

Second Order Thinking

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In the long term, most fund managers get average results because they are first order thinkers. A first order thinker will say something like “Apple’s earnings growth will decline because of a slowdown in phone upgrades and stiffer competition from other smart phone brands, therefore sell the stock”.

A second order thinker will say “Apple has metaphorical contracts with its customers and its main product – the iPhone has high retention rates so even if the frequency of phone upgrades slows down, Apple generates a large amount of cash every year, to the tune of almost \$50 billion – enough to buy a company like General Motors once every year. \$50 billion in free cash flow every year gives Apple a degree of optionality not available to any other company on the planet. While there may be a question mark as to how much that \$50 billion can grow, growth in the absolute sense is not important to the shareholder. What matters is per share growth and a company like Apple can simply repurchase shares which will increase the value of every share, therefore buy the stock”.

While the second order thinking example sounds long-winded, it is eerily simple. No projections about future sales growth, new products or new acquisitions are needed. Only two variables matter – the retention rate of iPhone users and what the company does with the fountain of cash it generates.

Thinking about second order effects is a good way of understanding fast growing industries. The problem with fast growing industries is that they attract lots of competition which reduce profits and returns on capital. An anecdote from Warren Buffett puts this in perspective.

“All told, there appear to have been at least 2,000 car makes, in an industry that had an incredible impact on people’s lives. If you had foreseen in the early days of cars how this industry would develop, you would have said, ‘Here is the road to riches.’ So, what did we progress to by the 1990s? After corporate carnage that never let up, we came down to three U.S. car companies–themselves no lollapaloozas for investors. So here is an industry that had an enormous impact on America – and also an enormous impact, though not the anticipated one, on investors”.

First order thinkers were right about the impact of the automobile – it created the modern world as we know it. However, investors in the automobile industry have not made any money in aggregate because of the competitive dynamics of a fast growing and capital-intensive industry.

The price you pay today for future growth is more important than the growth of a company itself when markets are expensive. History shows that the majority of companies trading at expensive valuations today will not provide better returns than the market in the future and this stacks the odds against investors. This is one of the reasons that we do not overexpose Tacit strategies to ‘blue sky’ companies and focus very much on repeatable cashflows which can grow in the future.

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