



Let's Get Creative

June 2017

We'd like to introduce you to a very talented swimmer we recently discovered while surveying the investment landscape for sharks.

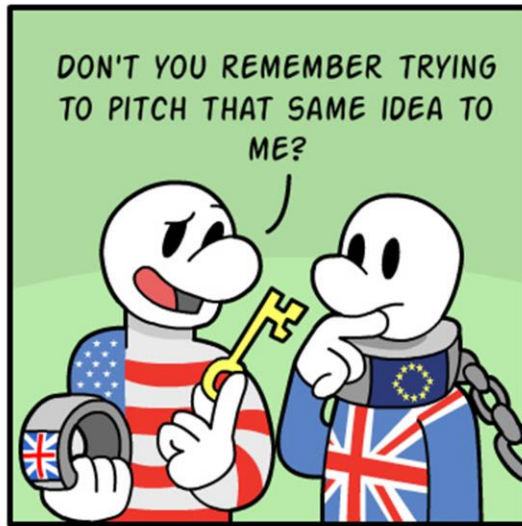
Kennedy Wilson went public in 2009 and remains underfollowed and misunderstood despite management's investment success.

Management has a demonstrated nose for value and a proven track record of identifying and capitalizing on shark-infested waters.

Previous investments have systematically exploited the historical cycle of boom and bust.



A few years ago, I pitched Kennedy Wilson, as a play on distressed European real estate.



Brexit

redpanels.com

Then this happened.



A couple years ago, I pitched SeaWorld.

Then this happened.



This year, I was thinking about pitching the dollar stores.



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Jeff Lewis
@ChicagoPhotoSho

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Bezos: "Alexa, buy me something from Whole Foods"

Alexa: "Buying Whole Foods"

Bezos: Shit

9:37 AM - 16 Jun 2017

75,245 174,099



Then this happened.

And THIS happened!!

"Procrastination is like masturbation. At first it feels good, but in the end you're only screwing yourself."

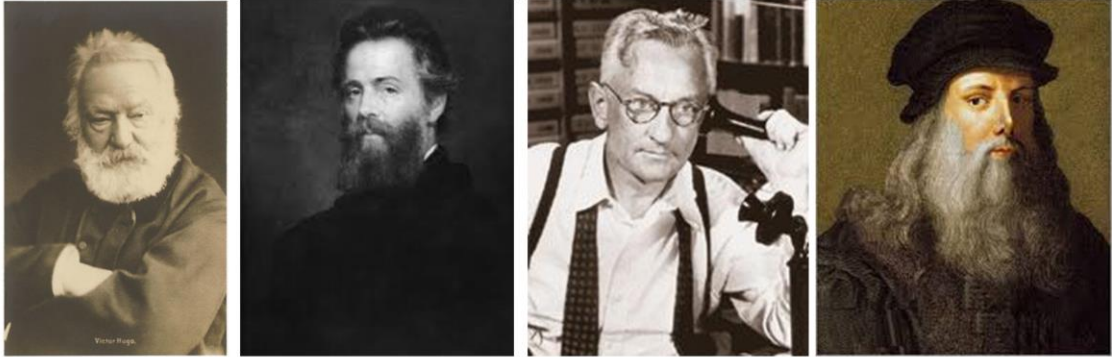
- Anonymous

(because no one would own up to it)

So tonight, I thought I'd talk about something I am actually pretty good at.

Something that everybody does on a regular basis.

Procrastination.



Source: [The Procrastination Equation](#)

The great French poet and novelist, Victor Hugo, whose masterpieces include *Les Mis* and *The Hunchback of Notre Dame*, had a unique way of dealing with procrastination: he had his servant strip him naked in his study and not return with his clothes until his work was complete.

Herman Melville reportedly had his wife chain him to his desk while he was struggling to finish *Moby-Dick*.

Gene Fowler wrote dozens of books and screenplays during his career in Hollywood. "Writing is easy," said Fowler. "All you do is sit staring at a blank sheet of paper until drops of blood form on your forehead."

Leonardo da Vinci had a reputation as a daydreamer who never finished anything. It took him 6 years to complete the *Mona Lisa*. He only finished *The Last Supper* after The Duke of Milan threatened to cut off funds.

So it would seem that each of these brilliant men were very good at screwing themselves. Yet they created some of the most beautiful art in their respective fields. Are these statements inconsistent? Let's have a look.



FLW is perhaps the most famous American architect in history. His masterpiece, Fallingwater, is nestled into a waterfall near Pittsburgh. It's a special place I've visited many times.

Fallingwater was commissioned by Edgar Kaufmann in 1934. Almost a year after their initial meeting, Kaufmann called Wright on a Sunday morning to let him know he would be visiting before lunch, and couldn't wait to see the plans. There was only one minor problem – Wright hadn't actually drawn anything!

As the story goes, Wright calmly finished breakfast and drew the plans in the time it took Kaufmann to drive up for lunch.

Procrastination paid off. It often does. I'd suggest that it may even be a necessary precondition for creativity. This is one of the topics I'd like to explore today.

Specifically, how can creative thinking improve the investment process?

A blueprint for creative thought

- The benefits of thinking more broadly
- Let's get creative (for math nerds)
- Designing the investment process

To start, we'll consider the benefits of thinking more broadly.

Next, I'll share some of my own tricks to spark creative thinking.

And we'll wrap up with a few examples of how creative thinking can inform the investment process.

Thinking more broadly

Investing demands that we think differently. That we see differently.

Part One:

What do we mean by thinking more broadly?



When most folks think about investment managers – assuming anyone else does think about investment managers – I imagine that they probably envision a bunch of math nerds sitting around at lunch laughing at a joke like this.

My wife used to tell people I “did math” for a living.



Investing certainly requires that we “do math” . . . but it’s not rocket science.

In fact, even science isn’t rocket science. Well, maybe except rocket science.

Most of the “real work” in science and in investing requires little more than basic math skills. The “real work” is done here. Successful investing demands that we think *differently*. That we see *differently*.



So how do we see differently? Well, I can tell you that it is very difficult to do if you are just sitting around reading what everyone else is reading and doing what everyone else is doing.

Shane Parish at Farman Street likes to remind us about the dangers faced by the one-legged man.

Broad experiences allows us to think more broadly.

Thinking more broadly makes us better investors.



So I'm going to challenge everyone tonight to think more broadly.

I'll provide some examples of how broader thinking can inform the investment process.

Many of these examples were initially inspired by Matthew Frederick's *101 Things I Learned in Architecture School*.



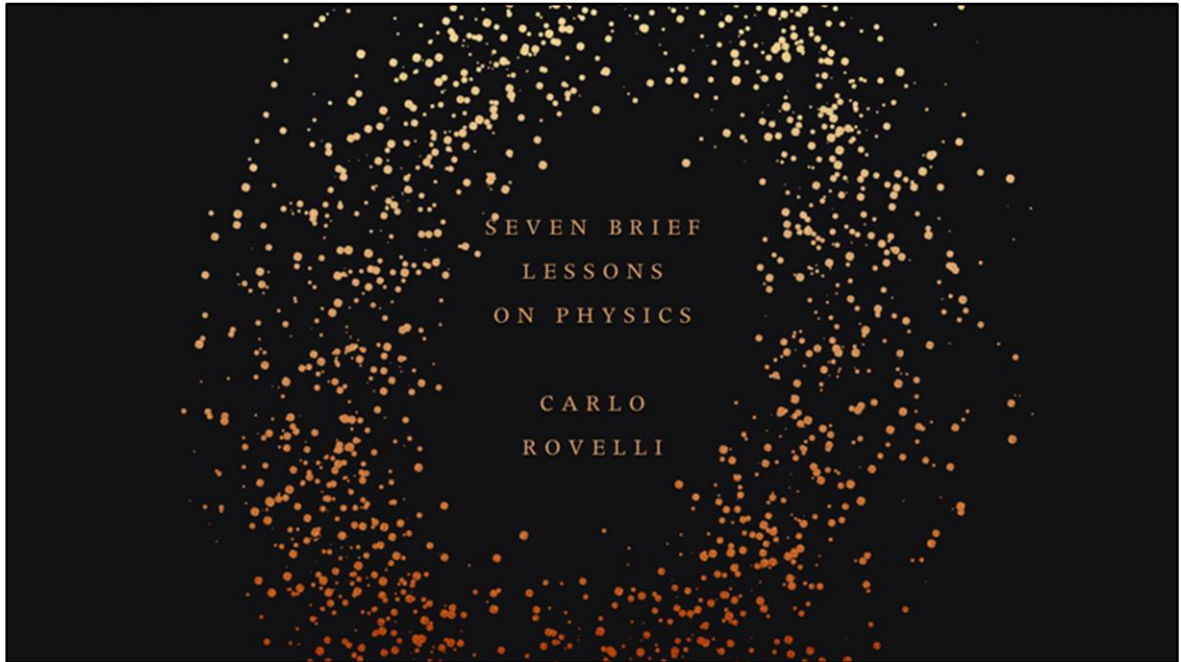
In addition to architecture and design, we'll consider some other schools of thought.

The famous physicist Richard Feynman, for example, taught us the difference between knowing the name of something and truly understanding it.

In one lecture, Feynman called out a first-grade science book which showed students images of wind-up toys. It asked: "What makes it move?" The answer in the teacher's edition was simply, "Energy makes it move."

This is true. But "energy makes it move" doesn't really teach us anything. In order to truly understand an idea, as opposed to memorizing definitions, we'd be better served by taking the toy apart.

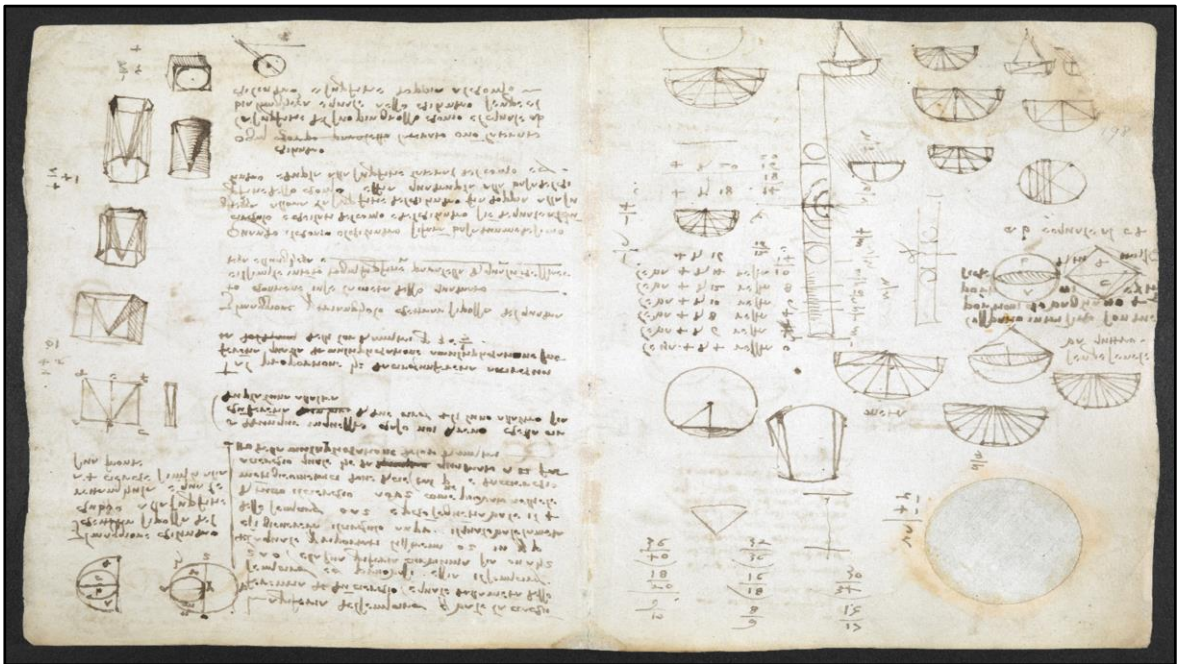
By SEEING how it works.



Both science and investing, begin with a vision. A simple idea.

One lesson in Carlo Rovelli's "Seven Brief Lessons on Physics," is made up almost entirely of simple drawings.

Rovelli teaches us that: *"Before experiments, measurements, mathematics and rigorous deductions . . . science begins with a vision."*

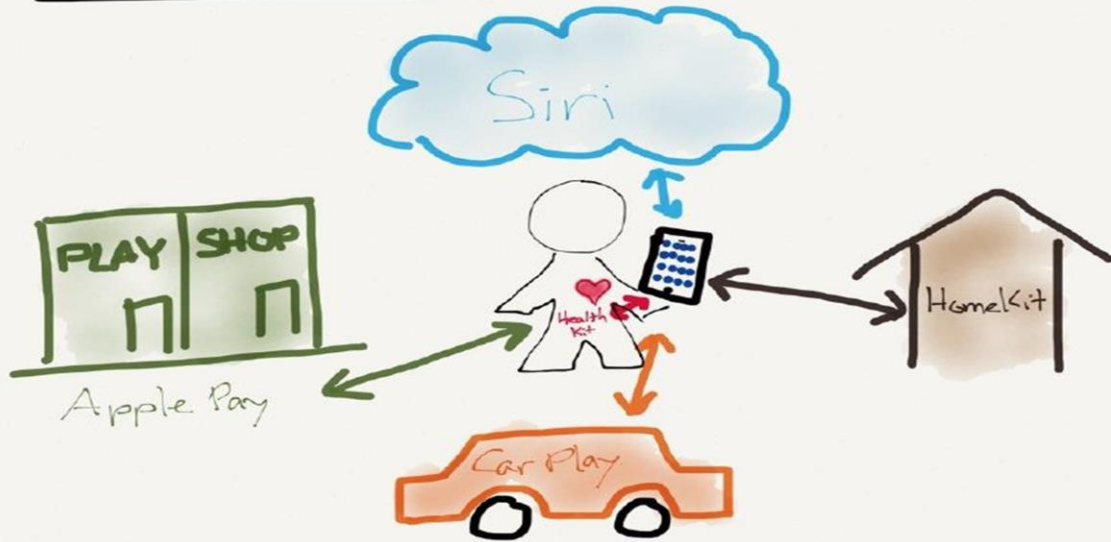


Simple drawings help us express those visions.

Many of history's greatest learning machines used simple drawings to solve problems.

Apple's Services

strattechery.com

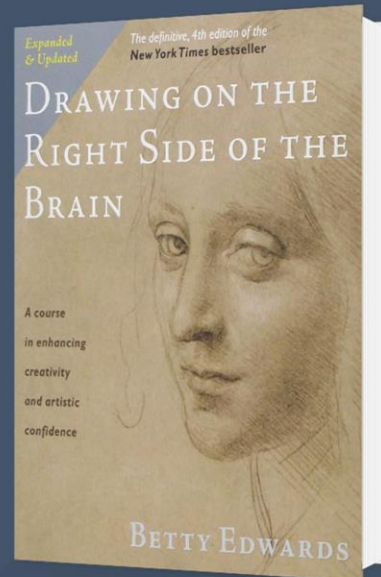


Simple drawings can also deepen our understanding of complex ideas.

“

Perceptual skills, learned through drawing, can be used for thinking more broadly in many fields. *If we learn to appreciate perceptual skills, we can "see things in context," "see the whole picture," and "see things in proportion and in perspective."*

”



In *Drawing on the Right Side of the Brain*, Betty Edwards teaches us that perceptual skills, learned through drawing, can be used for thinking more broadly in many fields.

We can see things in context. We can see the whole picture.

We can see things in proportion and in perspective.



Let's see what she means.

Raise your hand when you recognize this image.

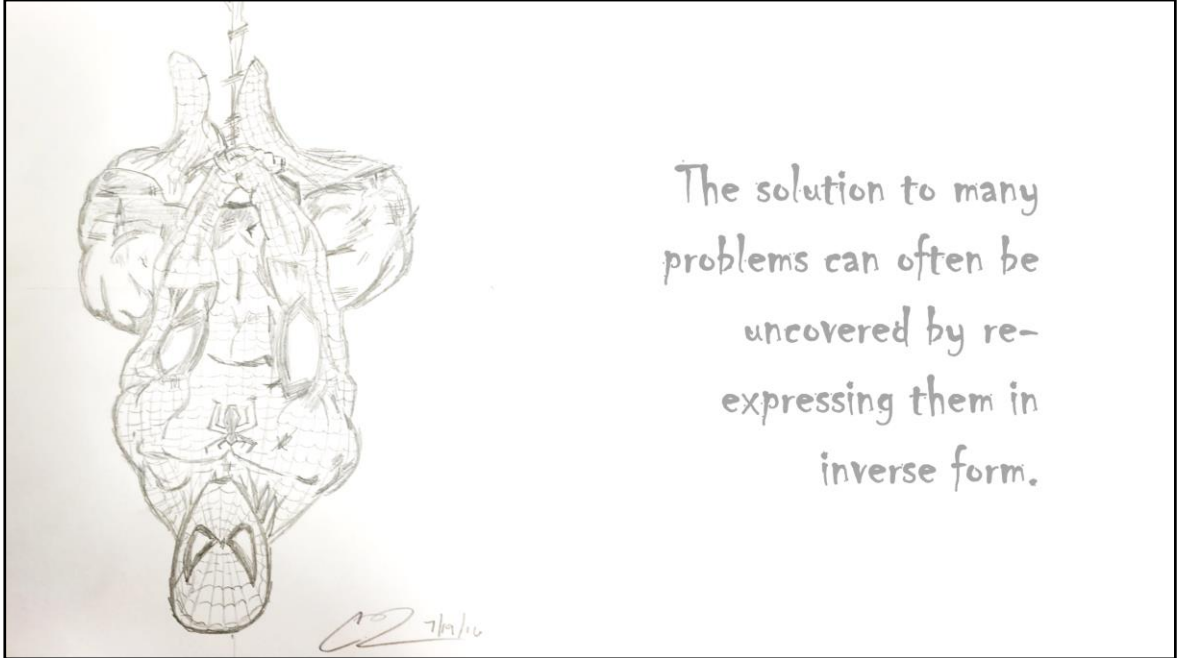
If you recognize it, please don't say anything. Just raise your hand.

OK. So we now know that upside-down faces are difficult for most people to identify.

But why? Because we are used to processing faces like a one-legged man. We are used to seeing images one way - right side up.

We are not used to looking at things differently.

We need to train our mind to do so.



One of the first exercises in Edwards' book is drawing upside down. Try it. You'd be amazed at how good your work turns out.

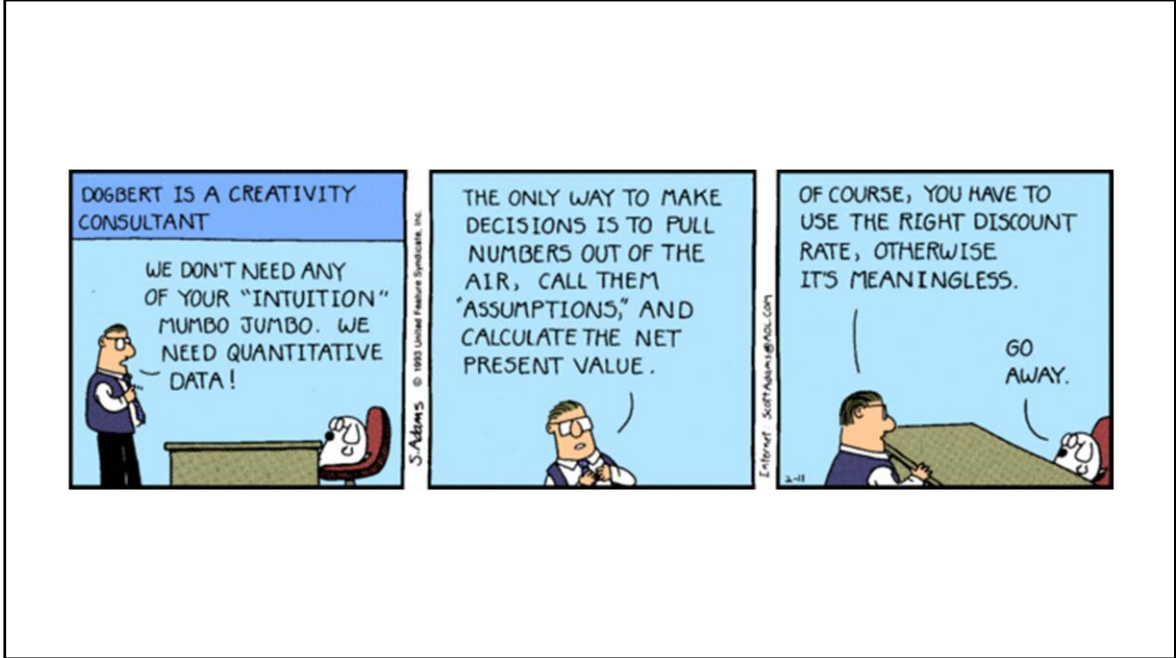
It works because the left hemisphere of the brain – the analytical side - finds identifying and naming things upside-down too hard.

As a result, the right hemisphere of the brain –more suited to visual perception, pattern recognition and spatial relationships –takes over.

Drawing depends on one's ability to "see" differently.

Charlie Munger has provided us with similar advice for problem solving - "Invert, always invert."

The solution to many hard problems can often be uncovered by re-expressing them in inverse form.



Dilbert gives us a good example of a complex problem better addressed by inversion.

DCF's, no matter how much we love them, are loaded with problems. First and foremost, we are not very good at forecasting. And we know this. But we don't stop there.

We can't resist plugging in our bad assumptions to see what number comes out. And even if our assumptions are okay, even Dilbert knows that if we don't use the right discount rate – whatever that is – the output is meaningless.

So, if DCF's aren't worth the spreadsheets they are calculated on, how do we know an asset's value? Quite literally, we turn the DCF upside down. Instead of trying to forecast growth rates years or decades into the future, we take the current share price and determine what it implies about growth.

Then, we can determine how likely we believe that growth rate actually is.

The solution to many hard problems can often be uncovered by re-expressing them in inverse form.

“**Do not read so much . . .**

look about you and think of
what you see there.

Richard Feynman

So, lesson number one, in a nutshell:

Don't read so much. Look about you and think of what you see there. Think more broadly.

Lets get creative

Schedule time to think.
Relax. Let your mind wander.

Lesson two.

This is the fun stuff.

How to schedule creativity.

“ The most effective, most creative problem solvers engage in a process of meta-thinking.



Source: 101 Things I Learned in Architecture School

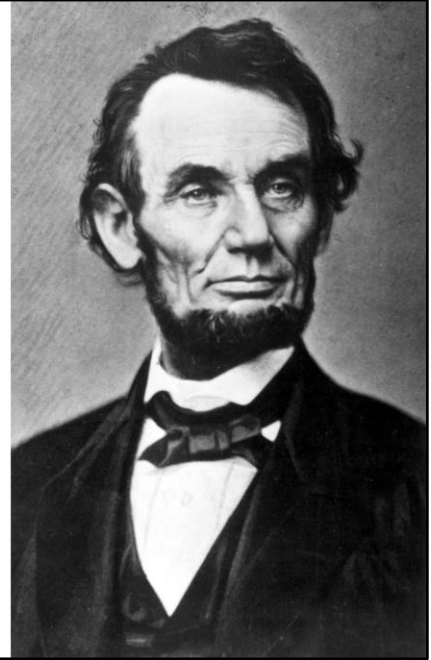
The most effective, most creative problem solvers engage in a process of meta-thinking.

Meta-thinkers, in short, make an effort to think about how they are thinking.

They are constantly testing, stretching, and criticizing their thought process.

“

Give me six hours to
chop down a tree and I
will spend the first
four sharpening the
axe.



Successful investing requires a similar discipline.

In order to see differently, we need to spend more time sharpening the axe.

We need to spend more time thinking and less time doing.

This means SCHEDULING TIME TO THINK.

LITERALLY.



Thinking is REALLY hard when your desk looks like this.

There is a strong positive correlation between the number of screens on your desk and your perceived importance.

I believe there is an even stronger **NEGATIVE** correlation between the number of screens on your desk and your **ACTUAL** productivity.

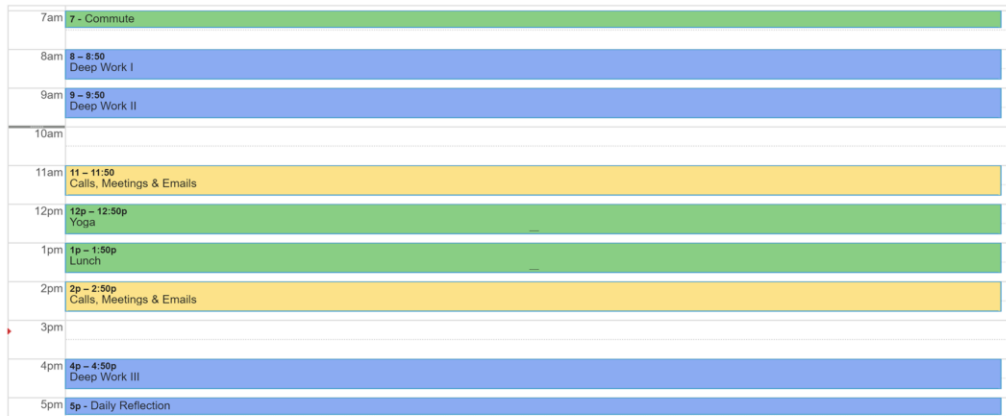


This is what my desk looks like.

It is optimized for thinking. Optimized for Deep Work.

Here are a few examples of how I schedule time to think.

Schedule time to think



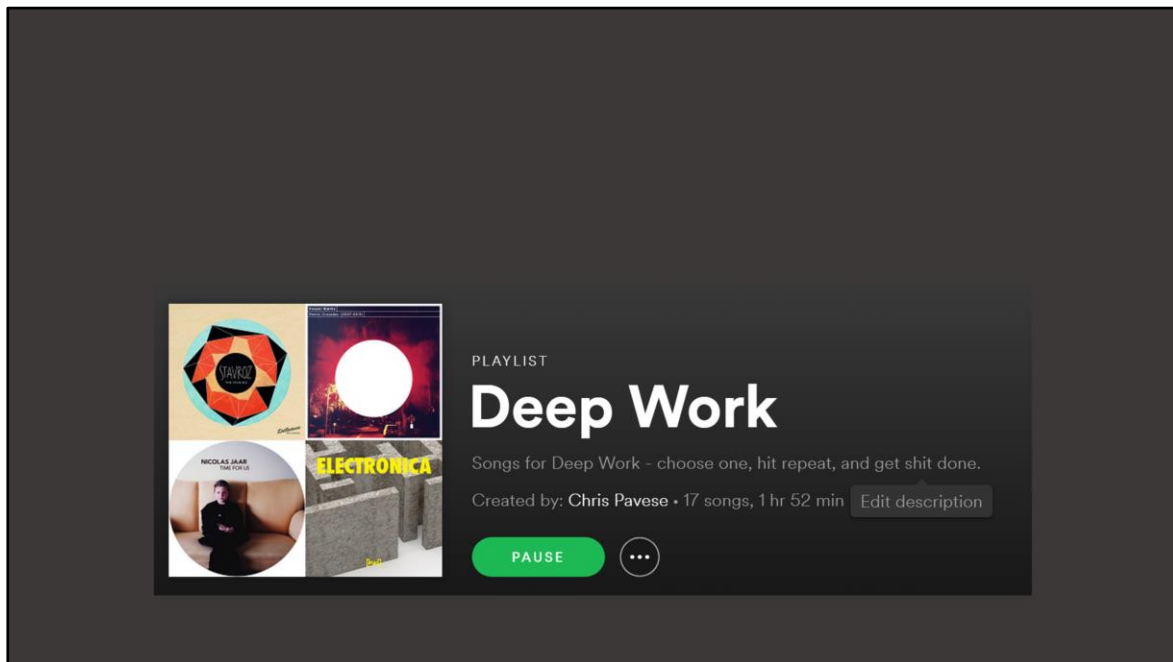
This is what my calendar looks like on a typical day.

Buffett has said that he keeps absolutely nothing on his calendar.

He does this to protect his time.

I suppose I'm less disciplined than Buffet.

So I've recently experimented with blocking off everything on my calendar to ensure no one else steals my time.



You'll notice that the first two appointments on my calendar EVERY day are blocked off for Deep Work.

My mind is at its best in the morning.

This is when I work on whatever is most important each day.

I'll often knock out these first few hours at home, at the library or at a coffee shop.

The key is to guard this time like your life - or your performance - depended on it. Because it does!

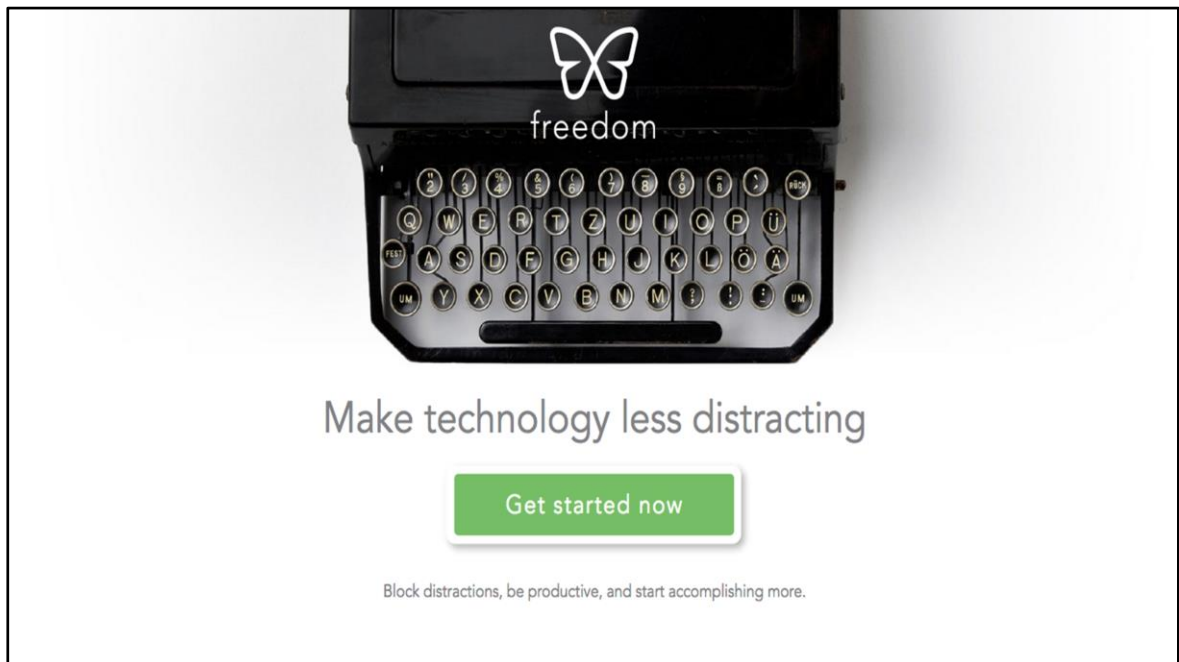
I have found a few tools useful in guarding this time.

The first is shown here.

Get yourself a set of good headphones.

Headphones drown out distraction.

For me, listening to something on repeat helps prompt a flow state.



Enemy number one of flow, is the internet! Here's a tool for turning that off too.

Freedom, which works across your devices, basically turns off the internet for a set period of time which you determine. Poof. No more distractions.

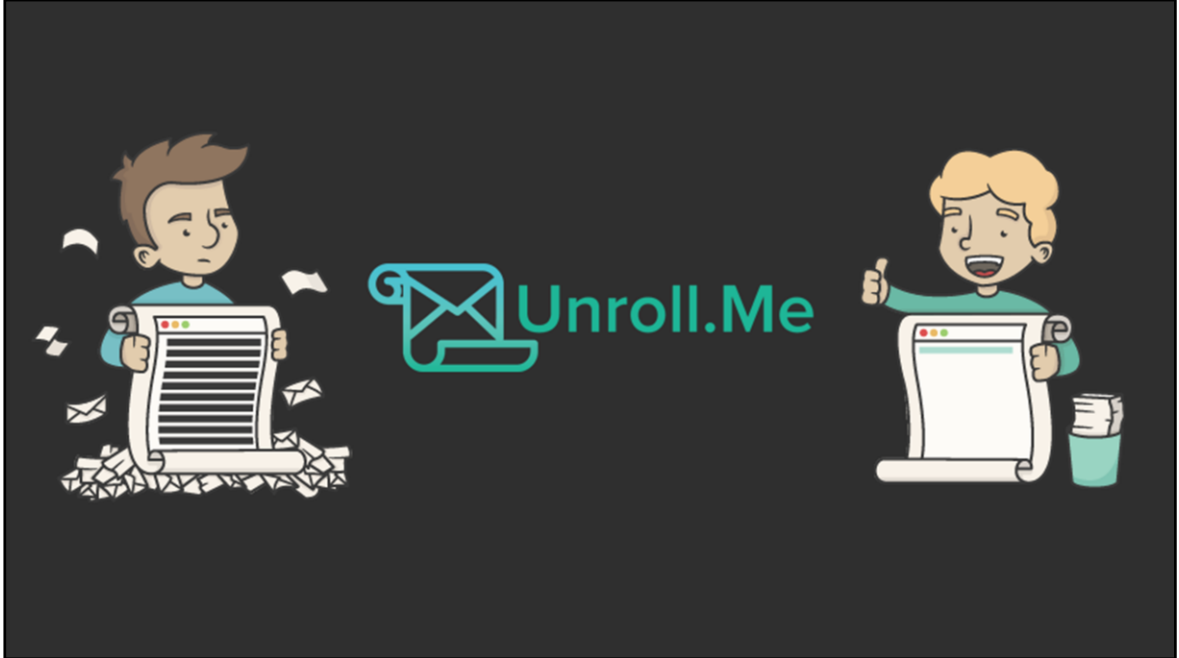
I know this is a scary idea.
But trust me. It works wonders.

How often have you been deep at work, stopped to look something up, and lost an hour or two before you remembered what you were initially looking for.

Freedom forces you to write those things down for follow up later.

Like putting blinders on a horse.
Disconnecting forces us to sit with our thoughts.

And when "time's up," we'll have a short list of things to follow-up on, rather than a long list of constant interruptions.



OK. Scary idea number two.

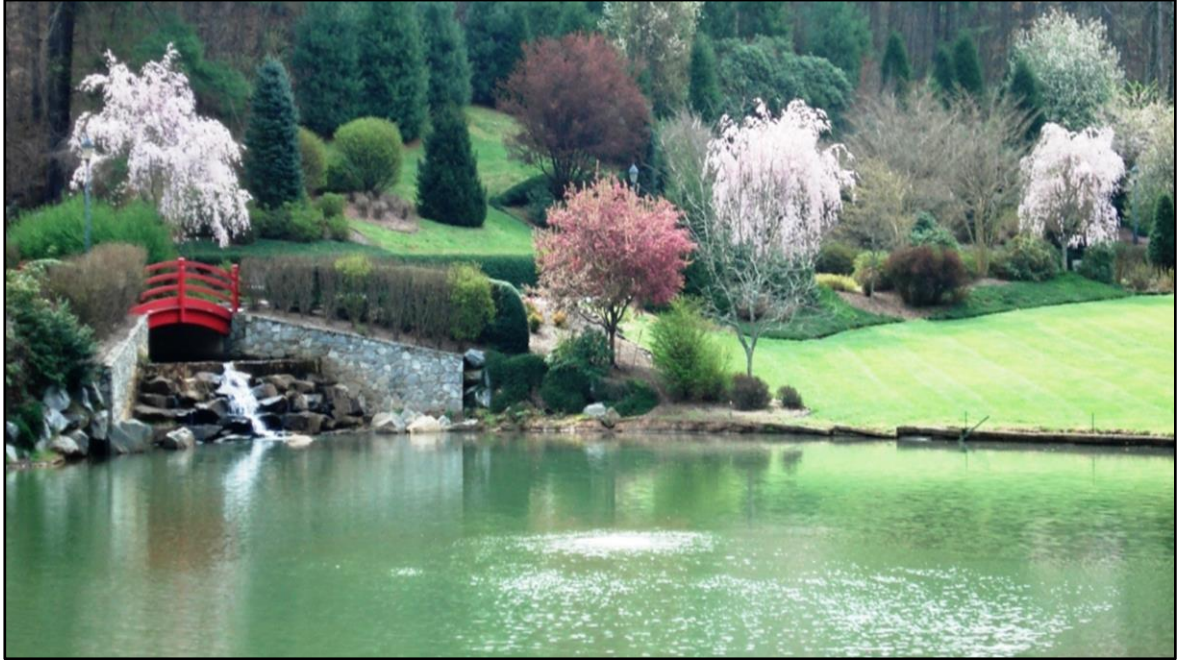
Stop checking email. Seriously. It can wait. The alternative is constant interruption. How is it that we've all been brainwashed into thinking this is okay?

Resisting the urge to check email is hard. Very hard. So it's important to know our limitations and control our environment. If you are going on a diet, better to get the junk food out of the house, than to trust your willpower.

A no email diet requires the same discipline. You may have noticed that I have scheduled specific times on my calendar for checking and replying to emails.

Don't trust yourself to be this disciplined to start. You won't. But there are tools to help. I use Unroll.Me to assist with managing email. It takes all of the daily noise out of my inbox and rolls it up into one message, that I read at the end of the day.

Added bonus: you get the great satisfaction of knowing how much crap you're dodging. Last I checked, I was rolling up north of 1600 emails. Less than 5% of what is sent to me actually hits my inbox during the day.



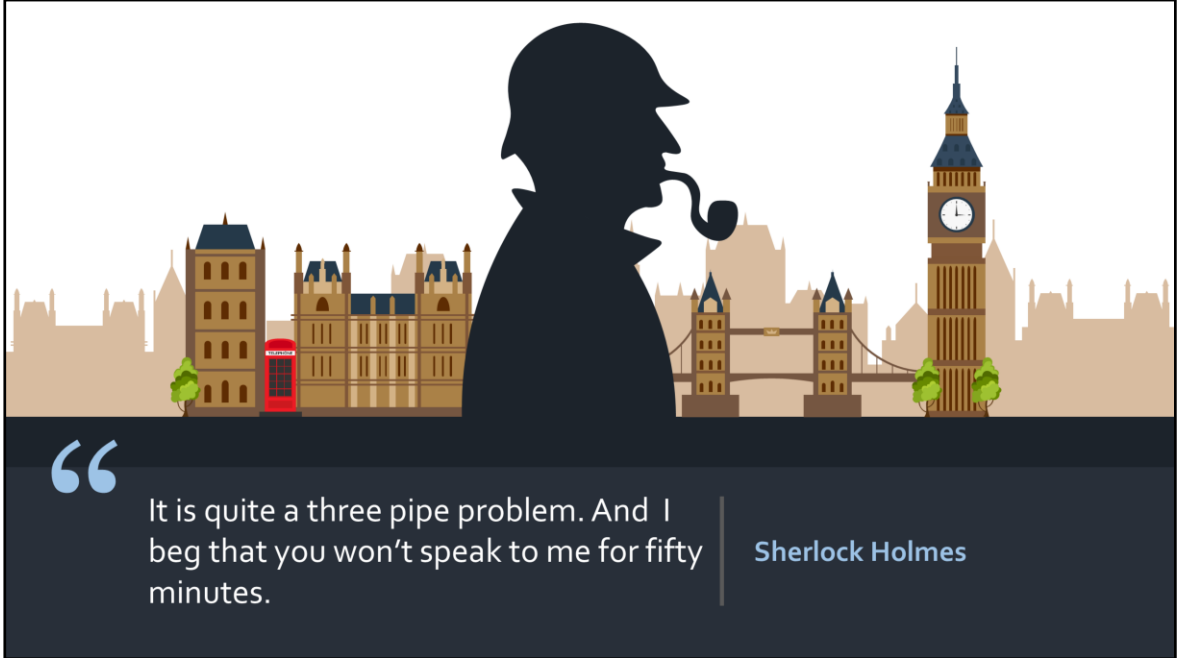
We have been brainwashed into believing more information is better information. That more screens are better than fewer screens. That working equals doing. That only 'doing' has value.

In today's world, "working" is sitting at your desk staring at your screens all day, pushing out emails, rushing to meetings and . . . very efficiently, getting nothing done. This is a dangerous world. And it's a miserable world!

Yet, this is the world most of us choose to live in. A world where we are forced to make rapid decisions with little thought. Wouldn't our investors be better served by fewer, better, long-term decisions?

In this world, walking, for example, is not working. It's not doing. But a walk provides just the right spark to make new connections. Connections that allow us to make better decisions. This only happens when you relax and let your mind wander.

Go to the gym, take a stroll through *The Broyhill Walking Park*, go for a ride, draw something upside down, sit in a quiet room and think – or set a good tune on repeat. You get the point. Unplug.



If we rush towards problems too quickly, we risk never getting to the answer at all.

One of the many lessons we can learn from Sherlock Holmes is his “three-pipe solution” for problem solving.

Rather than jumping right in, Holmes often sits with his pipe and gives his mind time to reflect and strengthen connections.



“ There is no *idea dump*; no *story central*; no *island of the buried bestsellers*.

Good story ideas come quite literally from nowhere.

Your job isn't to find these ideas but to recognize them when they show up.

Here is Stephen King on the creative writing process:

“I tend to go through periods of idleness followed by periods of workaholic frenzy.”

“There is no Idea Dump; no Story Central; no Island of the Buried Bestsellers; good story ideas come quite literally from nowhere. Your job isn't to find these ideas but to recognize them when they show up.”

I think this is analogous to the investment process. Idea generation is organic. There is no silver bullet. But left alone, ideas can “magically” appear in the mind if we let them.

Our job as investors isn't to sit in front of the screens all day chasing every idea that comes by in 140 characters or less. Our job is to take the time to let the good ideas simmer and recognize them when they show up.



YOU HAVE TO KEEP A DOZEN OF YOUR FAVORITE PROBLEMS CONSTANTLY PRESENT IN YOUR MIND, ALTHOUGH BY AND LARGE THEY WILL LAY IN A DORMANT STATE.

EVERY TIME YOU HEAR OR READ A NEW TRICK OR A NEW RESULT, TEST IT AGAINST EACH OF YOUR TWELVE PROBLEMS TO SEE WHETHER IT HELPS.

EVERY ONCE IN A WHILE THERE WILL BE A HIT, AND PEOPLE WILL SAY, "HOW DID HE DO IT? HE MUST BE A GENIUS!"

Richard Feynman put it best.

“ Properly gaining control of the design process tends to feel like one is losing control of the design process.



Source: 101 Things I Learned in Architecture School

For architects, “properly gaining control of the design process can feel like one is losing control of the process.”

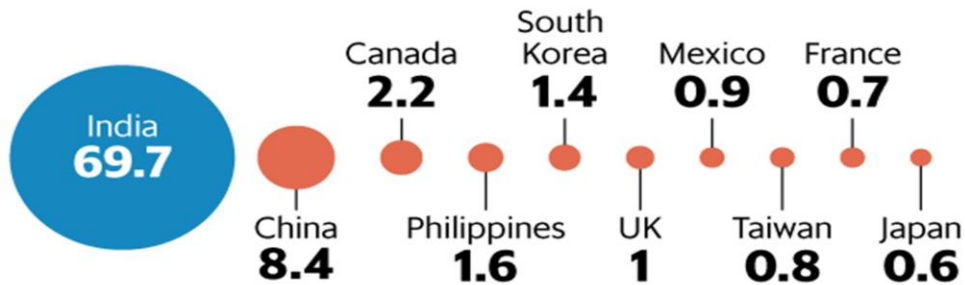
For investors, losing control doesn't feel good.

The investment process should be structured and methodical.

But process is not mechanical. We should engage the process with patience.

WHO GETS H-1B VISAS

Percentage of H-1B visas in fiscal 2014 awarded to people born in each country



Source: US Department Of Homeland Security

Here's an example of what I mean by patience and uncertainty.

We turn over a lot of rocks when researching potential investments. Most of the time, the immediate benefits of what we find are unclear. The long term benefits can be significant but are largely unknown.

For example, we began looking at the IT services industry a year or two ago. These are wonderful businesses. But they can be difficult to understand at first blush. So we simply watched and learned for a while.

We did nothing. For over a year. We let the idea marinate. Then, H-1B Visas became a hot issue during the presidential election. The stocks got cheaper. And one of our managers took an activist position in the sector.

Over time, the idea slowly crystalized. But only because we let it simmer and gave it time to "show up."

“ **The secret to doing good
research . . .**

is always to be a little
underemployed.

You waste years by not being
able to waste hours.

- Amos Tversky

So Lesson Number Two:

The secret to doing good research...

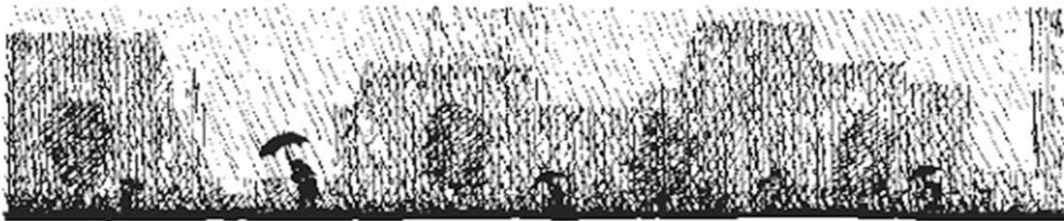
Investment process design

Good investors, above all else,
demonstrate good process.

Lesson Number Three.

Good investors, above all else, demonstrate good process.

“ Being process-oriented . . . is the most important and difficult skill for a designer to develop.



Source: 101 Things I Learned in Architecture School

For architects, being process-oriented is the most important and difficult skill for a designer to develop.

It is equally important for investors. So what does it mean to be process oriented?



How many poker players do we have in the room?

How many of you have suffered from a bad beat?

In poker, a “bad beat” is when you correctly see that there is a high probability of winning the hand, you bet big, and you lose. In many casinos, the house will actually pay you for a bad beat.

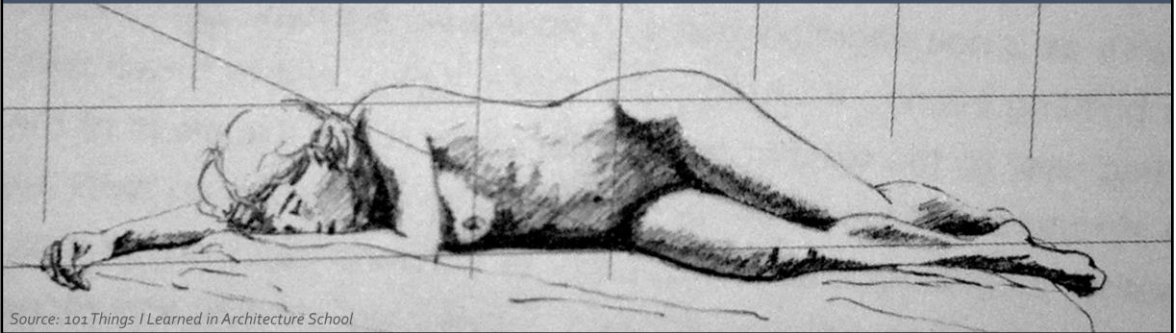
Financial markets don’t quite work that way. There is no such thing as a good beat. But that doesn’t make all losing investments unwise.

Good poker players, good architects, and good investors understand this.

“

Never work at 100% level of detail from one end of the sheet toward the other.

Instead, start with the most general elements of the composition and work gradually toward the specifics.



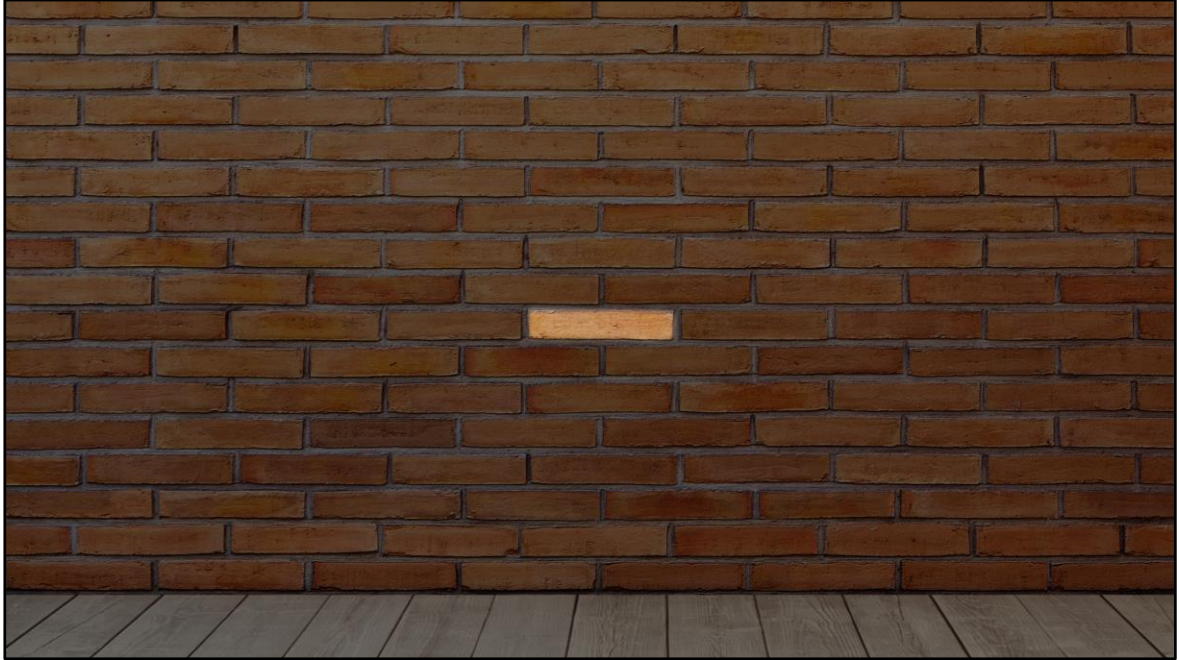
Source: 101 Things I Learned in Architecture School

Even a strong process can lead investors too far into the weeds. It is very easy to get lost in the details.

This is true of the investment process as well as the architectural design process.

“When drawing in any medium, never work at a “100% level of detail” from one end of the sheet toward the other, blank end of the sheet. Instead, start with the most general elements of the composition and work gradually toward the more specific aspects of it.

So, when researching potential investments, start with the basics.



When an investment problem is so overwhelming, don't wait for 100% clarity before beginning your analysis. Start with the most general elements and work gradually toward the specifics.

In his classic, *Zen and the Art of Motorcycle Maintenance*, Robert Pirsig recalls how one of his students struggled to write a 500-word essay on the United States. He tells her to start with the upper left-hand brick of the opera house. She goes away, sits in a coffee shop, starts writing about the brick, and couldn't stop writing.

Within every large problem are many smaller problems struggling to get out. Use Pirsig's brick to break down big problems into smaller chunks.



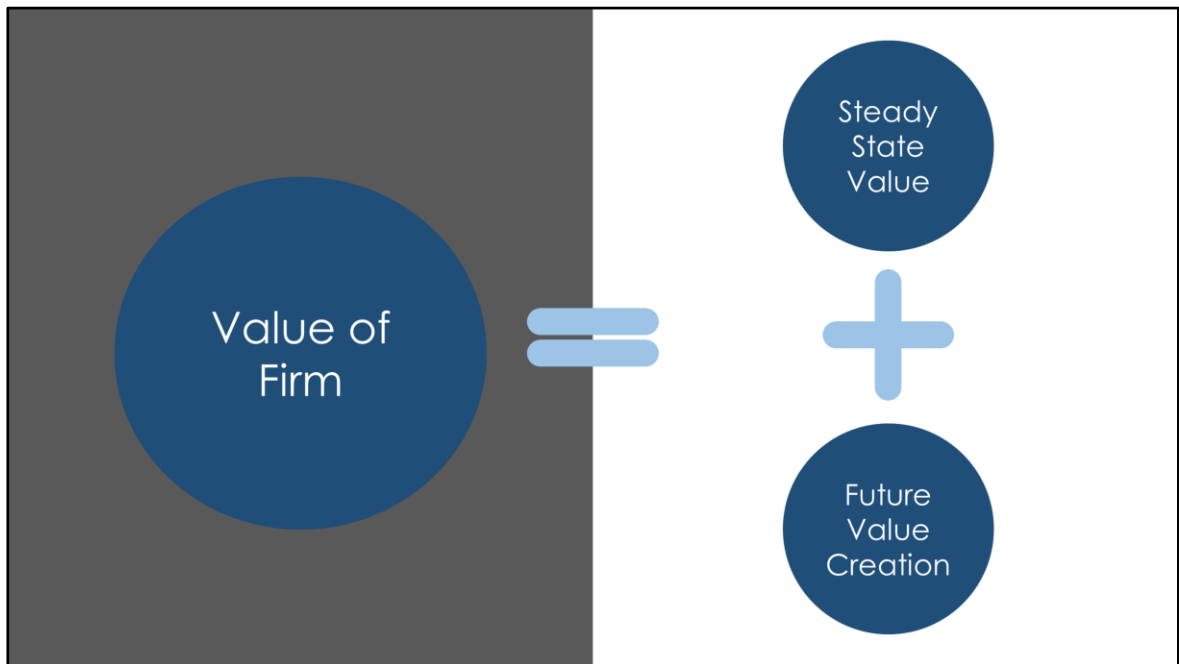
In physics, a Fermi estimate decomposes the problem into its knowable and unknowable parts. It's an attempt to flush ignorance into the open, to expose and examine your assumptions. The classic example is, "How many piano tuners are in Chicago?"

To answer we might consider the following:

- How many people are in Chicago?
- How many people are in each household?
- How many households have pianos?
- How often are those pianos tuned?
- How long does it take to tune a piano?

From here, we can estimate the number of piano tunings in a single year in Chicago. We can also calculate the average number of piano tunings each piano tuner does per year. Dividing the two gives us an estimate of 225 piano tuners in Chicago.

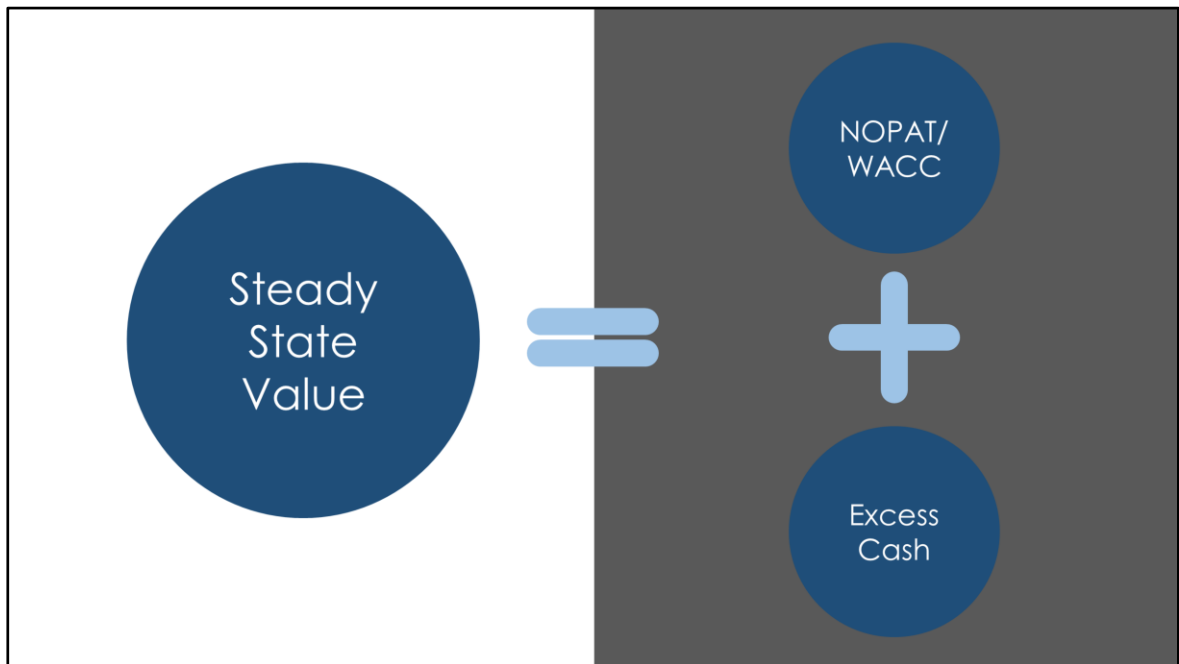
The actual number of piano tuners in Chicago is about 290. Not too shabby.



In investing, we can break down the value of a firm into two components:

1. Its “steady state value”
2. Plus any “future value creation”

Future value creation is the hard part as it requires making explicit forecasts far into the future. It’s easy to get lost in the detail here. But sometimes it’s not necessary.



Why not start with steady state value, which is far simpler to estimate.

We can calculate the “steady-state value” of a firm using the perpetuity method.

We simply assume that the firm’s current net operating profit after tax is sustainable indefinitely.



Here's an example:

For many value investors the tech sector gets put in the too hard pile. And for good reason. This cartoon is a great example of how I imagine most of us feel when analyzing the sector.

It is very easy to get lost in the details. But we can use "good old regular data" to break the problem down.

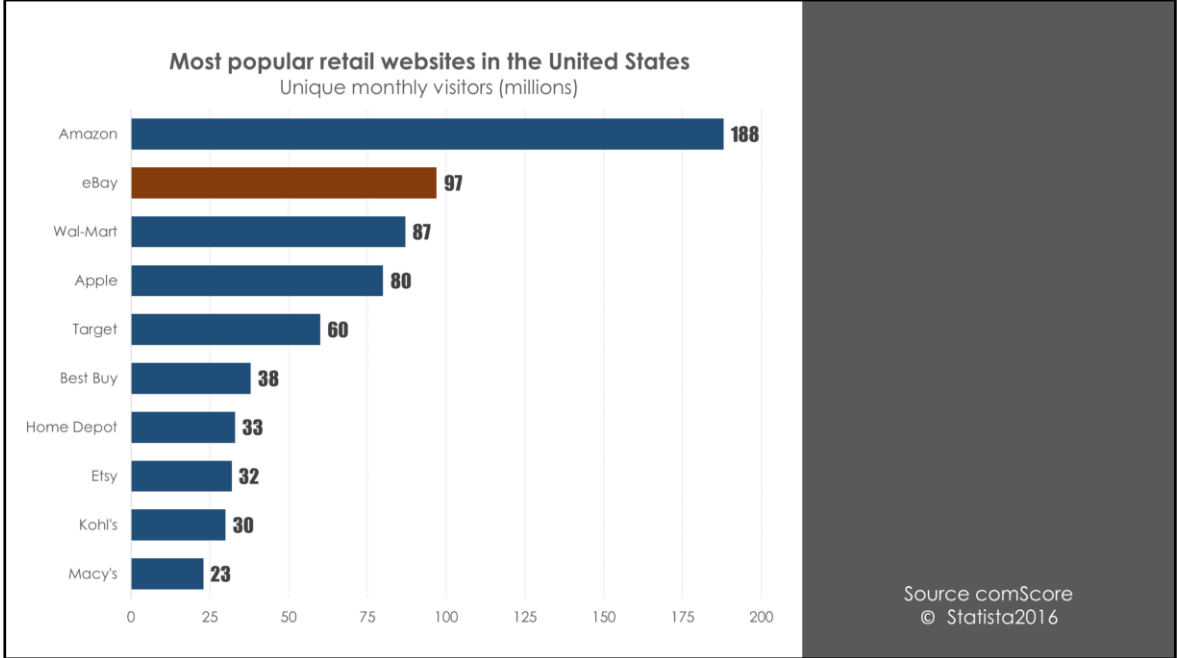


We can break every problem down into smaller chunks.

Instead of obsessing about “future value creation” we can focus on a firm’s “steady state” value.

And if we can buy a business at or below steady state value, we don’t need much to go right to earn good returns.

Sounds easy enough right? Let’s give it a shot. Name the three most popular retail websites in the US. I’ll give you the first.



How many of you would have guessed that eBay remains so dominant in e-commerce? Sure, it's a distant number two. And yes, it is losing share to Amazon. But everyone knows that today. And everyone is losing share to Amazon!

The more important question is, can EBAY still grow – even while losing share – if the industry is growing at a 20% clip? We think so.

For how long? Who knows. But we have a pretty good margin for error on our cost.

HOW TO MAKE
MONEY ON..

ebay™



In other words, we didn't need all the answers.

We had a pretty good estimate of steady state value.

And we bought shares at a price pretty close to that value.

We broke the problem down into smaller chunks and focused on what was knowable.

THE CREATIVE PROCESS



Let me leave you with a final thought to ponder while you are listening to some great ideas over the next few nights.

We are sure to see many examples of very structured and very methodical analysis.

The *finished* product often appears this way. But the process is not mechanical.

The creative process is often messy.



Trust your instincts.

Something will come out eventually.

Creative thinking recap

- ✓ Draw stuff
- ✓ Schedule time to think
- ✓ Start with a single brick or piano
- ✓ Bad beats can mean good things
- ✓ Slow down, smoke a pipe, and read some Stephen King

And if you find yourself sitting on the pot for too long, try this:

1. Draw stuff. It's good for your brain.
2. Schedule time to sit and think. Seriously. Put it on your calendar.
3. Start with a single brick or a piano. Break problems down into chunks.
4. Bad beats can still mean good things. Focus on process, not outcomes.
5. Slow down, smoke a pipe, and maybe even read some Stephen King. I promise King's novels are a better read than 10Ks.

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