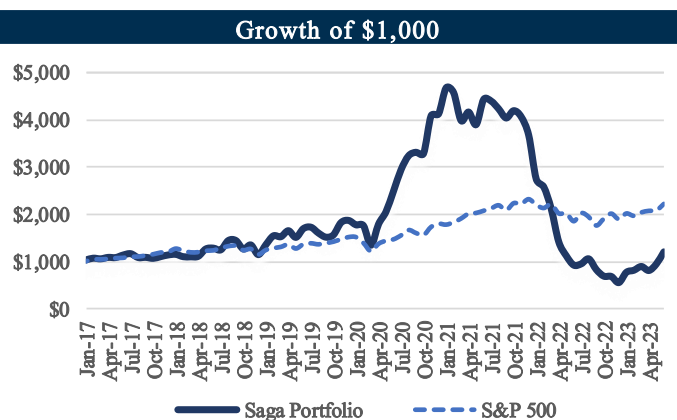
**SEMI-ANNUAL UPDATE**  
**FIRST HALF 2023**

## H1 2023 Results

During the first half of 2023, the Saga Portfolio (“the Portfolio”) increased 117.3% net of fees. This compares to the overall increase for the S&P 500 Index, including dividends, of 16.9%.

The cumulative return since inception on January 1, 2017, for the Saga Portfolio is 20.8% net of fees compared to the S&P 500 Index of 123.4%. The annualized return since inception for the Saga Portfolio is 2.9% net of fees compared to the S&P 500’s 13.2%. Please check your individual statement as specific account returns may vary depending on the timing of any contributions throughout the period.

	Performance (as of 6/30/23)				Growth of \$1,000	
	Saga (gross)	Saga (net)*	S&P 500	Relative Results		
2017	16.0%	14.3%	21.8%	-7.5%		
2018	2.1%	0.6%	-4.4%	5.0%		
2019	65.6%	63.2%	31.5%	31.7%		
2020	123.8%	120.5%	18.4%	102.1%		
2021	-9.6%	-10.9%	28.7%	-39.6%		
2022	-84.7%	-84.9%	-18.1%	-66.8%		
H1'23	118.9%	117.3%	16.9%	100.4%		
H2'23						
<b>Cumulative</b>	<b>33.2%</b>	<b>20.8%</b>	<b>123.4%</b>	<b>-102.6%</b>		
<b>Annualized</b>	<b>4.5%</b>	<b>2.9%</b>	<b>13.2%</b>	<b>-10.2%</b>		



\*Saga Portfolio serves as a model for client accounts. Net returns assume 1.5% AUM fee, or 0.375% applied to account balance at beginning of each quarter.

S&P 500 performance includes dividends.

Source: S&P Dow Jones Indices LLC

## Portfolio Update

There were no significant changes or new companies in the Portfolio during the first half of the year. Despite some pretty big price swings, the long-term outlooks of our companies are largely unchanged. I will provide updates on our companies and their outlooks in the next investor letter following 2023 operating results.

If you read other funds’ investor letters, they typically focus on the recent changes in their portfolio’s stocks, highlighting the contributors or detractors to performance. There is often some macro commentary with thoughts surrounding changes in interest rates, inflation expectations, or risks of a potential recession. Then there might be some high-level commentary on a few companies that were added to the portfolio.

I have tried to use these letters to focus more on the Saga Portfolio’s investment philosophy, process, and explain what we own and why we own it, rather than attempt to speculate the potential reasons for why stock prices have wobbled up and down. Of course, over the last three years our stocks have more than just wobbled. They have experienced roller coaster-like volatility that puts Cedar Point to shame.

From a long-term investor’s perspective, huge volatility is a gift and likely improves long-term returns, although it may not feel like it while in the middle of selloffs. However, nothing tests your conviction and makes you dig deep inside than when the price of one of your stocks falls 90%, let alone if it happens to multiple stocks...at the same time.

We all know that the market can get manic from time to time both on the upside and the downside, but I would not have predicted that some of our stocks' prices would reach the lows they did. You never really know to what extent fear can spread and last year was a great example of the frantic depths that sentiment got in several of our companies. Fortunately, the Saga Portfolio does not use any leverage or invest in options, so time is our friend as opposed to a ticking bomb, as we can let our companies execute and eventually prove their worth.

A reasonable question is, "Can the Portfolio avoid a similar decline in the future?" I have reflected on this question a lot because obviously it would be preferable to not experience such significant drawdowns in the future. Unfortunately, I have not been able to come up with a good answer. I think the reason is because there isn't one. If there was, there would be a simple investing formula that would deliver consistent outperformance every single quarter or even every single day.

Like most things in life, there are different tradeoffs between choices. For example, one solution to lower volatility is to diversify more. That means owning more stocks, which means investing in ideas that you find less attractive or understand less. Owning only your favorite stock is more likely to lead to the best results but will also have a lot of volatility. It also puts all your eggs in one basket, which can permanently impair the value of a portfolio if something catastrophic happens to that company. The opposite end of the spectrum is owning a widely diversified index fund where any single stock has little impact and you are guaranteed not to outperform or underperform the market's return over your holding period.

The Saga Portfolio has pretty consistently owned seven or eight different stocks throughout most of its history; primarily concentrated in the top five or six positions. Despite being more volatile in the short term, I have found this to be a good balance between investing in the top ideas but limiting the risk that any one or two positions could permanently impair the Portfolio. This strategy has worked well historically but was tested in 2022 when several of our positions fell far out of favor. With one exception (explained in the [Q2'22 Investor Letter](#)), I continued to find our companies' prospects very attractive. If our companies execute the way I expect them to over time, their value will become more obvious to the rest of the world, and the market will eventually value them more fairly, providing the attractive long-term returns we look for.

If I could find other opportunities that I liked equally well, I would be happy to own them. However, understanding the different dynamics, history, and nuances of a particular company within its larger ecosystem takes a great deal of research. It is not as easy as buying something for less than the working capital on its balance sheet like in Ben Graham's day. There simply are not dozens of very attractive opportunities that one can discover and understand a priori. Very few stocks are truly undervalued and they all come with some sort of hair on them which I explain in more detail later. Even though I am continually looking, when considering the prices that our current holdings are selling for, few other opportunities have come close to looking nearly as attractive in my opinion.

Another potential solution to volatility is to invest in companies that are considered "safer" and therefore likely to have smaller drawdowns when the market gets scared. I do not purposely seek out controversial companies, it just so happens that is where I often find more attractive opportunities. Which great investment was not considered highly controversial at the time of purchase? I tend to agree with the perceived risks of most opportunities, which is why we only own a handful of companies. Every once in a blue moon, I find the market's perceived risks unfounded and then invest. Investors don't outperform by picking favorites, they do it by finding diamonds in the rough. If one requires the feeling of safety of the crowd, then owning the S&P 500 Index is probably the best way to go.

The next question is, “How could I still believe our holdings were undervalued at some of the prices they sold for in 2020 and 2021?” Again, I do not have a perfect answer. If I knew our stocks were going to crash, I would have sold them. But I did not know, nor will I ever know what stocks will do next. People believe they can time the market’s tops and bottoms with perfect precision, but that is only possible with the help of hindsight. I am certain that if we followed more of a market timing strategy, we would have sold far before any highs were reached, and as stocks started to fall, reinvested far before the ultimate lows, experiencing less of the run-up and much of the eventual drawdown.

No investing decision is made in isolation. It is always compared to the other opportunities available at the time. Following the COVID stimulus that helped lead to a more speculative market, essentially all asset prices rose. When looking across the investing universe, I tended to prefer owning our holdings that I understood well and believed to have attractive long-term outlooks as opposed to ones that I understood less well or had less attractive long-term outlooks. Obviously the long-term expected returns of our stocks were lower at their highs compared to what they were at their lows. But if the S&P 500 Index is our opportunity cost, I continued to prefer holding our stocks versus the index over the next decade. What has and continues to drive my investment decisions are: what a company is expected to do over the long-term, versus the price at which it sells for today, *compared to all the other opportunities that I understand equally well.*

Whether I like it or not, none of the potential solutions to lower the risk of future drawdowns (more diversification, investing in “safer” names, or timing the market) make a lot of sense to me largely because they limit the upside potential over the long-term. Therefore, I continue to invest the Saga Portfolio in a similar manner after the drawdown as before. As I reflect on the Saga Portfolio’s investing philosophy and process, I always come back to a model that Charlie Munger described as “surfing,” or for lack of a better term, “sit on your ass investing.” For the rest of the letter, I thought it would be helpful to dig deeper into this model, the reasoning behind it, and what it entails.

### **Surfing vs. Mean Reversion**

People use different models to help them forecast the future, an important part of the investing process. One model is reversion to the mean which can apply to many different situations. It says that if a variable is outside the historic mean, then that variable will trend towards the mean in the future. A classic and overly simplistic example used for investing is that if a stock has historically sold for 15x earnings, and it currently sells for 10x earnings then it is undervalued, or if it sells for 20x earnings it is overvalued.

Another example may be if a company is earning above industry average returns on capital, then it will likely have lower returns on capital in the future due to increasing competition. This has generally been a good rule in a competitive market, but that does not mean it works for all companies in all situations. Savvy investors who have identified companies able to maintain higher returns on capital for longer than the market initially priced into their stock (companies with durable competitive advantages) have been able to earn excess stock returns. It is in situations like these where the market paints a broad brush across all companies that one can find an exception, an anomaly, where the general rule of thumb such as reversion to the mean may not apply.

A different model that I have referenced in past letters is what Charlie Munger calls surfing. In the speech, *The Art of Stock Picking*, he explains –

*“When technology moves as fast as it does in a civilization like ours, you get a phenomenon which I call competitive destruction. You know, you have the finest buggy whip factory and all of a sudden in comes this little horseless carriage. And before too many years go by, your buggy whip business is dead. You either get into a different business or you’re dead—you’re destroyed. It happens again and again and again.*

*And when these new businesses come in, there are huge advantages for the early birds. And when you’re an early bird, there’s a model that I call ‘surfing’ – when a surfer gets up and catches the wave and just stays there, he can go a long, long time. But if he gets off the wave, he becomes mired in shallows.... But people get long runs when they’re right on the edge of the wave ...*

*That’s exactly what an investor should be looking for. In a long life, you can expect to profit heavily from at least a few of those opportunities if you develop the wisdom and will to seize them. At any rate, ‘surfing’ is a very powerful model.”*

I like to think of investing based on mean reversion as boogieboarding and secular trend investing as surfing. Neither approach is right or wrong, but it is important to understand the differences. You do not want to use a surfboard while boogieboarding and you definitely do not want to use a boogieboard while going after 50 foot waves.

Mean reversion boogieboarding has an inherently shorter-term horizon. It seeks more frequent opportunities that earn smaller returns. Opportunities appear safer, but they are closer to shore and more crowded. These investors tend to focus on near-term financial metrics such as sales and earnings and to what extent they may beat or miss near-term expectations. People can earn good returns from buying and selling stocks seeking more modest gains, but it requires a constant funnel of new ideas, high portfolio turnover, and an increased focus on the near-term stock price action.

Secular trend surfing has an inherently longer-term horizon in an attempt to catch the big rides. It focuses more on strategic analysis, competitive advantages, and the size of the market opportunity. The key to big wave surfing is picking the right waves to ride, which requires an extreme level of selectivity, understanding of innovation cycles, and the ability to move further away from the comfort of crowds that stick closer to shore.

## **Power Laws of Big Waves**

Like other living ecosystems that involve feedback mechanisms, stocks and the underlying companies they derive value from follow power laws. The distribution of all stock returns over any 10-year period is heavily skewed, with a small number of companies generating outsized gains and the majority that don’t just underperform but provide negative returns for shareholders. While 10-year periods are not equal to a company’s entire life, it might as well be when compared to Wall Street’s typical horizon of next quarter to year. At the very least it filters out most stocks that may skyrocket over a short period but then come crashing back down to Earth. We are not trying to play a greater fool game by getting lucky in a stock’s upswing and then selling before an imminent crash.

Over each of the last 40 years (as far back as I have data), ~20-30% of listed U.S. stocks beat the S&P 500 over any 10-year period. That means ~70-80% of stocks underperform the S&P 500, and not only do most

underperform but ~50% of listed stocks provide negative total returns. If one has any chance of earning decent returns over the long term, then they must own the few stocks that outperform.

One investment strategy to nearly guarantee you own the few stocks that provide outsized returns is to own a widely diversified index fund such as the S&P 500. The index fund would include stocks with poor returns, but also the handful of companies generating most of the value, providing a market average return.

The other strategy is to filter through the thousands of available stocks and build a portfolio that seeks to only own companies that have the potential to generate high returns and avoid those that do not. What would this strategy imply? Owning any individual stock is riskier than owning a diversified basket of 500 large cap companies; therefore, if picking an individual stock, one should expect it to beat the index by a wider margin. Over any 10-year period, ~5-10% of stocks will beat the S&P 500 by more than 10% per year. This is the pond that we are trying to fish in.

There is one common characteristic across every single one of the ~200-400 outperforming stocks at the beginning of each 10-year period that is obvious - they all significantly exceeded the expectations that were baked into their stock price at the beginning period. All the stocks were at least initially considered “controversial” investments.

One can break down a stock’s return into a function of three variables: 1.) change in valuation multiple (price the stock sells relative to a fundamental value) over the holding period, 2.) change in that fundamental over the holding period, and 3.) return of capital to shareholders.

While growth is not essential to providing excess returns, almost all stocks in this group grew revenues or gross profits by at least a double digit compounded annual growth rate (CAGR) over the period. If a company’s future is going to look a lot like its past (has lower future growth) then the market has been more likely to discount its future appropriately and the stock will then only provide average returns.

There are a few companies that had lower fundamental growth and provided excess stock returns. Sometimes the market expects the long-term outlook of a more mature company to deteriorate for whatever reason. It places a very low valuation multiple on current operating results, but then results eventually prove more durable. Management can repurchase shares at attractive prices and as the business proves itself over time, the market eventually revalues it higher. This has primarily been where more traditional “value investors” have focused. A few companies over the past decade like O’Reilly Automotive, Mettler-Toledo, or Cintas had slower fundamental growth, but the attractive stock returns primarily came from returning capital to shareholders and the market now placing a higher valuation multiple on the operating results.

However, just because a company outperformed over a given 10-year period does not mean it will outperform into the future. Of the stocks that beat the S&P 500 by over 10% per year in any 10-year period, only 20-30% end up outperforming the S&P 500 over the next 5-year period. In other words, even if a stock has been a big winner with strong outperformance over the last 10 years, it has the same odds of beating the S&P 500 as any other stock available in the market.

With these insights in mind, my approach has been to buy any new stock as if I would be forced to own it for at least the next 10 years. This filters out companies that either have 1.) a less certain long-term outlook and 2.) may have a more certain long-term outlook but valuation makes them look less attractive. It does not mean that I know precisely what the company’s operating results will be in the near or even intermediate term, or how the stock market will react to those results. It means that eventually the company is expected to provide results that far



exceed current expectations and inevitably the market will appreciate those results. It can be hard to know exactly when something will happen, but easier to know that something will happen.

While this approach may seem restrictive or even lazy from an outsider's perspective as it typically leads to long periods of little to no stock trading activity, it focuses attention on the key variables that will drive returns over time. It does not mean one must hold every investment forever, but thinking about the price you want to sell a stock at the time of your initial purchase is like thinking about divorce on your wedding day. It is unlikely to lead to an overly fruitful relationship and it probably makes sense to move on to the next opportunity.

Of course, the key to investment surfing is forming a long-term outlook for a company. To do that you need to have a good understanding of where an industry and the companies within it are in their life cycle, which is directly related to innovation cycles and their implications.

### **Innovation Cycles/Waves – Fluid, Transitional, Specific Phases**

Industries experience waves of innovation interspersed with periods of stability and consolidation. Anyone can see how businesses are born, grow, mature, and inevitably decline over time. Over the long term, companies behave more like biology than anything else. It is similar to a person going through childhood, adulthood, and then old age. "Growth companies" eventually run out of steam. Solid blue-chip companies that once seemed invincible are suddenly overtaken by younger competitors which initially had fewer resources. When a wave of radical disruptive innovation sweeps across an industry, it makes existing technologies obsolete. It is not if an existing product and business will be overturned by technological change, but when.

When valuing a company, most investors build some type of discounted cash flow (DCF) model. The models include an explicit forecast period plus an estimate of continuing value. One problem is that explicit forecasts typically draw assumptions based on recent year trends which are then extrapolated over the next five or so years, with growth rates declining over time. This may be a good assumption for more mature companies where the future looks a lot like the past, but it can lead to bad forecasts when industries and the companies in them are experiencing a lot of change.

Another major problem with DCF models is that the continuing value often assumes business results will be more of the same with a terminal growth rate in line with GDP. However, companies can change a lot in a 10-year period, particularly those earlier in their life cycle. Expectations that are anchored to recent fundamentals can risk underestimating the terminal value, which often represents the majority of corporate value. Minor differences in assumptions that a company is able to compound its earning power over the next decade can have significant impact to intrinsic value. Companies also do not live forever. Half of public companies get delisted within 10 years. Assigning a terminal value to a company that won't be around risks overstating its intrinsic value. The only way to form these long-term views is to have a good idea about where a company is in its life cycle relative to the different phases of innovation.

In the book, *Mastering the Dynamics of Innovation*, James Utterback provides a framework for analyzing the three phases industries go through. The phases are related to the rate of innovation and underlying dynamics surrounding product, process, and competition within the industry. He breaks them into the 1.) fluid phase, 2.) transitional phase, and 3.) specific phase.

### 1.) Fluid Phase

The fluid phase is when a new disruptive technology is in its infancy. A great deal of product innovation and change happens and the eventual product, business model, and competitive landscape surrounding the technology is highly uncertain. Many new firms are started by entrepreneurs who experiment with the new technology to discover product-market fit. The new products using the technology are often crude, expensive, and unreliable, but they fill a function in a way that is wanted in some niche markets.

### 2.) Transitional Phase

If demand for a new product grows, the industry may enter the transitional phase. In a natural selection-like process, customers begin to gravitate to the product that best serves their needs, and the subpar product alternatives die away. The needs of users of the new technology become better understood and a dominant product design with widely accepted standards emerges. Incremental changes (sustaining innovations) in products made by competitors will tend to be copied rapidly.

The focus of firms begins to shift from product innovation to larger scale production and a set of efficient producers usually emerges, favoring firms with superior operational processes. Many firms are unable to compete against more efficient operators and the number of competitors drops as they ultimately fail by either going out of business or selling to the increasingly dominant firms. The eventual size and number of companies in an industry will largely depend on the total size of the market and relative economies of scale and operating leverage inherent in providing the product or service (discussed more in the [H2'22 Investor Letter](#)).

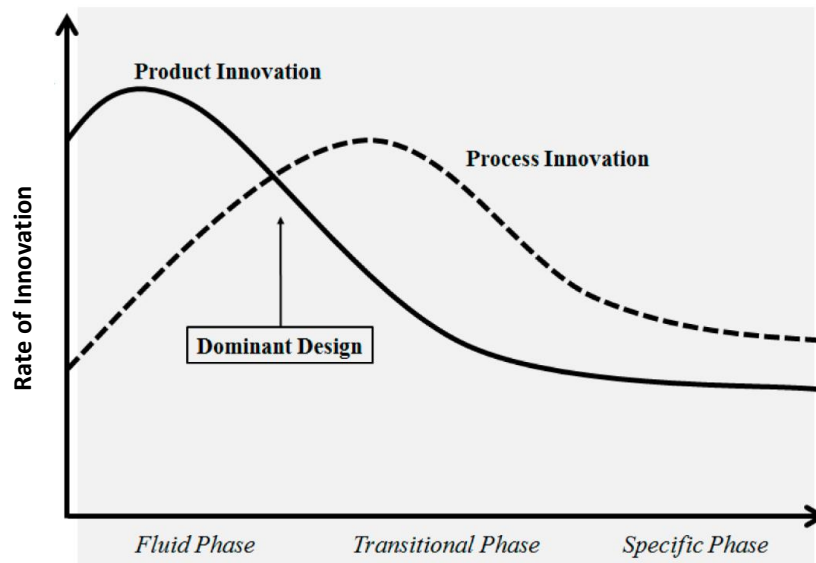
### 3.) Specific Phase

Finally, a technology will enter the mature or specific phase which aims at producing a very specific product at a high level of efficiency. The competitive environment reaches a point of stability. Depending on economies of scale and the market size, only a few firms produce standardized or slightly differentiated products with relatively stable sales and market shares. Products are highly defined and differences between products of competitors are minor. Any change in either product or process is likely to be difficult and expensive to institute.



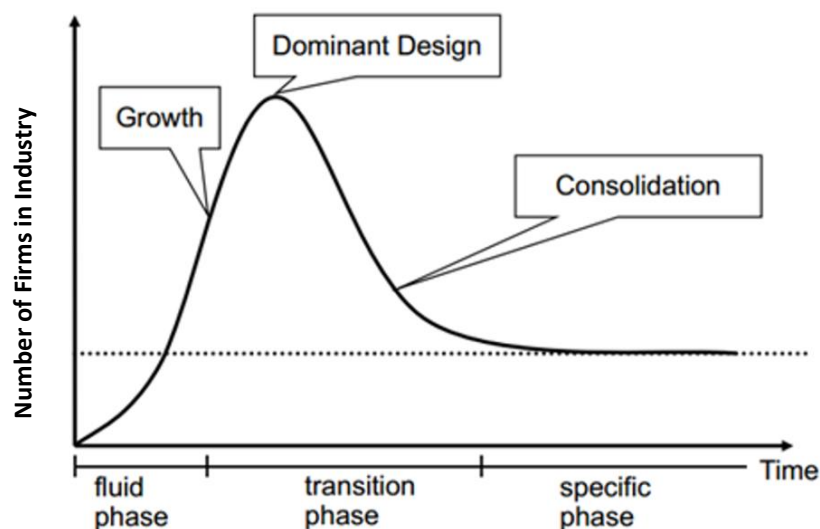
The chart below shows the relationship between product innovation and process innovation during the different industry phases. Product innovation tends to be high in the early phase of the industry's life with many different firms offering diverse versions of products. As product-market fit is discovered with a dominant product design, the rate of product innovation decreases while process innovation increases as firms focus on improving efficiencies in cost and time.

A dominant design negatively affects radical innovation while having a positive impact on process innovation. This supports Clayton Christensen's Innovator's Dilemma for why incumbent firms rarely succeed in disruptive innovations but typically succeed in sustaining innovations.



Source: *Mastering the Dynamics of Innovation*, by J. Utterback, 1994

Below is a chart that shows the entry and exit of firms as a market transitions between phases. A growing number of firms enter the market during the early fluid phase. Then firms exit as the market consolidates among the more dominant firms.



Source: *Mastering the Dynamics of Innovation*, by J. Utterback, 1994

## Identifying The Hidden Winners

To get back to the surfing analogy, waves are created when energy travelling through the wind is transferred to the water out at sea. That energy travels through the water and eventually approaches the shore. A rising ocean floor pushes up against the energy, causing water to rise and potentially curl over.

When the energy is first transferred to the water at sea (fluid phase) it is essentially impossible for a surfer to determine which specific swell lines will turn into great surfable waves. It is similar to when a new technology is discovered but it is difficult to know how it will be applied as a product or service and who will benefit.

As the energy approaches the reef or shore break, a surfer is now able to analyze the variables that will lead to a great surfable wave (transitional phase). They must assess numerous factors such as the angle of an approaching swell line, how the rising ocean floor affects the wave, and direction of the wind, to name a few. Half the battle is in determining whether an oncoming set of waves will be choppy and fold over, risking a major wipe out, or whether they will have a clean break, peel down the line, and propel a surfer to shore. By the time the wave breaks, the force and quality of the wave are more obvious for anyone to see, and the wave begins to slow as it approaches the shore (specific phase).

From an investor's perspective, we are looking to own things that are undervalued. To do that the market must underappreciate the future of the underlying company. Not only do we have to pick a winning company, but we have to pick a winning company that the rest of the world does not think will win, or at least to the same extent that we think it will.

When considering the long-term outlook of an industry and the businesses within it, trying to consistently predict the winners during the fluid phase is nearly impossible and something the venture capitalists can sort out. On the other end, the winners and their addressable markets in the specific phase are widely understood and generally valued pretty fairly with the exception of the occasional panic/major selloff. Meta Platforms was a good example of a wave that was more mature and obviously very strong but the rest of the world believed otherwise.

The real mispriced opportunities are in digging through industries that are in the transitional phase. This is where the majority of the 200-400 outperforming stocks at the beginning of each 10-year period were. This is because the future is widely considered uncertain. Analyzing the addressable market is still a vague exercise using historical assumptions despite the potential for completely new use cases.

The economics of the business in the transitional phase are less clear if only doing a cursory analysis. Many write off a company simply because "it still loses \$X per widget?!" Companies in the transitional phase typically spend elevated amounts on research and development as well as on growing infrastructure to scale ahead of expected demand. Reported losses are only amplified for firms that are investing heavily in intangible assets, which are expensed as opposed to capitalized.

I could dig into the difference between companies with "GAAP-losses" vs. "real losses" in greater detail but instead I recommend reading the paper titled, *Good Losses, Bad Losses*, by Michael Mauboussin and Dan Callahan who do a great job summarizing the topic. The main takeaway is that not all losses are the same. Companies that spend on attractive business opportunities, despite depressing near term earnings, will provide attractive business results (future cash flows) and the stock will eventually reflect the underlying economics of those investments.

Industries going through the transitional phase is a great hunting ground for mispriced opportunities. Despite what may appear like a highly uncertain future, customers have already selected the winners. As demand is moving to the eventual survivors, the quality of the product improves as the winning firms continue to learn more about what customers want. As they scale production, the output of the industry grows even as the number of producers declines. With greater scale and efficiencies, the unit price of the product typically declines, which further expands the addressable market. Increasing relative economies of scale advantages, capital requirements, and therefore greater operating leverage, raise the barriers to entry. This is all happening while the market's valuation may be anchored to past fundamentals that do not necessarily reflect the more favorable future.

## Riding Waves

If one is searching it can be easy to spot a big oncoming wave. The hard part is deciding which ones you can get up on and enjoy the long ride. Even assuming the surfer identified a great wave, got up on their board, and it is propelling them forward in what can appear to be a graceful long ride to shore, they still have to be able to physically endure the force as they navigate what can be a volatile ride. For those surfing a wave beyond their ability, they may end up bailing out on what could be an epic ride.

Let's dig into one of the biggest waves over the last 20-30 years, the smartphone. Over the last 15 years, global smartphone unit sales have grown from 124 million units sold in 2007 to 1.4 billion units sold in 2022, totaling 6.4 billion users. The oncoming mobile phone wave was obvious, but estimating the ultimate size, competitive dynamics, and individual long-term winners was more difficult.

Numerous companies have come and gone that have attempted to find product-market fit with the first mobile phone products becoming available in the 1980s. Most notably, Nokia was a leader with global market share reaching nearly 50% in 2006, the year before Apple unveiled the iPhone. Nokia's early vertical integration provided some economies of scale when producing low-cost phones throughout the world. However, their insistence on designing and producing their own hardware, chips, and using their proprietary, yet often considered clunky, Symbian operating system, made it difficult to keep up with the rapid 6–9-month product life cycle.

While numerous companies benefited from this major wave (particularly several parts suppliers), the big winners would come from outside the mobile phone industry. Apple launched its iPhone in 2007 and Google began licensing its Android mobile operating system in 2008. Steve Jobs believed the iPhone was *five years ahead* of any other product at the time it launched. It combined the iPod, phone, and Internet browser into one device with the first highly functional touchscreen.

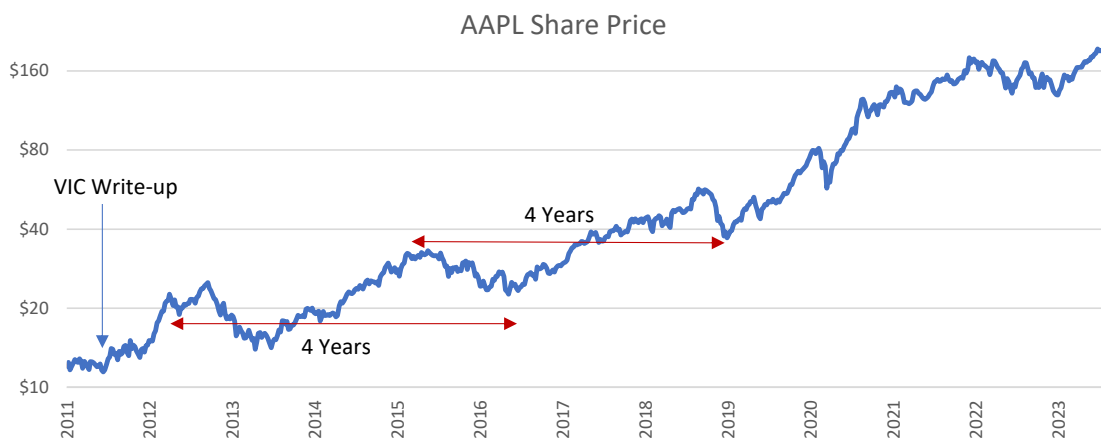
However, Apple's durable competitive advantage did not come from the iPhone's advanced technology which would eventually be copied, but in owning the mobile operating system which controlled the user interface and the app store. In 2008, Apple opened its app store to third party developers and by the end of 2010 dominated the high-end smartphone market with ~50% U.S. market share, while mobile OEMs using Android flooded the low-end and middle market. Nokia, Blackberry, and devices that did not adopt Android's mobile OS saw market share plummet.

Apple was able to build a large enough userbase and app developer network to reach a sustainable ecosystem before Android's more open mobile OS user experience improved and took over. Despite the billions of dollars invested by Nokia, Blackberry, Microsoft, Palm or the numerous other companies that have attempted to win in the smart phone industry, Apple's iOS and Google's Android established themselves as the winners in what is the most valuable piece of real estate, people's pockets. If one had the insight that the mobile phone would become

a smaller computer and therefore require an operating system to run third party software, resulting in scale and network effect advantages for the end-state winners, then all one had to do was wait until the winning operating systems emerged.

I came across this [Value Investors Club \(VIC\) write-up](#) on Apple from 2011 that outlines the investment case but also describes the bearish sentiment surrounding Apple at the time. From a business analysis standpoint, the author hit the ball out of the park. They discussed Apple's installed userbase, app developer network, and scale advantages, as well as why vertical integration between the OS and hardware design provided an advantage in smartphones when it proved to be a disadvantage in the personal computer industry.

Few stock charts have had such a perfectly straight line up and to the right as Apple had since 2011. However, despite Apple providing some of the best returns to owners, it experienced two periods of ~4 years where shares were essentially flat, underperforming the S&P 500 by a wide margin during those periods. This is from one of the best performing stocks over the past decade.



Source: Factset, Saga Partners

However, the business analysis was only half the battle. The author's bull case was for Apple to double its earnings by 2013/2014 and sell for 10-20x earnings, providing a 55-100% gain. I wonder if the author sold after Apple exceeded his bull case with shares doubling within the following year. If they sold in 2012, they would have fortunately missed the 50% decline in share price at the end of the year, but also the 10-bagger over the next decade.

What made owning a stock like Apple over the last 10+ years so difficult was not holding it through the inevitable drawdowns or periods of underperformance, it was holding as it continued to make new all-time highs while the rest of the world screamed that it was overvalued. Companies that are in the top 5% of all companies, or top 1% in Apple's case, typically look "expensive" on a traditional valuation basis much of the time. This is a difficult pill to swallow for those that only want to own "cheap" stocks. Yet, even during the occasional times these stocks don't look expensive on a traditional valuation basis, the world is screaming that it is because their future looks much bleaker for numerous different reasons.

This is the whole game of investing. Even if your analysis was right, it required a certain level of emotional independence to be able to consider the numerous other opinions throughout the world, then look down at your analysis and conclude, “I respectfully disagree.” The goal is trying to get as close to the right answer as possible. The key is to only ride the waves that are right for you, regardless of the opportunity or potential upside. If one depends on someone else’s conviction, then when the wave inevitably gets choppy, they will likely bail out at the worst possible time.

## **Future Waves**

Waves like personal computers (Microsoft), e-commerce (Amazon), smartphones (Apple), Internet search (Alphabet), and social media (Meta Platforms) have been powerful economic forces that investors have now been riding for decades. There have also been numerous other waves that have been a little more under the radar but just as attractive. Digital payment networks (Visa, Mastercard), software-as-a-service verticals (Salesforce, Adobe, ServiceNow), discount retailing verticals (Home Depot, Tractor Supply Company, TJ Max, O’Reilly Automotive), the aerospace after-market (Transdigm, Heico), online car auctions (Copart), LTL trucking (Old Dominion Freight, Saia), or fast casual dining (Chipotle) to name a few.

I would expect that on average, these companies still have long runways ahead of them. However, just given their sheer size relative to the addressable markets, and that the market appears to better appreciate their competitive strengths in most, I would not expect investors to earn the outsized returns they provided in the past. Of course, there will be exceptions. Some will continue to be big winners, but the big returns came from discovering these waves 10-15 years ago when they were further out at sea, a fraction of their current size, and widely considered more speculative.

While there were numerous waves over the past twenty years, we will be surfing over the next twenty. The question is which waves, and more importantly, which specific companies, to ride? When I look out into the future, there are waves that seem inevitable, such as artificial intelligence (AI) having a big impact on the economy, as will blockchain technology, or something like the metaverse/virtual reality. However, I have no idea how these technologies will evolve at this point. They are in the fluid phase of their life cycle. Understanding how they develop into specific products and who will benefit is highly uncertain, at least to me.

It is like sitting in the year 1900 and trying to forecast what the automobile industry would look like in 1925. Ford developed the first mass-produced Model-T car in 1908 and General Motors was founded in 1908 which then pursued a series of poorly executed acquisitions over the subsequent decade. When mobile phones and handheld smart devices were experiencing rapid innovation in the 1990s, was it possible to predict who would be the ultimate winners in 2020? I argue that it probably wasn’t until ~2010 that the long-term smart phone industry outlook became clearer.

## Streaming Television

There are certain waves that I consider as predictable as one needs to invest prudently. One of the examples in the Saga Portfolio is streaming television. In the year 2000, one could have made the statement that all television will eventually be distributed over the Internet one day, but exactly how the industry developed was highly unpredictable at the time. In the last several years, connected TV has moved into the transitional phase where the market has largely already chosen the winners who are scaling their products and now benefiting from rising barriers to entry.

Where will most of the economics go in the streaming television value chain? Historically, there was scarcity in distribution of TV content which was either broadcast over limited airwaves or through physical cables. This benefitted the suppliers/aggregators of TV content, notably the national broadcasters (NBC, CBS, ABC, FOX) and the national cable networks (ESPN, FX, CNN, etc.) which split some of the economics with the distributors (Comcast, Charter, Dish, DirecTV) who controlled the customer relationship.

As TV began getting distributed digitally over the Internet rather than over the air or through cables, there no longer was a scarcity in the amount of content that could be distributed. Viewers can access any content they want at any time as long as it is available on the Internet. The TV broadcasters and cable networks were initially hesitant to disrupt their cash cow of advertising dollars and share of cable and satellite subscriptions. Putting content online and shifting viewers to the Internet decreased the reach of viewers that advertisers want and the attractiveness of the cable package for subscribers.

Netflix formed a new business model that charged a subscription for access to any of the content it had available. It started by licensing old back catalog content. As they gained scale the content increasingly improved as they licensed or produced higher quality content. They were early and quickly grew ahead of others which provided them with a scale advantage to amortize the costs of content over more subscribers.

Fast forward to the present and the legacy TV companies have been forced to move their content to the Internet because that is what viewers demand. Much of the TV debate has been focused on the heated streaming war battles between the content suppliers (Netflix, Hulu, Amazon Prime, Disney+, Max, Peacock, Paramount+, etc.). These companies historically focused on a subscription model but have recently shifted more to an advertising model as a way to pay for the increasing costs of TV content. Netflix continues to benefit from its relative scale, but as advertisers shift dollars to connected TV, they will continue to care about reach and targeting. None of the apps will have as good of reach or targeting as the operating system who has the direct-to-consumer relationship and are the gatekeepers between the viewer and TV content. I expect that much of the value that the suppliers of TV content earned historically will move to the ultimate aggregators/distributors of it. The real question isn't who will win the highly competitive streaming app battle, but who will win control of the smart TV operating system?

Data shows that the TV operating system space has been consolidating among fewer key players. Roku continues to grow market share each year and now reaching nearly half of all U.S. households. The economics of the business have been masked by the company reinvesting in growth and more recently experiencing a cyclical decline in the advertising industry. However, the long-term future has never looked so clear in my opinion. For those interested, I went on the [Business Breakdowns Podcast](#) in June where I discussed the connected TV space and Roku's business in more detail.

Whether it was [Jeff Bezos](#) with Amazon, [Steve Jobs](#) with Apple, or [Anthony Wood](#) with Roku, certain managers have been very clear about their vision and long-term objectives from the very beginning despite being doubted for much of the journey. Sometimes you just have to listen, evaluate the results thus far, and have a little longer time horizon than what most of the world is willing to take.



## Conclusion

I am not suggesting that surfing is the only way to invest in the stock market or that this type of investing is for everyone. Buying and holding companies with long-term secular trajectories sounds simple. It is not, especially if managing other people's money. If one looks carefully at the price of every single multi-bagger throughout history, shares experienced significant drawdowns on their way to providing exceptional returns. The key is being able to pick the long-term winners (no easy task) and then holding on (again, no easy task). Most investors are shaken out somewhere along the ride. The odds are not in the stock picker's favor. But if one is able to discover and own just a few of the big winners, the returns are sure to make it worth the effort.

Despite its challenges, surfing is a powerful investing model. It focuses attention on the key variables that will drive returns over time as opposed to guessing how stocks will jump up and down in the near-term. Searching for companies in the transitional phase of their innovation cycle that have emerged as early winners, in an industry with rising barriers to entry, and that have long runways ahead of them, is a great hunting ground for mispriced opportunities. With this approach, one does not have to get a lot right (although we attempt to), as long as they get something right *and* are able to hold on for the ride.

I could not be happier with the investors that have decided to go "surfing" in the Saga Portfolio. It truly has been a privilege to manage your hard-earned capital. Our success is directly correlated to an investor base that is aligned, stable, and thinks long-term. It has made it possible to navigate what have been significant ups and downs over the last few years and will make it possible to continue to do so far into the future. As always, please reach out if you have any questions or comments!

Sincerely,

Joe Frankenfield

## Appendix

Year	Monthly Performance (gross of fees)*												Annual Performance			
	Jan	Feb	Mar	Apr	May	Jun	July	Aug	Sept	Oct	Nov	Dec	Saga (gross)	Saga (net)	S&P 500	Relative Results
2017	3.9%	3.8%	-1.2%	3.2%	-0.3%	4.9%	2.9%	-7.0%	0.4%	-1.5%	3.4%	3.2%	16.0%	14.3%	21.8%	-7.5%
2018	1.5%	-4.3%	-0.2%	1.3%	13.9%	1.4%	-2.4%	15.7%	0.1%	-12.1%	6.8%	-15.1%	2.1%	0.6%	-4.4%	5.0%
2019	18.7%	13.9%	-1.2%	8.7%	-8.5%	12.2%	2.1%	-7.1%	-5.5%	3.6%	16.5%	2.6%	65.6%	63.2%	31.5%	31.7%
2020	-4.7%	-1.0%	-23.5%	33.5%	14.9%	21.2%	18.6%	10.0%	2.3%	-0.4%	24.3%	1.0%	123.8%	120.5%	18.4%	102.1%
2021	13.8%	-2.1%	-13.0%	4.9%	-6.4%	13.7%	-0.4%	-3.7%	-4.6%	4.2%	-3.1%	-9.6%	-9.6%	-10.9%	28.7%	-39.6%
2022	-25.0%	-6.0%	-18.1%	-32.7%	-20.9%	-17.6%	3.4%	11.0%	-21.5%	-16.4%	-1.0%	-19.0%	-84.7%	-84.9%	-18.1%	-66.8%
2023	39.7%	5.7%	9.7%	-9.1%	17.2%	26.8%							118.9%	117.3%	16.9%	100.4%
<b>Cumulative return since inception</b>												<b>33.2%</b>	<b>20.8%</b>	123.4%	-102.6%	
<b>Annualized return since inception</b>												<b>4.5%</b>	<b>2.9%</b>	13.2%	-10.2%	

\*Saga Portfolio serves as a model for client accounts. Net returns assume 1.5% AUM fee, or 0.375% applied to account balance at beginning of each quarter.

S&P 500 performance includes dividends.

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