SilverCross Investment Management

The SilverBullet Newsletter

Insights from SilverCross

THE COMPOUND EFFECT

By David Simons, 31 July 2019

SilverCross Global Small-Cap Fund turned five on 30 July 2019. During this period[i], the Fund recorded a total return of 122%. This translates into an annualized return of 17.3%. The reference index[ii] rose by 64% during the same period.

It is no exaggeration to say that the first five years have developed favorably, despite continuous macro-economic and political uncertainties. We believe that our focus on companies instead of news headlines has made this possible. Not that uncertainties never resulted in short-term declines in the value of the Fund. They have. Twice in the history of SilverCross, global stock markets declined strongly. The Fund declined much less during those difficult periods. The subsequent bounces back were consistently stronger than the temporary declines. This raises the question: how is this possible? Is this luck or is there more to it? In this SilverBullet edition, we take a deep dive on one of the core concepts of our investment philosophy. This core concept is an essential part of our success up to today.

The long-term as ingredient for success

An important part of our focus as investors is to assess the long-term growth opportunities of a company. Since stock prices follow earnings, growth is essential for long-term stock price appreciation. Smaller companies have more potential for sustained growth. We only invest in a company if we see it can scale its business meaningfully for at least five years. Our goal is to be a long-term shareholder in growing businesses.

How important is it to be a long-term shareholder?

We see ourselves as a partner of the management teams of the companies we invest in for the SilverCross portfolio. As a long-term engaged shareholder, we can influence the strategy. We request from management teams that they ensure their businesses contribute to, or at the very least do not detract from solving the challenges we face in society. These can be related to the environment, social or governance. They can achieve this, for example, by reducing the environmental impact of their production processes and by having a strong social policy for its personnel. Making sure that suppliers treat their personnel respectfully is equally important in that respect.

A long-term orientation is also essential for a superior investment result. Time is the friend of a company that generates consistently high return on invested capital. This brings me to the power of compound returns, or compounding.

The million-dollar question

What would be your answer if I asked this question: Do you want Eur 1 that doubles for 31 days each day, or do you prefer to receive Eur 1 million today? Take some time to think about it, as I will get back to it later in the article.

The importance of the above question cannot be exaggerated. The power of interest-on-interest is easily underestimated. Especially on a longer time horizon. In the first few years, it doesn't really look special. But let time go by and the effect becomes very visible. It's like a snowball rolling downhill. No wonder Albert Einstein once said that compound interest is the eighth wonder of the world.

You may have heard of an investor by the name of Warren Buffett. He is sometimes called "the Oracle of Omaha," because he has achieved an annualized investment return of 21% since 1976. It made him one of the wealthiest people on earth. How did he do it? He invested in good businesses and held on to them for decades.

This sounds simple. Almost frighteningly simple. Yet it's not easy. You will encounter several powerful hurdles along the way. One, you must find the right companies to invest in. Two, there are taxes and important life events that require money. Three, you feel the urge to sell when they have risen in value significantly, or when times are gloomy. None of these should discourage you.

By now you can guess what the best answer is to the question. The answer is mind-boggling. How on earth is it possible that Eur 1 that doubles for 31 days becomes more than 1 billion? That's the power of compounding in action. The first 20 days of the month, you will remain under Eur 1 million. Finally, on day 21 you break through one million. You see, it starts slow, but it grows exponentially.

Time in the market, not timing the market

I hear you say: "But this is unrealistic. Who makes 100% a day for 31 days?" True. Then how about the following example. You invest Eur 1000 on the same day your baby is born and subsequently invest an additional Eur 1000 for your child each birthday until the adult age of 18 has been reached. You invest it in stocks that compound at a more realistic 10% per year until your child reaches the graceful age of 65 years. Altogether, you invest a total of Eur 19,000. How large will your child's pension pot be? A staggering Eur 4 million! Alternatively, your child can start saving when he or she turns 19, putting aside Eur 1000 per year until retirement. Total invested Euros will be Eur 45,000. How much is there for retirement? Just Eur 800,000.

I draw two important conclusions. The first is that the rate of return on an investment doesn't need to be outlandish for spectacular wealth accumulation.

The second conclusion is the importance of starting early. This is by far the biggest secret to compounding. The longer you wait, the more you will have to save later in life. The amount you must save to invest every year grows exponentially. So, don't wait!

How to become a smart investor?

Now that you understand that you must start investing sooner rather than later, how to do it? There are three ways to invest in stocks. You can buy an index tracker, also known as an ETF. It's the simplest, cheapest way to invest in stocks. It also guarantees an average return. You will invest most of your money in the biggest companies in that index, regardless their prospects, for better or worse. The biggest companies grow more slowly than smaller companies. So it could be more attractive to invest in smaller companies.

If you want to beat average, you can choose to pick great smaller companies yourself. This is easier said than done. Greatness can be temporary. Every company has its ups-and-downs, just like your personal life. It's not the end of the world. It's usually a temporary setback. But you must be vigilant. Sometimes the setback is structural. Then you need to act. Regrettably, it is usually not easy to distinguish a temporary from a structural setback.

If this sounds like too big a challenge, then there is a third option. Hire a professional investor to pick great businesses for you. SilverCross has a team of dedicated, experienced investors that do nothing other than scour the globe in search for great smaller companies. Each of these is selected on its ability to generate an attractive long-term compound rate of return. The team stays on top of all developments related to each company it has invested in. This helps to distinguish when an inevitable setback is temporary or structural and act accordingly. Because good companies can turn into bad companies and bad companies can go bust.

Professional fund selectors like to label how an investor selects stocks, based primarily on "value" or "growth." characteristics. They then put them in a "style box." Yet we believe these styles are not mutually exclusive. SilverCross is both – we buy growing companies when we consider them undervalued. A better style categorization for SilverCross is probably described as a "compounding" investor.

Let time work for you

If you decide to become a compounding investor as well and decide to invest in SilverCross Global Small-Cap Fund, you liberate yourself from the urge to time the market. You will not be hounded by the perennial question if "now is a good time to invest." You won't be investing in the overall stock market anymore. Instead, you become a part owner of a small group of excellent businesses that can compound in value over time. As Warren Buffett once said: “Time is the friend of the wonderful company, the enemy of the mediocre.”

When will you start to let time work for you?

About SilverCross Global Small-Cap Fund

SilverCross Global Small-Cap Fund is focused on generating superior investment returns. The Fund was founded in 2014 by David Simons and Chris Andrews in cooperation with IBS Capital Allies. The specialist investment team selects 25-35 smaller globally listed companies. The approach is to be a long-term investor. It uses a research process that is focused on finding well-managed, resilient companies that can achieve sustainable growth in a socially responsible manner.

For more information, visit www.silvercross-im.com.

Last edited: 10 August 2019

[i] 30 July 2014 – 30 July 2019

[ii] MSCI World Small-Cap Index Total Return Net