How to Identify Great Capital Allocators?

This was the topic at the recent MOI Global Zurich chapter dinner I attended. Here I summarize my notes and thoughts on this topic.

I understand capital allocation as follows:

> How do companies spend their limited resources, be it capital, time, or mental resources, so that they create the maximum amount of value per invested unit of capital?

So it's all about value creation, efficiency and high returns on invested capital, however you want to define it.

So how to identify a great capital allocator? First, try to find people with a solid record of value creation. Growth in earnings per share or free cash flow per share could be useful metrics. Exceptional customer loyalty, products that solve real problems, or a full R&D pipeline with promising improvements could be qualitative factors to look for.

One shortcut is to look for owner-operators. People who own a large stake of their company and are the driving force. Especially if those people already have a strong track record.

A case study by Phil Ordway of good capital allocators was mentioned.

Then we discussed a number of topics and companies.

Amazon
Jeff Bezos was mentioned as a great capital allocator. Because he is obsessed with creating customer value, and takes a very long-term view. He has a deep understanding of capital allocation from his 8 years working on Wall Street (including working at a hedge fund). Plus, he is the owner-operator.

Disruption / Innovator's Dilemma
Disruption is a real challenge. Many companies are faced with the Innovator's Dilemma, being stuck with path-dependancy and an inability to cannibalize their still profitable, but increasingly obsolete, business units. Steve Jobs was a master of breaking this dilemma. Mark Zuckerberg seems to be pretty good at it as well.

BMW vs. Tesla
So what should a company like BWM do, faced with the disruption created by electrification and autonomy, or more generally speaking, by software and data? Should they compete with the Google's and Tesla's of the world on software, and potentially lose a lot of money, or would it be better to milk the current cow and slowly decline?

Warren Buffett and his textile business
Warren Buffett was faced with the same situation in his early textile business. He did a very sensible thing. He did not try to save the business at all cost. He took the profits, and reinvested them more productively. In his case, buying great and profitable companies like banks and insurance companies. And when his textile business started to lose money, he shut it down completely. He faced the facts and acted accordingly. He wasn't romantic about it.

Mergers & Acquisitions
Acquisitions only make sense when done sensibly. Buy great assets, and don’t overpay. A lot of times, mediocre acquisitions are made, for way too much money.

Stock buybacks & Dividends
If its own stock is undervalued, it creates value for a company to buy back shares. If buybacks don’t make sense, paying a divided is better than acquiring a mediocre business, or starting a mediocre project.

Apple
What should a company like Apple do? So far they have been heavily buying back shares and paying out dividends. So it seems that the current management can’t find better opportunities internally or externally to deploy the cash.

To summarize, there seems not to be a single way to identify great capital allocators. It all depends on the specific circumstances. Personally, I like the owner-operator approach. This might be a great shortcut to find, and then partner with, great allocators. In fact, when I look at my personal portfolio, this is exactly what I ended up doing in a lot of cases.

(Image by [401(K) 2012]())