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Searching for Resilience

BY MICHAEL WEEKS

For a business to survive 260 years in the same industry, with the same family owners, is a remarkable achievement. Starting in 1761 as a one-man shop making lead pencils, Faber-Castell has grown into the largest producer of colored and graphite pencils globally, producing over 2 billion pencils each year, as well as pens, markers, highlighters, and related products.

Already the leading pencil producer in the mid-1800s, Faber-Castell has stayed on top of their industry for close to two centuries, betraying incredible entrepreneurial ability and drive. When the English supply of graphite began to fail and pencils became unaffordable, they bought a Siberian graphite mine and relied in part on reindeer transport to bring new raw materials to their factories. They expanded their product catalog, built up operations across Europe and the Americas, and invested in new technologies and equipment to improve their production. They helped introduce trademark law in Germany to protect their reputation against competitors. They established a 10’000 hectare forest plantation in Brazil to ensure their wood supply. They took their business seriously.

Nine generations of history also come with hardship. When the Americans joined World War I, Faber-Castell was cut off from the US market despite having operated there since in the 1850s. All of their US assets—land, equipment, inventory, patents, and trademarks—were seized and sold at auction after the war ended. During World War II their largest factory in Brazil was seized, not to be recovered for another twenty years, while their German factories were commandeered by the Nazi war machine. And in 1971, after 95 years of building a reputation as the finest producer of slide rules, they saw this entire side business vanish almost overnight when the pocket calculator was commercialized.

Resilience—or, the ability to survive hard times, as Faber-Castell has demonstrated time and time again—is something that we value instinctively. Yet, it’s not a popular subject. For all the years we’ve heard talk of sustainability, it seems that economic resilience, a once important dimension of economic prosperity, has become a relic of the past.

Economic resilience is easy enough to understand when it touches the tangible aspects of our savings: the security of owning a home or a business, the peace of mind

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that comes from having some reserves tucked away just-in-case, or having a steady stream of income for planning our daily lives. But step into the financial realm, that of bank accounts and investment portfolios, and our ability to reckon resilience fades away. Put a dollar sign in front and we stop seeing our savings as a fixed and permanent investment, the way a business owner would, and we begin to view it as something as formless and transitory as a checking account. Even the words we use to describe it are replaced by a new vocabulary, where correlations, allocations, and expected returns reign supreme and have replaced the more grounded understanding of what we own and why.

In the financial realm, the size of our savings is supposed to matter most. The bigger our account statement, the more we have, the more secure we are reckoned to be. But resilience is simply not a matter of size. A man with $100 million can lose his fortune just as easily as the man with $100 thousand. There are many roads to ruin, open to rich and poor alike. Through the ages, fortunes both great and small have succumbed to war, inflation, and confiscation, while many more are squandered each year by those who are overconfident, overleveraged, envious, or simply living beyond their means.

If we want to avoid this same fate, we must consider the nature of resilience, its source, and how we might obtain it for ourselves.

Observations on Resilience

Resilience is an unseen aspect of economic life. We cannot count it or touch it. It doesn't appear on financial statements. Yet its presence gives us assurance and allows us to sleep well at night, while its absence drives men and women to the unemployment office, machinery to the scrap heap, and businesses into bankruptcy. Even unseen, it is a factor in nearly every decision a business owner makes.

What makes resilience so hard to spot is that it can only be proven during those rare times of crisis. Warren Buffet famously said that it is only when the tide goes out that you discover who's been swimming naked. This becomes more sobering when you realize it can apply to ourselves as well as others. We may think we are prepared for what may come, but this is only a guess. The only real test for hard times is to survive hard times.

It follows that resilience is not the same as looking good or having predictable financial results. Year after year of sales growth, rising market share, unwavering operating margins, and ever-increasing dividend payments may be attractive features for an investment, but do not imply a sturdy one. Any financial metric can be gamed, and in our experience many of them are. Indeed, a steady profit margin may be a sign of a sturdy business, but not if it comes at the cost of increasingly unhappy customers, discouraged employees or squeezed suppliers. Regularity is one of the best covers for hidden risks.

Worse, a steady business model can actually become a source of fragility if placed in the wrong hands, as when companies with highly regular income streams leverage up their balance sheets, providing more immediate returns to their owners at the expense of their own resilience. Private equity has perhaps perfected this business model, but the growing dependence on debt in all walks of life reveal this as a defining feature of modern times. Interest rate repression promotes or even demands that individuals, firms and governments leverage up merely to maintain their economic standing.

Resilience is not a destination. Seeking resilience means abandoning a narrow definition of success like sales growth or annual returns and instead becoming prepared for any eventuality that can cause serious harm. It is gained by pursuing new capabilities and flexibility, and by avoiding landmines. It means creating new options for the future

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instead of more plans for the present. It is not enough to be prepared for what everybody knows will happen, or to be prepared for the make-believe world of financial models. Resilience demands real entrepreneurial alertness, judgment, and genuine capital accumulation.

Just as the tangible parts of our savings do not all have the same purpose, not every investment will add to resilience at the same time and in the same way. A business owner may choose to deploy more or less machinery, labor, inventory or cash in his business, based on his view of the world at that moment. Some of these investments are susceptible to rising inflation and cost pressures, others bear country, legal and counterparty risks, and still others depend on foreign exchange or financial stability. Most do poorly at the announcement of capital controls or declarations of war. Hoarding gold as a form of long-term reserves may be a useful protection from some of the events above, but participating in capital accumulation and real economic compounding is also necessary for the resilience of one's savings. Betting all your savings preparing for one outcome might make you rich, but it also leaves you vulnerable if your view of the world is wrong or ill-timed. Instead, building a collection of assets with different dimensions of resilience can form something more enduring. This collection may not look anything like what is prescribed by the rules of financial diversification, but it may yet survive when diversification fails.

Resilience comes at a cost. We are reminded of a metaphor used by Nassim Nicholas Taleb dealing with the nature of redundancy: "Layers of redundancy are the central risk management property of natural systems."[2] Redundancy, he writes:

> allows you to survive under adversity, thanks to availability of spare parts. Look at the human body. We have two eyes, two lungs, two kidneys, even two brains (with the possible exception of corporate executives)—and each has more capacity than needed in ordinary circumstances. So redundancy *equals* insurance, and the apparent inefficiencies are associated with the costs of maintaining these spare parts and the energy needed to keep them around in spite of their idleness.[3]

We reckon the idea of redundancy in the physical world as a metaphor for resilience in respect to our savings. There is a financial cost to resilience, as with insurance, but there is also a trade-off between different objectives. While they are not opposites, resilience is something quite different from maximizing returns. "Redundancy is ambiguous," Taleb writes further, "because it seems like a waste if nothing unusual happens. Except that something unusual happens—usually."[4]

Hunting for the Unseen

The relevance and even existence of unseen and unquantifiable factors is often disregarded by those who play with other people's money. In part, the problem lies in the fact that investors are keen on formulaic approaches and act as security renters rather than owners.

Resilience can never be seen except through the eyes of an owner. An owner's understanding is hard to come by, as it must go beyond observations about markets or financials to the point of recognizing the factors that define the business. Once armed with that understanding, you can weigh the factors which make the business economically productive against those that threaten its viability, and evaluate the

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[2] *Nassim Nicholas Taleb, Antifragile: Things That Gain from Disorder* (New York: Random House, 2016), 44.
[3] *Nassim Nicholas Taleb, The Black Swan: The Impact of the Highly Improbable, 2nd ed. (New York: Random House, 2010), 312.*
[4] *Taleb, Antifragile, 45.*

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environment they are likely to operate in over the next five or ten years. Then you can make a judgment call on what resilience is there and whether it adds something important to your own savings.

Sometimes we can gather financial clues from past crises. A sudden decline in sales, such as the automotive industry faced last summer, can be an important test case in resilience. Swiss-based Ems-Chemie, a business we hold dear and a supplier to this sector and others, saw their sales fall precipitously when European car producers shut their doors. Sales in the first half of 2020 were down 25% from the prior year with some months down around 40%. Fewer cars means fewer car parts—no getting around that—but despite the drop in sales, the company's operating margins at this time were hardly changed from the prior year, and in fact second highest in the company's history. Maintaining its profitability in the face of a crisis is a powerful indicator of the resilience of any business. Look closer at this firm and you will find that their flexibility and inbuilt resilience, pursued relentlessly over many years, permeates the organization.

While examples like these are telling, the problem with relying on financial clues is clear: you don't see resilience in the good years, examples from past crises are few and far between, and resilience in the last crisis may not mean anything for the next one, since each crisis is different.

So, if resilience is hard to spot, understanding is hard to get, and financial clues are few and far between—what's left? We might invert the problem and hope for an easier answer.

A more effective way to add resilience to one's savings is by ruthlessly avoiding its opposite: economic fragility. Thankfully, unlike resilience, fragility is often staring you in the face. This is where financial analysis really starts to shine. Is the company dependent on a few key customers and suppliers? Is the company overleveraged or buying back shares at indecent prices, just because it can? Are there elements of pricing power, or do their earnings evaporate at the first sign of trouble? Could a government ruling or decree suddenly break their business? Can their customers really afford to buy their products next year?

There are about 2'700 listed businesses presently valued at more than $1 billion in Europe and North America. One-fifth of them were loss-making in the three years before Covid. Thirty percent were loss-making in the last twelve months. If a company is struggling during 'normal' times, what does that say about its ability to survive when times are hard? Admittedly, fragility can be hidden too and will sometimes slip through the cracks, but much of the time it can simply be avoided. One simply has to want to avoid it, and be willing to accept the reputational risks that come with that. As an individual this may be easy, but many professional investors cannot afford this luxury.

Perhaps the best way to find resilience is to look for its source: Resilience only comes from owners. Resilience is not a fluke that one stumbles into. It is a deliberate and purposeful objective which some aim for and others don't**.** A good business plan, a profitable sector, a lot of cash, loyal management, or hardworking employees may all be wonderful, but only owners have the time horizon required to balance the present against an unknowable future, and only they have skin in the game—their own savings on the line. Unlike investors (renters), owners have no easy exits. They must build up reserves and competencies in the good years to give them options in the bad. They are motivated by a sense of responsibility—to themselves, their families, those they work with, and those who will come after them.

In the public markets these owners are very few and far between. Passive investors seem to rule the roost these days. Naturally, they are not concerned whether the businesses they own are likely to still be around in 20 or 30 years. What they care about is sector definitions, market capitalization, relative weights, outperformance, and

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whether they can earn a few ESG brownie points along the way. All of this helps to sell a product, but is of little use once hard times are on the horizon and the investors are flocking to the door.

Our principle for evaluating owners is straightforward: you judge them by their actions. Take any business and lay out the major decisions made in the last several years. Read their letters to shareholders. Ponder their reasonings, their objectives, their motivations. Motivations matter, and with enough practice it is easy to gauge the unseen.

A case study

Bakkafrost is a vertically integrated salmon farmer operating in the Faroe Islands and Scotland. Salmon farming is a lucrative but complex business, particularly when managing the whole value chain in-house: from genetics to eggs, hatcheries to smolt operations, salmon feed to at-sea transport, grow-out, harvesting, processing, sales, and logistics. The whole process takes about 30 months from egg to harvest, and any small mistake or unusual weather conditions means you have to rethink your entire process. After two and a half years of expenses and hard work, the market price for salmon can vary wildly (salmon prices have been every bit as volatile as Tesla shares). A choice every salmon farmer has to make is what to do with the fish once it is ready to harvest. Do they sell their fish to wholesalers and other processors, or do they take it a step further, converting some into filets or smoked salmon that goes straight to the grocery store? This latter step is called Value-Added Processing or VAP, and Bakkafrost aims to sell about 30–40% of its fish through this channel each year.

Despite the name, the economics of Value-Added Processing are anything but obvious. Bakkafrost's VAP business will often swing between large gains or losses depending on how salmon prices move every few months, and though the swings balance out over time, the average contribution is hardly worth writing home about. In the ten years from 2011 to 2020, Bakkafrost has reported cumulative revenues of about €4.5 billion and operating earnings of €1.1 billion, yet of those earnings only €14 million, or 1.2% of the total, have come from their VAP division. A financial observer might say, quite rightly, why bother? Salmon farming is hard enough, why dedicate additional capital and resources for a pittance? What a financial owner doesn't see—and which the owners of Bakkafrost see plain as day—is the resilience this seemingly irrelevant processing step embeds in the organization. Their VAP business lets them choose which customers they want to serve and how. And being able to choose your customer can add mightily to one's resilience in times of stress, as was the case last year.

When hotels and restaurants shut their doors last year, all the food that was headed to this channel, including many millions of whole salmon, all needed to end up somewhere. Remember the 30-month lag between laying eggs and the salmon harvest? This means that while the demand for whole salmon evaporated, supply kept pouring in and the markets were soon stuffed full of whole fish with no one around to buy them. Prices tanked, and producers were desperate for buyers. People were still buying salmon at grocery stores—often more than before because they weren't eating out so often—but the average customer there has no use for a whole head-on, gutted, six-kilo salmon. In contrast, an extra filet or pack of smoked salmon would be an easy purchase. As the market demands rapidly shifted, Bakkafrost turned their VAP machines on full blast and delivered more fish to this one market that stayed open (40% more fish were sold in this channel than in the prior year). This kept them in the market, took the strain off the rest of the business, and earned them a modest but extraordinary financial reward. When Bakkafrost expanded their VAP division in 2016 they did not have anything like

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Covid in mind, but they did understand and value the importance of adding resilience to their business.

As investors seeking resilience for our savings, then, we must find a way to recognize the business owners with the same commitment to resilience as our own. We must learn to account not only for financial metrics but also the unseen aspects of human character.

In the end, it is about understanding people. We make judgments about the people behind the ownership and management of what we own. What is their motivation? Their time-preference? How does it all match our own?

When it comes to our own savings, unseen and unquantifiable issues such as resilience matter. Frankly, in times of frenzy and financial excess, that which is unseen matters most of all.

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