Sankala Group

The Wardrobe Analogy

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In this letter I want to expand on an analogy we often tell clients in person. Perhaps some of you remember us comparing our work in portfolio management to maintaining a great clothing closet? I'd like to dig a bit deeper into why this concept (and our approach) is both powerful and practical.

The clothing closet idea has evolved over 14 years, and began when my "waste not/want not" mindset happened upon an old can of mahogany wood stain starting to go bad in my garage. Rather than throwing it away, I began "executizing" things. That is, staining things which really did not need to be stained the color dark mahogany, bringing a more "executive" feel to my hammer, shovel handles, ski rack and garage shelves, etc.

Soon after, I walked into my clothing closet and was struck by how chaotic, and for lack of better word, "entry-level" it felt.

No problem. A few days later a set of 35 hardwood hangers arrived at my door. I opened the box, and got to work putting my suits, blazers, and wool clothing on them, and then my dress shirts on the remaining ones. Alas — I still had about 10 more shirts on wire hangers. That, of course, was visually clashing with the now beautiful hardwood side of the closet. So, I went back to the website from which I had purchased the first 35. Their technology must have seen this before, as they were poised to upsell me on a set of 10 more hangers, this time much wider ones, almost ¾ of an inch thick.

On arrival, I bumped the more timeless and foundational pieces onto the thicker hangers to better support their shoulders and extend their life. The remaining shirts, including the bolder and exotic ones, all found thinner wood hangers to live on.

Aesthetically, I was satisfied. It turns out 45 hangers fill a standard western sized closet pretty well. Not too loose, nor too tight. And that is when it dawned on me – I would never buy another hanger again! From now on, it would be "one in, one out" in terms of hanging clothing.

As time went on, the beauty of that system really emerged. Each time I bought something new, another thing had to be deemed threadbare, stained, or so far out of style it would never come back. A certain magic is born of that systematic discipline. It led to a saying we use on our website: "*meaningful diversification, not proliferation*."

The "fixed hanger count" approach really forces you to consider if you have good clothing for every major life event, in a count/proportion to the frequency/importance of such events, and that everything exists in wearable condition.

Far more valuable, over the years, I've seen this system is especially efficacious when applied to investment portfolios.

First, it's critical to identify what investments are timeless and foundational, and to give them a larger position size (a thick hanger) in your portfolio. Examples of such classic investments are U.S. small capitalization value equities, the S&P 500, gold, long-dated U.S. Treasury bonds, and real estate[1]. They are all great in their own right, and they have a low correlation to one another, which leads to a smoother ride overall as one zigs while another zags. For example, long term Treasurys tend to go up during a recession, while stocks are apt to go down. Real estate usually does well during inflation, and gold becomes more valuable when the government prints too much money. The S&P 500 does very well during normal conditions, and small cap value stocks usually generate excess returns coming out of a recession, and have

[1] Granted, most clients invest directly in real estate, reducing the need for us to duplicate that exposure in their portfolios, however, real estate is, indeed, a foundational asset class.

been one of the best investments in the last century. By holding each of these diverse asset classes in our "closet," we are prepared for most major economic "occasions."

Similarly, investors also need a good number of thinner hangers to amend, complement and support such cornerstone pieces. Those investments can include Japanese, German, United Kingdom, Australian, and Korean equities (each strong innovative economies, underpinned with a different/helpful non-USD currency[2]), counter-cyclical equities[3], and sectors and segments that have fallen out of favor with investors and thus have unusually high expected future cash flows relative to their prices. These holding types are all excellent compliments to a wardrobe, provided we can purchase them when they are periodically on sale. They support the core very well over time, adding return for each incremental unit of risk/volatility, due to their lower correlation with U.S equities.

Finally, we also need to leave room on one end of the closet for a number of thin hangers to hold items that are more "speculative." These are clothing pieces which are not timeless, but are *de rigueur* for some reason. Examples include individual stocks deemed significantly undervalued, or perhaps reasonably valued relative to high growth rates. They are companies we think have a good probability to annualize at 20%+ over three years if conditions cooperate. Fast fashion, if you will? Such positions might also include crypto-currency holdings and timely holdings in less stable/less developed capital markets like China, Brazil, Vietnam, Turkey, India, South Africa, etc. On occasion, they might also include commodities or other analytically intensive investment ideas like nuclear power, shipping, or even rarer/unique securities like baby bonds, preferred stock, or convertible debt.

While I personally have strong views about the right total number of hangers required for a good, resilient, and statistically diverse portfolio, the hanger count is not as important as having the right balance of thick and thin hangers, and the discipline not to add new hangers once you have decided on how many fit in your portfolio/closet. It is also key not to be confused between the timeless and *de rigueur,* and to avoid giving large coat hangers to clothing which does not deserve it. This control of position sizing is crucial to risk management.

To be specific, our firm sees that 10% of most portfolios should be devoted to analytically rigorous and more volatile investments where unusually high rates of return are possible. We also feel the maximum initial position size for an individual stock should be no more than 2% of overall portfolio value. At that size, if the stock doubles in a given year, it can help us beat relevant benchmarks by 2%, which justifies the rigorous research we must do in order to

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[2] Q2 2023 SG Letter – How the U.S. Dollar Affects Investments

[3] Q4 2019 SG Letter – Counter Cyclical Businesses

determine if valuations/probabilities are more favorable than other investors realize. I often hold five (5) such ideas at any given time, which is the number of special investments I can credibly say I have my finger on the pulse of – perhaps more deeply than other buy-side analysts. I find that investors claiming to understand more companies than that are often working on hearsay, not unusual levels of knowledge or information.

Large hangers, on the other hand, can range up to 15% portfolio exposure. Such slots are reserved only for the most foundational investments, which have proven themselves over decades and throughout various economic environments. Again, these are things like U.S. small capitalization value equities, the S&P 500, gold, long-dated U.S Treasury bonds and real estate.

Going deeper, the serious financial value in this conceptual framework is actually less about the construction of the closet/portfolio, and is more about its ongoing maintenance. For example, by having a fixed number of hangers, you honor the fact that everywhere and always in finance, each purchase must have a corresponding sale. Even when an investor has earned new money, which they seek to invest, they are basically selling fiat currency to buy some other type of investment. Or, if they are exiting an equity investment that has matured to above-average valuations, they are selling corporate equity in exchange for, say, U.S. dollars. Every trade is fundamentally a paired transaction – a buy and a sell. The logical extension of that fact is that when we decide to buy one thing, we make a choice (conscious or unconscious) about the value of what we are selling. If you allow the number of hangers to increase, I promise that you will find those choices become less conscious. However, if you maintain the count, those decisions will organically become far more conscious.

This is critical for a whole range of practical reasons. The process not only assures you have considered both sides of every trade, it also helps make sure you're not accumulating unwatched cash, or failing to consider when investments should be sold, letting dust collect and moths feast. Investments with little room for further performance should be traded to fund new investments with better scope ahead. Doing this, you avoid ending up with a chaotic closet of unwearable, impaired, or played out clothing.

Corollary to that, when you actually choose a given hanger size (be it 2%, 5%, 7.5% or 10%) you open the door to participating in one of the best simple algorithms in investing – rebalancing[4]. When you know each investment's hanger size, (original allotted space in the closet) as events unfold and some investments appreciate and others decline, they become a different size in the portfolio. Maybe a 2% position shrinks to 1%, or a 5% position increases to 7.5%. All you need to do is trade the portfolio back to its original hanger sizes, and subtly, without emotion, you have sold down winners and bought more of what is priced reasonably. So long as each

[4] Q4 2020 SG Letter – Rebalancing Alpha

investment has some quality and promise, this naturally increases the value of the portfolio by enhancing its predicted future cash flows. In a nuanced way, you have "sold high, and bought low." It simply isn't possible to engage in this time-tested strategy of rebalancing if you don't know how it was originally balanced, *i.e.*, how many of each size hanger you began with, and which piece of clothing was on each hanger.

In our field, many things can be described quite precisely in quantitative terms. However, describing the larger conceptual processes that drive the underlying arithmetic can be more difficult. The analogy of a good wardrobe helps us enormously because it addresses most *all* crucial high-level topics in portfolio management:

- Position Count
- Position Sizing
- Position Correlations
- Position Trading/Swaps
- Position Lifespan
- Position Condition Monitoring/Awareness
- Cash-Flow Improvement & Maintenance Strategies
- Reducing Emotional/Reactive Action & Increasing Disciplined/Proactive Action
- Professional, Repeatable, Mindful Stewardship

Last, but certainly not least, once you commit to this discipline, the seriousness of the investment process is amplified. You will trade less, research more deeply, and think more closely about each acquisition because you simply cannot be flippant. Each slot is precious. This process works especially well when investing with a committee because the level of seriousness aligns better with a slow diligent process than it does with a faster, more emotional or entertainment driven approach.

While this analogy isn't a specific "edge" in investment analysis like most of our other letters explore, we think investors can save years of un-needed errors by simply applying this analogy early, and adopting such a discipline. This approach can work for decades on end, and is far higher order than any individual investment.

So happy *executizing*!

execute. *verb*. "*Carry out or put into effect (a plan, order, or course of action)"*

Best,

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