The Coffee-Can Portfolio

March 12, 2018
by Scuttlebutt Investor

> I could improve your ultimate financial welfare by giving you a ticket with only twenty slots in it so that you had twenty punches - representing all the investments that you got to make in a lifetime. And once you'd punched through the card, you couldn't make any more investments at all. Under those rules, you'd really think carefully about what you did, and you'd be forced to load up on what you'd really thought about. So you'd do so much better.

— Warren Buffett

What if I told you to buy the shares of five companies but you can't sell those shares for 10 years?

You have to hold on to those shares through thick and thin until 2028. That's a heck of a long time for a lot of things to happen. Under those circumstances, what five companies would you pick? Easier said than done. Ideally it is companies that can stand the test of time and meaningfully grow their earnings and value over time thus maximizing your return. This idea of making investments and not touching them for a long time to let the magic of compounding do its work is the core idea of the "Coffee-Can Portfolio".

Background

I recently finished reading 100 Baggers by Chris Mayer- a decent and easy read (even for the novice) that can probably be polished off in a couple days. Thanks to AMM Dividend Letter for recommending it. Unfortunately the book is not in print anymore so you'll have to pick up a used copy. Mine looked like it was stolen from the local public library. Fortunately the "This is no longer the property of the King County Library System" stamped inside alleviated my guilt. To sum it up though - the book goes back into history (to 1962) to study stocks that have returned at least 100x to analyze what they have in common and to better enable the identification of these types of stocks in today's market. It builds on the work of a previous writer (Thomas Phelps) who wrote "100 to 1 in the Stock Market" - a book that fortunately is still in print after a long hiatus. **The core principle to making 100x or more on your investment is identifying companies that have a long growth runway and holding on through thick and thin.** In other words, "Buy right and hold on". This latter part of "holding on" is where most investors fall flat. Most investors sell far too early to reap the full gains that they would otherwise make.

There is one part of the book that I've become quite intrigued by and enamored with. It is called the **"Coffee-Can Portfolio"** and it is referred to as a crutch that can help with the "holding on" part that most investors (including myself at times) are quite terrible at. The notion of the "Coffee-Can Portfolio" was originally introduced in the 1980s's in a paper by Robert Kirby (a portfolio manager at the Capital Group). The idea is a reference to the Old West when people would put all of their valuable possessions in a coffee can under the mattress and not really touch them for a long time. If you translate this same idea to stocks - you basically find the best stocks you can and let them sit and marinate for a long time - Mayer proposes 10 years. This isn't all that different than the punchcard idea proposed by Buffett that I quoted at the top of this post - I know most are familiar with this quote. The genius lies in its simplicity at protecting us from our own vices that include impatience, boredom, groupthink, herd behavior and short-termism. These behaviors result in our selling great companies too early or just buying a smattering of things rather than making a significant investment in our highest conviction ideas. The reality is that great investments often take a long time to play out and compound into multi-baggers, but you have to hold on for this to happen.

While I have always been a proponent of playing the long game and rarely selling, I've never quite committed to the idea in the way that the coffee-can portfolio is described. And that's really all it is - a mental commitment to one's self. There's no physical impediment to selling these investments at any time other than just the personal commitment to holding on that one has made upfront. However, going in with this thinking and commitment and understanding the reasons why is still a powerful deterrent to selling too early.

The Thought Process

I got quite excited by the idea of deciding which companies I would put in my coffee can. But I simplified it even further. As discussed above, let's say I could only pick 5 companies (versus Buffett's twenty punches) to go into the coffee can and as Mayer suggested- I couldn't touch the coffee can for 10 years or until 2028, what companies would I put in it? A somewhat of a scary thought - 10 years is a really long time to commit to. As Buffett articulated - you have to think really carefully about what you put in.

The first thing I contemplated was my objective. Investing by definition is forgoing consumption today to consume more later - in this case, 10 years later. So the objective is to maximize return, which of course means that you can't lose money. But pure preservation of capital and maximizing the growth of capital can sometimes be at odds with each other. Choosing between these two objectives required me to think about the size of the overall investment in the five companies. If the coffee can is a significant part of the my net worth, I would probably want some element of conservatism to it. However, if I was structuring this as a small investment with some "play money", I might be more aggressive and go all in on some companies with high growth potential (that also have greater potential downside). For the purposes of this exercise I assumed that the amount is significant and I resolved on companies that have strong growth potential but somewhat limited downside. Easier said than done.

Now to the fun part - What do I buy? My initial inclination was to buy some of the great tech companies of our generation - the FAANG stocks as they're called. Facebook, Apple, Amazon, Netflix and Google. Surely they are growing and performing really well. But there's a potential problem here. The market caps of nearly all of these companies are pretty massive. Trees don't grow to the sky. The law of large numbers would tell you that the upside has to be limited when companies are that big. There are surely no 100 baggers lurking among the FAANGs. Best case - maybe a 5 bagger - but even that feels like a stretch. To be clear - a five bagger (highly unlikely) over 10 years ain't too shabby but there's the potential for much more to happen over 10 years with a smaller company.

My mind then turned to developing markets where there is massive growth potential - China and India for example. China has the BATs - Baidu, Alibaba and Tencent. But these suffer from the same challenges as the FAANGs - their large size potentially caps the upside. But there are also many other companies in these markets with smaller market caps and strong growth potential like Ctrip.com, JD.com, MakeMyTrip or Dr. Reddy's Labs. The problem here - these companies and their domestic consumers are not squarely within my circle of competence. I have no easy way to analyze or understand Chinese or Indian consumers so while I know that these markets are growing like mad, I don't know that much else.

Surely, small caps are the answer then. Generally - they benefit from having longer runways for growth with smaller market caps that can appreciate multiple times over. The 100 Baggers book also preaches that smaller companies are preferred. The challenge here is that it's difficult to prognosticate what companies will be duds and what companies will be studs amidst thousands of small caps. It's easy to say - wow, if you bought Apple way back when it was on the brink of bankruptcy, you would've made so much money. But in reality, that probably wasn't a good decision at the time - Bad decisions can lead to good outcomes and good decisions can lead to bad outcomes. Still, it seems to make sense to at least have one small cap with a lot of promise in the mix because if it does take off, the gains on it have the potential to offset other losses many times over.

In the end, I realized that this exercise was quite hard but I settled on 5 companies (with a definite US bias). I don't have a perfect answer for why these five might be better than some other five. The reality is that you could just as easily swap out another company in here and have a strong justification. There's no right answer. But you have to have some belief that these companies will continue to prosper over the next 10 years if you are to put them in your coffee can. In fact - these are the general criteria I used in selecting the five companies.

- Long growth runway (large Total Addressable Market or TAM) or expected demand from now until Judgement Day
- High returns on capital and ability to reinvest at high rates. The reinvestment part is important as you don't want companies paying out earnings in dividends that trigger tax consequences and require me to find other places to invest that money
- Profitable or a logical path to profitability if the company is investing in its business
- Excellent management that is adept at allocating capital. The importance of this cannot be understated.

- Wide moat that protects the business from competition and a management team focused on continuously widening it
- Smaller market caps preferred. Emphasis on the preferred here because I violate this preference here.

The Coffee-Can Starting Five

Before I get to my starting five, I should include a couple caveats.

- While I do like these companies as long term investments, my intention with including these picks is not necessarily to make stock recommendations but rather illustrate the thought process that I went through in picking these companies for the Coffee-Can portfolio.
- I haven't developed a detailed thesis on each of these companies here in the way that I typically do. I've only shared my high level thoughts on investment merits.
- I can't opine on the valuation of these companies. As with the market as a whole, the valuation of these companies appears to be on the high side. Having said that, great companies with strong growth prospects often trade at premium multiples. I can't in good conscience recommend buying indiscriminately at current prices. On the other hand, valuations also looked high a year ago and two years ago. There's never really a perfect time to buy and it's impossible to predict where the market will go in the short term, but we know it is up in the long term. So whether these five or some other five companies - we can help mitigate some of this by cost averaging over some time period and buying during market corrections. Even great companies become mis-priced from time to time.
- I've tried to diversify my picks among industries, overall secular trends, market cap and also geography, but five companies is still a very concentrated portfolio for the average investor as it may not provide the level of diversification sought. Some investors may want to increase it to ten or more companies. Whether five, ten or twenty companies, the objective remains the same - to be really thoughtful about the companies in the portfolio and then hold on to those positions over the long term.

My five:

Amazon (AMZN): Probably not a surprise to anyone here. Amazon hits on all the criteria above, with the exception of smaller market caps. But the potential of Amazon and the immense Total Addressable Market it is going after cannot be ignored. Global retail on it's own is a massive market and this doesn't even take into account the option value of all of the other businesses that Amazon is involved in or looking to enter (AWS, delivery and logistics, banking, streaming video, the list goes on). Furthermore, the secular shift from offline to online will continue to provide it with nice tailwinds for the foreseeable future. Bezos is a business genius that is likely to meaningfully grow earnings power by finding places to reinvest cash flow over the years to come.

Netflix (NFLX): Again with the FAANGs? Yes - Netflix is among these but it is the FAANG with the smallest market cap (at $140bn - sounds crazy that I am saying that is small) and a fairly large market opportunity. Netflix's subscription video streaming business has global ambitions and the scale of the business should enable them to spread high fixed costs for content over an ever increasing base of subscribers, that currently sits at ~120 million globally. Yes, the space is getting increasingly competitive as media companies aren't sitting still. HBO, Disney, Hulu, Amazon, Apple and others want to stake their claim in the space as well with competing streaming services. But Netflix's focus and capacity to invest up to $8bn on high quality content in 2018 should continue to solidify its position as the primary streaming service for consumers. Furthermore, CEO Reed Hastings has been way ahead of everyone in the media industry in understanding where the market was going.

Boeing (BA): Boeing has had a massive run up over the last ~2 years. But can you think of any other company in the world that has the next 7 years of revenue already in the bag? Probably just Airbus (Boeing's main competitor). Boeing has a backlog of nearly 6,000 planes which amounts to 7 years of production. And Boeing benefits from an incredibly wide moat with high barriers to entry. It's fairly difficult and technically complex to make large passenger jets. There's really only one other company (Airbus) in the world that does it. China will eventually become a competitor with the Comac C919 but it will be a few years until the first one goes into service and several more years until it has any type of foothold in the market. Even then, they will only be able to compete for some of the short haul business (smaller planes for shorter distances) and it may be a long time before customers outside of China sign up to order. A multi billion dollar services business maintaining planes for airlines that the company is building out provides option value.

C-Trip.com (CTRP): C-Trip is an online travel agency (OTA) and is the equivalent of an Expedia or Priceline for China. C-Trip's travel portals enable Chinese consumers to book all things travel related like accommodations and flights. C-Trip has a large share (~35%) of a fast growing market. China is the largest source of tourists in the world with 4.5 billion trips taken in 2017- nearly three times as big as the US- and growing at a faster pace. Rising wealth in China shouldncontinue to benefit travel demand and drive C-Trip's business over the long term.

Coupa Software (COUP): This is a wildcard pick of a relatively smaller company (<$3bn market cap) that benefits from a large addressable market - helping companies manage their spend. Anyone that reads this blog knows my fondness for software, especially enterprise software (as articulated in my post on CDK). Enterprise software is wonderful for a couple reasons: 1) it is sticky i.e. it benefits from high switching costs. Once a company adopts a new software platform, it is reluctant to switch lest it retrain its workers and incur the organizational cost and pain of making a switch; 2) it typically provides a nice recurring revenue stream, especially Software as a Service models; 3) it benefits from high operating leverage as most software costs are fixed so every marginal customer is very high margin as the business scales. Coupa provides procurement and spend management software to enterprises. The

Company is on a path to profitability as it consistently grows its customer base and spend under management. Furthermore, the value proposition is compelling for its customers as it helps them save money.

In ultimately landing on these five, I filtered though a much larger list of companies and there were several that were very close to making the cut. In the end though, I committed to choosing only five. Some of the runners up that also fit most of my coffee-can criteria are: Tencent (TCEHY), Shopify (SHOP), Workday (WDAY), Constellation Software (CSU), Alibaba (BABA) Intuitive Surgical (ISRG), JD.com (JD) and MercadoLibre (MELI).

As I stated previously, I don't have a perfect answer for selecting the five I did over a much broader set. Rather, I just wanted to illustrate the thought process and the value that the coffee-can approach can provide in protecting us from our own worst behaviors (impatience, boredom) when it comes to investing.

What are the five companies that you would put into your coffee can for ten years? I know- there's a lot of thought that needs to go into it, but perhaps you've already thought about it or maybe you just have one or two companies you would put in. If you're up for it - I created a little survey and would love to report back what I hear in a follow-up post. While I'm sure there will be a lot of the expected, the more interesting feedback will be some of the companies that are lesser known and maybe even the rationale. Very brief Google survey here.
