Hurd on the Street

Principles Based—Not Rules Based

When Aristotle set out to create an account of all that exists, he realized that listing distinct categories which, collectively, contain all things, would be somewhat less arduous than listing all the things themselves. For instance, rather than listing man, horse, dog, and so on, he lumped all these into one category which he called substances.[1]

2,300 years later, the ability to reduce complex situations down to just a few categories remains a highly advantageous human trait. However, much like any good mental shortcut, it tends to get over-used, often to the point of becoming counterproductive. We would argue that the use of categories in equity portfolio management is one such example.

In 1992 Morningstar created the style box, in which all equities are classified into one of nine categories within a 3X3 box, with size (i.e. small/mid/large cap) on one side and style (i.e. value/blend/growth) on the other. This simplification is a great framework for monitoring overall portfolio diversification. Today, however, style boxes dominate portfolio manager decision making. A value allocation had better not own a company growing double digits, and a small cap allocation had better not hold a stock with a $2B market cap.

We believe it is prudent to worry far less about arbitrary rules, and far more on making decisions based on merit & quality, on investment principles. We believe in owning industry leading innovative companies in underpenetrated markets with significant growth runways, scalable cost structures, a strong shareholder base, a clean balance sheet, and that is reasonably valued.

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It's incredibly hard to find companies that meet this stringent list of principles. As such, when we think we find one, we don't want to be forced to sell just because its market cap gets too large. Furthermore, we believe we can benefit from investor supply & demand dynamics as a stock grows and becomes a natural holding to a larger investor base.

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The other issue with cramming thousands of stocks into nine categories is that, naturally, concessions are made. Take for instance our benchmark, the Russell 2000 Growth Index, which holds over 1,000 stocks. We find it difficult to find 30 stocks that meet our standards, let alone 1,000. To do so, the index must accept fringe holdings, ones that can only be justified as growth by cherry picking one or two stats, and because they simply don't fit elsewhere.

Further impairing the quality of growth indexes is that they are forced to retain holdings in all sectors. Our benchmark holds more than 8% across real estate, materials, telecom, and utilities. We rarely own these sectors due to the simple reason that there is minimal long-term growth potential.

We believe that, by using investment principles, we can retain the benefits of a rules-based index, namely the structural decision making and minimization of emotional bias. In addition, we gain the benefit of not being forced to make uneconomic decisions which ultimately, in our opinion, leads to a watered-down growth portfolio full of stocks with inferior qualities. Instead, we are free to focus on owning only what we believe are the highest quality growth stocks in the strongest pockets of the economy.

[1] https://plato.stanford.edu/entries/categories/

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