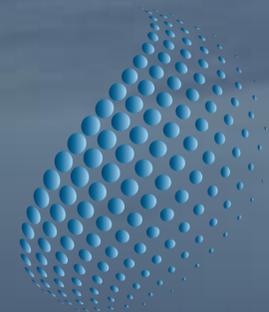


Growing trees with expanding root systems

By Kjetil Nyland



REQ CAPITAL
INVESTING WITH INSIGHT

In the plant world, the roots of the African rock tree, *Ficus abutilifolia*, can split open huge rocks and penetrate up to 60 meters deep in search of water. Plant roots perform a number of important tasks: They resist the effects of wind, water, and dirt, among other things¹. In addition, some trees can stand upright for hundreds of years because their roots grow deep and wide into the ground, surviving even when large sections are cut off². A strong root system is, therefore, a prerequisite for a tree to grow for decades because, without it, all growth becomes fragile.



Photo credits: Tampa-tree.com

Most people focus on what's visible and measurable: a growing tree with its corresponding branches and leaves in full glory. Or, in a corporate context: a company experiencing high growth and seemingly firing on all cylinders. But a closer look may reveal a growth profile based on a concentrated product line sold to a single customer in a narrow end-market with favorable macroeconomic tailwinds. Each of these risks may look low-risk by itself, but if you keep running the clock on a low-probability event, it's bound to happen. After all, compounding works both ways. Hence, we stay away from companies that are too dependent on any one of those factors, because we know that any one of these risks will eventually play out in the fullness of time.

Avoiding blowups

The fascination that most investors have with high-performing serial acquirers often stems from a return perspective: this group of companies is systematically able to deploy large amounts of capital at high returns over a long time. To return to the analogy between a plant and a tree: the growth of the tree itself with all its branches and leaves represents reinvestment opportunities that will be harvested in due course.



REQ CAPITAL
INVESTING WITH INSIGHT

To reach the "second half of the chessboard³", i.e., the point where an exponentially growing factor really gets going, one mustn't only aim for the highest reward, but also avoid blowups at all costs. That's why we shun single-exposure risk. If we don't make big losses at the fundamental level, most of the other outcomes are good ones. For this reason, we don't try to find rockets, but to avoid meltdowns



Finding rockets



Avoiding meltdowns

Therefore, we approach these compounders from two different angles, which are ultimately joined at the hip in the context of compounding:

1. Fundamental downside protection: internal diversification that ultimately reduces the risk of a blowup. We like deep and wide root systems.
2. From a return perspective: the ability to deploy capital with high returns through multiple small acquisitions of private companies – a growing tree with corresponding branches and leaves in full glory.

Teledyne

Teledyne's Henry Singleton, an early pioneer of the decentralized model and widely celebrated for his capital allocation skills over nearly three decades, may have shared a similar interest in plants and trees. In a 1978 Forbes interview, he said he saw diversification as insurance against disaster:

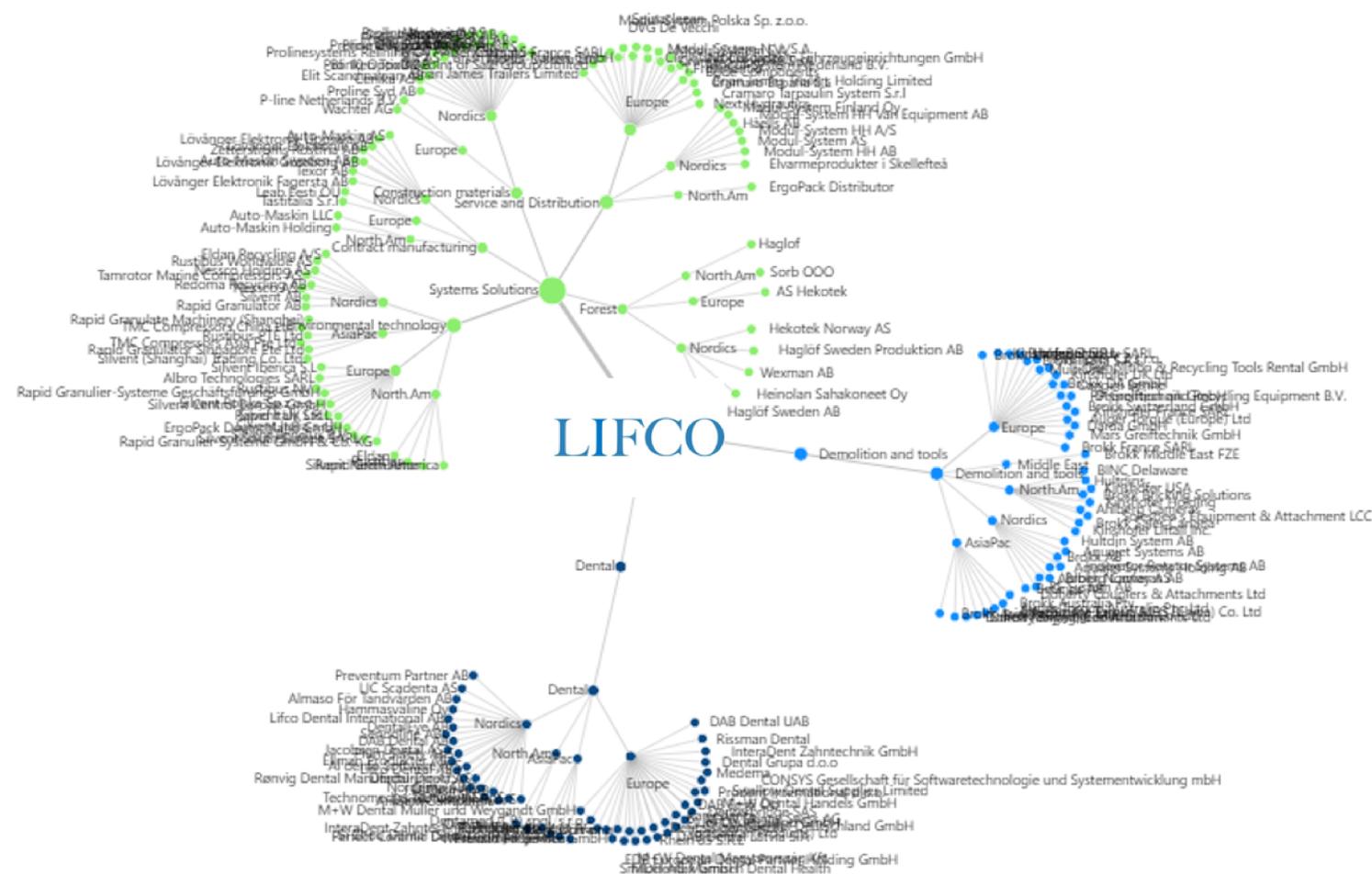
"Teledyne is like a living plant, with our companies the different branches and each putting out new branches and growing so that no one business is too significant."

Indeed, Teledyne designed a decentralized system of autonomy and ownership that collectively smoothed out peaks and troughs as well as any individual single exposure risk lurking around. It's fascinating to see how many lessons from Singleton and Teledyne are shared across high-performing conglomerates. Those investors who invested in Teledyne stock in 1966 earned an annualized return of 17.9% over 25 years, or 53 times the invested capital, versus 6.7 times for the S&P500⁴.



REQ CAPITAL
INVESTING WITH INSIGHT

The following organizational chart illustrates the extensive root system of Lifco, one of many high-performing serial acquirers from Sweden, with more than 200 companies across multiple niches and geographies:



Source: Lifco annual report

We, therefore, prefer growing trees with ever-expanding root systems. These structures should be celebrated for their compounding superpowers, but equally important is their ability to reduce idiosyncratic risk at a fundamental level.

Sources:

1. Myths and Misconceptions About Tree Roots Explained (treehugger.com)
2. The metaphor of root systems was originally inspired by a [blog post](#) (LibertyRPF) related to portfolio construction
3. A concept laid out by Ray Kurzweil
4. Distant Force: A Memoir of the Teledyne Corporation and the Man Who Created It (by George A. Roberts)



REQ CAPITAL
INVESTING WITH INSIGHT