Direct and indirect

Suppose we categorize activities into simple and complex. Simple activities tend to be found within the context of human-designed systems. The connections between inputs and outputs are linear and well understood, and outcomes are standardized and predictable. With complex activities, the connections between inputs and outputs are more intricate and are not fully understood. While there is an underlying intelligence at work in complex activities, outcomes are unique, path dependent, and can exhibit large variance.

Assembling a Lego set is a simple activity, while growing a tree is a complex activity. The Lego set is a straightforward matter, just add one piece after another, according to the instructions. On the other hand, the tree requires a different approach because its growth cannot be aimed at directly, such as by coaxing a seed to germinate or pulling on a sapling's branches. Instead, the appropriate approach is *indirect*: the seed should be properly planted in fertile soil, ample water and sunlight ensured, and so forth—such that over time the tree *grows itself*. The indirect approach can be thought of as cultivating conditions for the desired outcome to come about naturally.

If long-term investing is a complex activity, then a rather indirect approach is likely appropriate. What might that look like? For me personally, I've found it healthy to start from a foundation of studying companies and industries that I find interesting, energizing, and promising—something pursued for its own sake, as a sort of default mode. Uncovering meaningful insights is just part of the process, and when they arise it is spontaneous. Occasionally investment conviction falls into place, which feels as much like good fortune as the fruit of hard work. The process looks meandering a lot of the time. Do I also strive for productivity? Yes, but it is a delicate balance, and I think the pitfall is to force something to happen that must happen on its own. Observing the professional investment world writ large, its preoccupation with efficiency, predictability, and standardization is striking: industry categories and specialization, guidance and estimates, price targets, not to mention continuous market commentary, short-term performance reporting and evaluation, and so on. From the perspective of the indirect, one might get the sense that it's all a bit like pulling on branches to make the trees grow.

Running companies is a complex activity, and the companies I admire most embody the indirect approach. One of my favorite companies is a large global asset manager. It has a marquee franchise that has earned the trust of premier institutional allocators around the world, garnering hundreds of billions of dollars of assets under management. How did the company achieve this rarified position? Whereas its peers started life knocking on doors to raise capital for dealmaking (direct), what might be surprising is that this company existed for decades before hanging out its shingle as an asset manager (indirect). During that period, it was solely a principal investor whose goal was to compound its capital at attractive rates with a generational time horizon. Over many years, it built up knowledge, experience, and operating capabilities within select circles of competence and evolved a foundational investment philosophy.

Eventually the company created funds to manage third-party capital in areas where its operations provided advantages. These funds were largely opportunistic in nature and remained a small part of the overall picture for years. However, it would become clear that the company's core asset classes were an ideal fit for the largest institutional pools of capital around the world. At the same time, these asset classes comprised areas of the economy that were hungry for capital and represented large and growing markets where size was an advantage. Scaling up as an asset manager was a win-win, transformative growth opportunity and became a key strategy. That was about twenty years ago, and I have no doubt that the driving force behind the asset management franchise's subsequent ascent were its uniquely propitious initial conditions. Today, the company's heritage as a principal investor remains evident in its owner-operator culture and investment strategies, which continue to underpin its competitive advantages.

Another favorite company of mine is a provider of insurance for dogs and cats—cover for medical costs arising from accidents and illnesses. The company pursues a unique strategy in an arena where its competitors approach the market in uniform fashion: To pique the interest of prospective customers, these competitors aim to offer low price points, which by definition limit the funds available to pay claims, necessitating less-than-comprehensive coverage terms. These offers get traction because it is easier for shoppers to appreciate a low monthly fee than to comprehend the intricacies of an insurance policy, specifically the circumstances in which limited coverage might render them out of luck.

By contrast, my favored company's starting point is its mission to deliver the best possible value proposition to pets. Because insurance exists to pay when the pet needs it, limiting coverage defeats the purpose. This logically leads to the opposite pricing strategy of that pursued by the rest of the field: offer the most comprehensive coverage practicable, pay out more in claims, and add a fixed margin on top. The beauty of the system is that in spite of higher per-pet claims costs and lower per-pet gross profits, this company has exceptional customer lifetime values. How? Customers receiving better care are more loyal, which more than offsets slimmer gross margins in the lifetime-value math. It is a self-reinforcing, win-win system.

In this example, the direct approach is to go after the sale; the indirect approach is to lay the groundwork for healthy customer relationships. The indirect path often involves a degree of patience and determination found only in those who really believe in what they're doing. Going to market with higher price points necessitates skillful consumer education. Comprehensive coverage requires sophisticated data insights and pricing methods, which in turn leads to vertical integration, which entails additional capital intensity and regulatory scrutiny. These challenges might explain why others seldom try to copy the strategy.

Potential versus prediction

The feature of complex activities that we have been focused on is that the desired outputs cannot be managed directly, but rather must be allowed to emerge on their own. An interesting corollary is that complexity is intrinsically unpredictable: even if we may have a good sense of where things are headed, how and when the outcome takes shape is impossible to fully grasp. When it comes to complex activities—or *systems*, as they are more commonly called—what may look precisely engineered in retrospect was inescapably nebulous in prospect.

For example, our asset manager from before has a superbly intelligent capital structure: The company sources capital from not only traditional private funds but also publicly listed funds and insurance liabilities; its key operating subsidiary is itself publicly listed, furnishing a deservedly high-multiple currency for acquisitions; it possesses a large, liquid balance sheet; and it enjoys diverse cash flow streams from its various operations. The company thus has unparalleled access to capital from virtually every possible source—a tremendous advantage and enabler of economic development given the nature of its core business as an investor and owner-operator. It is easy to look at this situation and assume it is the result of careful and clever planning, and this is true—but it was possible only with decades of unpremeditated preparation followed by decades of opportunistic execution. The company's mastery of matching capital with opportunity within its circles of competence came first, then its capital structure co-evolved with the broadening of that mastery.

So too with our pet insurance company. To cite just one example, today it dominates distribution through the veterinary channel (competitors market online for the most part), a hard-won position owing to the persistent work of its national sales force. This unique distribution model has created an efficient and effectively uncontested avenue for generating customer leads and supporting veterinarians in driving insurance adoption. Such an elegant strategy might look like a master plan in action but in fact was the result of years of frustrating trial and error, was long questioned even inside the company, and is still evolving to meet new challenges. Its existence and success emerged from the company's unique mastery over a fundamental problem for both pet health and the veterinary profession: understanding, underwriting, and funding the costs of animal medical risk.

These two companies exhibit a pattern I have observed in successful enterprises generally: they harness the potential embedded in their systems by mastering activities that solve important problems. In doing so, they embed themselves ever more deeply in their systems, earning the right to solve more problems at greater scale. This kind of mastery, applied persistently, both unlocks and feeds the system's potential. The unleashing of this potential can become all but inevitable in the fullness of time, yet still unpredictable.

That the complex nature of business is intrinsically unpredictable would seem to be an investor's conundrum. But I would suggest that one can effectively work with unpredictability by adopting an indirect approach to the future. Let's describe what that would look like by first discussing its counterpoint, a direct approach to the future, which seems to pervade the investment management profession. Analysis often begins with tentative forecasts of business fundamentals over the next few quarters or years (what could be more direct?). From there, investors work backward to the research required to fine tune and "get comfortable" with the contemplated forecasts. Layered on top of these forecasts are expected trading multiples, the implied future stock price at a point in time, and finally the supposed internal rate of return (IRR) of the investment. Portfolios are constructed largely to optimize the prospective aggregate IRR, which necessitates continuous rejiggering. Because optimization can always be taken a step further, there can never be too many new ideas, so the pace is frenetic. All of this may appear sensible from the trenches of day-to-day decision making; after all, if the rewards everyone is after lie in the future, then it is only logical to begin and end there. And who doesn't want the highest possible IRR?

A different perspective is that an investment thesis should be firmly grounded in reality, so it is sensible to concentrate on just that. In this way of thinking, enthusiastic study of the past and present of companies and industries is the bedrock. When a strong view of the future comes into focus, it is not quite a forecast but an insight about where things are headed. Seeing that a company has a bright future is like identifying a sapling as a *sequoiadendron giganteum*—also known as a giant sequoia, among the most immense and longest-lived of tree species—planted in nourishing soil and uncrowded by other growth. This assessment is not, in point of fact, a prediction, but rather a perception of potential embedded in the present situation. Forecasts come with the territory, of course, but they are secondary—a tool for adding rigor and dimensioning what the future may hold. Emphasizing potential over prediction could be thought of as the indirect approach.

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