An Oblique Approach

On my recent trip to Japan I finished reading John Kay's newly published book 'Obliquity', which has some useful insights into how we achieve our objectives in all aspects of life but with particular relevance to business. In it he contends that most of what we do, whether personal, professional or corporate, is often best pursued indirectly or obliquely. Rarely is a direct approach best and in a complex business environment that we invariably find ourselves in, decision making cannot be governed by a grand design and should not proceed by being too precise about defining and implementing objectives.

This set me thinking about three things. First, how Lindsell Train runs its own business. Next, how we describe our investment approach and select a portfolio of Japanese companies. And finally whether our investee companies, both in Japan and elsewhere, define their objectives in a rational way.

Lindsell Train's primary business principle, 'To invest money as if it were our own', is self evidently an oblique approach for if we succeed in this we do not necessarily achieve investment and business success. However, we do succeed in aligning our interests with our clients and running money in the most rational way we know how. Achieving this objective brings the chance, therefore, of investment success for our clients and further growth in our business.

Our investment approach as portfolio managers is to buy shares in great businesses for less than they are worth and then to hold on to them for a long time. If we do this consistently we think we will perform well and satisfy our clients' ultimate performance objectives, albeit by taking an indirect or oblique route. Crucially we strive to invest in the best, most durable business franchises we can find. History tells us few companies in any market fit such criteria. Hence our choices are few in number, tend to make up less than 10% of the typical Japanese benchmark index against which we are usually measured, and thus can be unrepresentative of the market as a whole. Our companies have higher operating margins, less capital intensity and are more cash generative than the average. As a result they are either devoid of debt or swimming in excess cash, have the ability to pay a greater proportion of earnings out as dividends than the average company, can acquire businesses to expand sales and, periodically, buy back shares. Tradition and the stifling effect of corporate cross shareholdings, an important characteristic of the Japanese equity market twenty years ago, meant that paying dividends, acquiring other businesses and repurchasing shares was rare. Now - at least amongst our companies - it has become more common place. There has been a discernable improvement in shareholder returns. But when we first invested in these companies it was never certain that this would be the outcome, indeed it proved to be the oblique result. We have always held onto the principle that, more often than not, good things can happen to investors in durable cash generative business franchises. In other words we make our own luck. But you never know why and when - and particularly so in Japan where things happen slowly. So far, though, it has proved to be quite a result. In 2002 80% of our companies were wedded to paying stable dividends independent of the performance of the company. The average payout ratio of the portfolio at that time was 25%. Five years later the payout ratio had increased to more than 50% and today 80% of companies have linked dividend payments to earnings.

Let's turn to how companies describe their overall purpose or objective. Like an investment process, running a business is multi-dimensional. There are numerous and varied objectives and many and sometimes conflicting demands that individuals and organisations make on them. Some would claim that maximising profits is a business's ultimate purpose. Yet it is often when companies become exclusively profit orientated – and explicitly define this as their objective - that things go wrong.

Kay illustrates this with the example of ICI, the British chemical company, which succeeded in nurturing a pool of talent that ultimately led to the development of the British pharmaceutical industry through its mission simply to apply "the innovative and responsible application of chemistry and related science". But in 1991 when the company was targeted by Hanson Trust it sold its pharmaceutical business, Zeneca, and adopted instead a new mission statement for the rump of the business that read "The ICI Group's vision is to be the industry leader in creating value for customers and shareholders through market leadership, technological edge and a world competitive cost base.". Then the company embarked on a series of acquisitions and disposals that singularly failed to create value for anyone. By 2007 ICI ceased to be an independent company.

Then Boeing, which originally described its purpose as - 'to meet technological challenges with supreme magnitude' and in doing so cornered the world civil aviation market with the success of the 737 and 747. But under the new CEO Phil Condit it decided to adopt a direct approach, focussing on "unit cost, return on investment and shareholder return". The company then redirected its resources towards lower risk projects for the military and away from civil projects which allowed Airbus to take its market share. Worse, the company faced allegations of corruption from its close links with the Pentagon. By the end of Condit's reign the share price had gone nowhere at a time when average market values had soared.

And then there were the contrasting visions from John Reed of Citicorp and Sandy Weill of Travellers who formed the new merged company Citigroup. "The model I have is of a global consumer company that really helps the middle class with something they haven't been served well by historically" said Reed. Then Sandy Weill interjected "my goal is increasing shareholder value". It was Sandy Weill who led the combination. Within a decade all the shareholder value in the original Citicorp had all but disappeared.

One of the Japanese businesses we admire the most, Nintendo, has as its corporate objective 'To put smiles on the faces of everyone that Nintendo touches'. No mention of returns, no reference to growth. But its relevance is reinforced whenever we visit the company. We only succeed if we 'surprise, delight and entertain' says Mr Mori, the COO. And this is no trivial objective because, in order to fulfil it, Nintendo's games need to appeal to all age groups and genders. Since gaming used to be the preserve of young boys and male teenagers, devising a game that can simultaneously appeal to that discerning, experienced audience as well as uninitiated gamers such as the old, the fairer sex and to technophobes like me seemed an impossible task. But with a number of titles such as 'Brain Training' games, 'Wii Play' and 'Wii Fit' the company succeeded in putting more smiles on more faces, resulting in a massive expansion in sales, profitability and shareholder returns. Still the competition does not get it and instead chooses to categorise and create games according to the players' level of experience. As long as they do Nintendo's more oblique strategy should prevail. And, like ICI fifty years ago, Nintendo's determination to stick with its mission has allowed it to realise success which in turn has led to hugely improved shareholder rewards.

eBay, another company we own, has over the last 15 years developed into a corporation with a market value of $30bn, sales of $9bn with leading market positions in internet auctions and payments processing. This success has been achieved obliquely. It was never borne out of a specific desire to target such returns but rather from a much more prosaic ambition to simply 'connect buyers and sellers'. In 2005 the company bought Skype, the largest internet protocol telecom company, with the intention of facilitating communication between users of its auction business. As it turned out Skype's business mushroomed as general consumers, rather than eBay traders, took advantage of its free telephony to talk rather than trade. True to its mission eBay sold a majority of the business in 2009, crystallising a return that represented a disappointing allocation of capital over the four years they owned the business. Frustratingly, today eBay describes its purpose as 'pioneering new communities around the world based on commerce, sustained by trust and inspired by opportunity'. As Skype is the biggest community eBay nurtured, currently 560m users, it this seems this new purpose may have been characterised to reflect the way the business has developed rather than to reflect its original goals; goals that still have much more resonance to us at least.

Looking at some of the food and beverage companies we own, Brown Forman's aim makes most sense. It is 'to enrich the experience of life…by responsibly building beverage alcohol brands that thrive and endure for generations'. The 110 year heritage of Jack Daniels is certainly testament to its success. Other companies have much more nebulous, all encompassing aims; Diageo's purpose is to 'celebrate life everyday, everywhere'; Kraft's 'higher purpose' is 'to make today delicious'; and Kirin Holding's slogan is 'good taste makes you smile'. All are certainly oblique but smack too much of the PR agency's intervention for our liking, compared to the more tangible and specific objective of Brown Forman.

Many Japanese companies - including one we own, Ito En, the green tea beverage company - aim to 'put the customer first'. Again, a commendable ideal but one that has no connection with the underlying business of the company. Heineken commits itself 'to focus driving the growth of our brands and improving financial performance on ensuring that acquisitions, partnership and distribution strategies create value'. The judgement of whether value is created is a moot point, especially considering the recent acquisition of Scottish & Newcastle's UK business and we would prefer the company's objective focused primarily on the growth of the Heineken brand itself above all others. This aim, if indeed it is the primary one as we suspect, is pursued obliquely by management piggybacking on the success of regional brands.

What can we learn from John Kay's book and these observations? First it matters how a company describes or characterises its purpose. It can tell you a lot more about a company than it might appear at first reading. An understandable purpose often characterises a company's philosophical foundation from which its actions and strategy logically follow. Next the end result of what investors seek, good shareholder returns, is invariably better achieved obliquely. It was Jack Welch of GE who famously dismissed the phrase 'maximise shareholder value'. He observed that 'It's not a strategy that helps you know what to do when you come to work every day'. Trying to impose a design on the multifarious activities that characterise a business to achieve such an aim is possibly futile and probably detrimental. Kay concludes that 'businesses do not maximise anything'. Instead the most successful business leaders like Sam Walton of Wal-Mart or Bill Gates of Microsoft pursued the unquantifiable, but entirely meaningful, objectives of *building a great business*. We like to align ourselves and our client capital with such oblique objectives and concentrate our activities on identifying tomorrow's great businesses.

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