

Chancellor, Edward (ed) – Capital Returns

Palgrave, 2016, [Equity Investing] Grade ★★★★★

This is the even more brilliant sequel to the already superb 2004 book *Capital Account*. Edward Chancellor, the author of the classic *Devil Takes the Hindmost*, picks and chooses among the 2002 to 2015 *Global Investment Reviews* written by money manager Marathon Asset Management. The essays are sorted into themes. The benefits for us all of keeping some sort of diary, writing monthly investment letters or in some other way document happenings, the zeitgeist, thoughts and feelings become more than apparent. This wasn't too long ago, but things that shouldn't be forgotten are starting to fade away from ones memory. Here Marathon lets anybody peak into their diary.

Capital Returns has three important sections. The first one is what sets this book apart from its prequel; Edward Chancellor has written a terrific introduction that spot-on describes the main features of Marathon's investment philosophy. The next section presents essays that dive deeper into this philosophy and the final one looks to the buildup of, the crescendo of and the resurrection from the Great Financial Crisis. Although there are several interesting topics in the latter they are pretty well discussed and I will focus on the investment philosophy parts.

As any investment philosophy it contains several components but what differentiates Marathon's thinking is their focus on The Capital Cycle and a number of industry supply factors. Here they clearly stand out. It's been a long time since reading an investment book gave so many impulses like "I should start a time series of this" or "Hmm, perhaps I could build a model of that" etc.

So what is The Capital Cycle? It's really no magic; in good times when returns on investments are impressive and corporate valuations are higher than the replacement cost of the productive assets, industry capacity increases by pooling of new financing – equity and credit - into the area, allowing existing companies upping investments

and new companies entering the market. All earn good money but after a while the added supply and increased competition will overwhelm demand and the cycle will turn. In troubling times productive capacity will be retired, companies will leave the market or simply go bankrupt and eventually the lessened supply and competition will face a demand that is improving and the cycle of over and underinvestment starts anew.

What I see as unique in this is the strong focus on the supply side and how they systematically track a wide number of parameters to understand the cycle on industry, sub-industry and corporate level. Not all industries are capital heavy but you can still get a fair grip of whether industry capacity is increasing or decreasing. True to this analysis, the evaluation of corporate managers and their incentive schemes also zeros in on capital usage. How managers understand the capital cycle and allocate capital is critical for long-term corporate success and then you cannot have incentive schemes that promote myopic profit maximization and "optimal leverage" at any given moment in time.

The book discusses two types of investment cases that follow from the cycle, the franchise stock that can retain a ROIC longer than the market price and the turnaround case that will improve its ROIC more or faster than the market price. Importantly, the turnaround is not necessarily a traditional bottom-up case, but is rather found by a top down analysis first and corporate analysis second. This opens up more investment options.

The writing almost has the same philosophical depth and enjoyable language as that of Howard Marks, the theoretical depth isn't exactly that of a Michael Mauboussin – but not too far away. What comes on top of this, as the cherry on the cake, is the down to earth and vivid discussion on business operations and day-to-day investing.

Buy this book, read it, think hard and reread it.

Mats Larsson, Aug 9, 2016