Monthly Depth Report – June 2022

Medellin, Colombia and Evaluating Investment Risk

In our last letter, I let you know I'd be spending most of the month of May in Medellin, Colombia. It was my second trip to Colombia, and it's a fascinating and complicated place. The country used to be run by drug cartels, communist guerillas, a CIA-funded terrorist group, and of course, the police and "legitimate" government. Decades ago, Colombia was one of the most dangerous places in the world, and Medellin, the home of the infamous Pablo Escobar, was the most dangerous place in Colombia. Random shootings, kidnappings, car bombs, assassinations of government officials, and airline explosions were all part of life.

Colombia took an unorthodox approach to dealing with these issues. The country used the army and overwhelming force in the Communa 13 district of Medellin. It was a terrible event, but also an effective one as the neighborhood is now a safe tourist destination and arts community. Colombia not only negotiated with terrorists; it gave terrorist organizations a legitimate place in the government. It sounds awful, but the kidnappings stopped.

While Colombia has been safe enough for tourism for years, there are still issues. Tourist areas have armed guards everywhere. The hotel where I stayed had armed guards at both entrances 24 hours a day. Stories of tourists being drugged and robbed were prevalent. And on the flight there, I received information about armed protests related to the extradition of a drug trafficker.

I considered the possibility of catching a return flight when I landed in Medellin, but DKI is a research firm, and we don't make uninformed decisions. I looked up more information about the protests, and realized two things. First, an armed protest doesn't mean shooting. It's intended to be uncomfortable and to communicate seriousness of purpose, but if the protesters wanted to start a violent riot, they could do that without arranging a parade. Second, the protests were in the Antioquia region of Colombia, but not in Medellin. Leaving the country due to fear of the protests would be the equivalent of evacuating my home in Westport, CT because there was violence in Philadelphia. After all, they're both in the Northeastern US!

Evaluating risk is what we do for a living, so let's go through the process of determining travel risk, and figure out the parallels with stock market analysis.

First, neighborhood matters. I first went to Colombia around 13 years ago when the kidnappings had stopped and then again to Medellin last month because the protests were in a different neighborhood. It's the same in the stock market. We recently wrote an article on the dangers of investing in penny stocks on expectations that others would buy after you did, and the dangers of investing in meme stocks for no fundamental reason. Don't go into bad neighborhoods is good advice for both travel and the stock market.

That rule does have an important corollary. There are great advantages to figuring out when a neighborhood has changed and has still retained its old reputation. I had a wonderful and inexpensive trip to Colombia over a decade ago because while it still had the reputation of being a dangerous drug haven, the reality was it was safe to go to Cartagena, Salento, and Bogota as I did. It's the same in the investing world. I now own positions in gold, silver, oil, and Bitcoin that I would have never held three years ago. A rapidly expanding money supply and the ensuing inflation made me see the landscape differently. Sometimes, things DO change.

My old partner from Silver Arrow and member of the DKI Board of Advisors, Raji Khabbaz, often would say it's the leaders at the front of the pack that get the tall grass to eat (and a higher risk of being eaten). Years ago, we made a great return buying Las Vegas Sands after the Chinese government had lifted a crackdown on Macau, but before the market had adjusted to the ensuing improvement in business conditions.

Second, there are great advantages to being comfortable with complexity. Colombia is incredibly complex. Some people in Medellin won't say Escobar's name and refer to him as Voldomort. Others revere him and have his photo on the dashboard of their cars. I met people who were angry about the overwhelming use of force during Project Orion (when the army invaded Communa 13 killing both drug gang members and innocent civilians). Those same people also acknowledged that without the overwhelming use of force, the neighborhood would have never become the safe thriving artist community it is today.

Back in the mid-90s I spent years doing event-driven special-situations investing. Our willingness to deal with complex situations requiring multiple levels of analysis meant that higher returns were available. Sometimes, our investment thesis on ideas at Deep Knowledge Investing is simple and straightforward. Other times, we need to talk to dozens of industry experts, competitors, and people who ran divisions of companies to really understand a challenging situation. Being willing to wade in, do extra work, and understand a situation from multiple perspectives is an advantage for us.

Finally, in both investing and travel, there are important rules to stay safe. When I travel in other countries, I wear inexpensive clothing and a cheap digital watch with a plastic strap. I carry little cash and as an extra precaution in Colombia, avoided carrying an ATM card. I avoid any "red light" kinds of businesses, and treat everyone with polite courtesy. In Colombia, the person next to you may be armed and the argument isn't worth it. No drugs of any kind. No getting drunk in public. No walking with your head down focused on a cell phone. I follow these rules to avoid trouble, and if I'm in an area where there is trouble, everything about my demeanor communicates to the "bad guys" that there will be easier targets. While I have encountered some dangerous and uncomfortable situations through the years while traveling, the above rules have been effective at preventing anything really bad from happening to me.

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It's the same in the investment world. We look at things like free cash flow, and the quality of the balance sheet. We evaluate the quality of the competition and whether a company has a competitive advantage. We look for good businesses that should outperform over multiple years and avoid the cheap "value traps" that will always look cheap on declining performance. We try to figure out if management is capable or potentially corrupt. Finally, just like we'd exit a bad neighborhood while traveling, we can always sell a bad position if we've made an error in evaluating a stock.

On the topic of errors, we'd like to recommend this recent piece on the DKI blog. Jamie Dimon, the CEO of JP Morgan Chase, just warned of a potential "hurricane", or storm, or possible downturn in the economy last week. Besides the unhelpfulness of noting that eventually something bad might happen, we noted that he's both out of touch and late. For much of the country, higher fuel prices, higher housing prices, and food inflation are crushing many; even people who are employed and recently got raises. We also find it incredible that JP Morgan is just getting around to warning people that there might be issues. We've been talking to you and preparing subscribers for inflation, higher interest rates, and a falling market consistently since November of 2021.

If any of you have questions, concerns, or thoughts regarding issues we should address in a future depth report, please feel free to reach out to me at IR@DeepKnowledgeInvesting.com. If you think a friend, RIA, family office, or portfolio manager would be interested in this monthly commentary, please feel free to pass it on to them.

Thanks for being part of Deep Knowledge Investing,

Gary Brode

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