Kevin Duffy, editor **6/15/2022** Volume 3, Edition 2

THE COFFEE CAN PORTFOLIO

PORTFOLIO CONSTRUCTION
IQ vs. EQ

"In our portfolio construction, we are trying to maximize both our IQ [knowledge of positions] and our EQ (emotional quotient). Too few stocks will decapitate our EQ – we won't be able to sleep well at night, as the relatively large impact of a low-probability risk could have a devastating impact on the portfolio… We don't want to own so few that a small number of stocks slipping on a banana will send us into financial ruin."

~ Vitaliy Katsenelson, *Contrarian Edge*

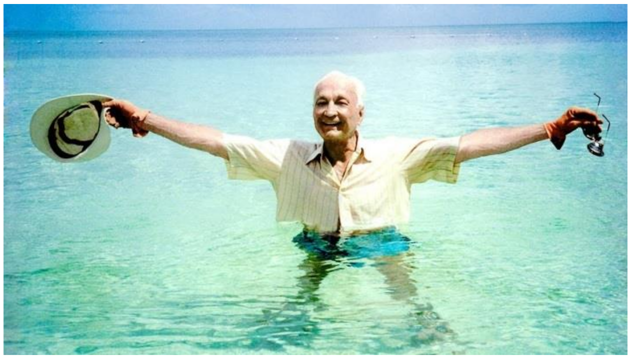
One way to increase your emotional quotient as an investor is to imagine multiple scenarios, especially those toughest on value-conscious investors. Bubbles are particularly vexing when garbage floats and quality sinks. Emotionally, it can be demoralizing when any fool can get rich by throwing darts while those thoughtful positions in your portfolio are being jettisoned by the crowd. This is why I like to own at least some stocks whose value is largely a bet on the future, a.k.a. "growth stocks." Bull markets stimulate the imagination and flatter the visionaries.

> RULE #9:
> IN A PANIC ALL CORRELATIONS GO TO 1. PANICS *ALWAYS* CREATE BUYING OPPORTUNITIES

Arguably, the most important scenario to prepare for is a panic in which *everything* goes down. Emotionally, it's tough to sell that stock that is only down 30% to buy the one down 50%. You need to have something working, or at least holding its own, during a get-me-out-at-any price meltdown, whether it is cash, portfolio insurance (put options, bear funds) or that rare antifragile stock (e.g., Walmart during the 2008 panic).

Controlling emotions internally and externally

Your IQ as an investor correlates with your investment process, not recent performance. "Never confuse brains with a bull market." (Readers in the investment business are probably laughing right now, saying, "Tell that to my clients!")



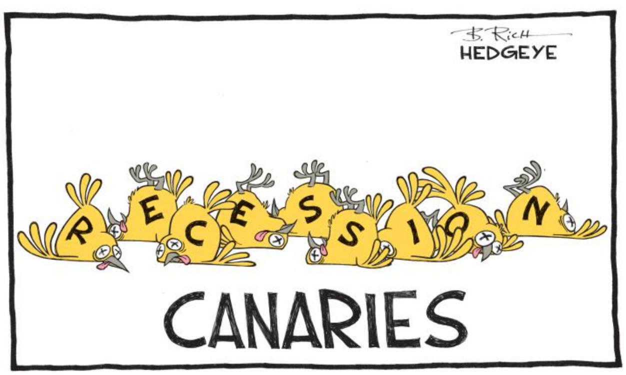
John Templeton in the Bahamas

How do you react when things are not going well? The changes I've made to the model portfolio over the past year have not exactly set the world on fire. I tried to catch falling knives in China and Russia and recommended five stocks at the end of last year that are down an average of 45%. Stretches where one looks dumb are inevitable in this business. Even legendary investor John Templeton underperformed the popular benchmarks by long stretches, up to four years in a row. Emotionally and financially, anticipate being out of synch for long periods and even getting it wrong at times.

At the external level, it helps to gauge the mood swings of the crowd and use that to your advantage. As Warren Buffett advises, "Buy when others are fearful and sell when others are greedy." "If you can keep your head when all about you are losing theirs... you'll be a Man my son!," wrote Rudyard Kipling in 1909, perhaps anticipating the speculative frenzy of 2021.

When it comes to controlling emotions, a sound framework is critical, including economic. As Jim Grant made clear in a 1996 interview:

> What we do is look for extremes in markets: very undervalued or very overvalued. Austrian theory has certainly given us an edge. When you have a theory to work from, you avoid the problem that comes with stumbling around in the dark over chairs and night stands. At least you can begin to visualize in the dark, which is where we all work. The future is always unlit. But with a body of theory, you can anticipate where the structures might lie. It allows you to step out of the way every once in a while.



Looking forward

No one is capable of predicting the future with certainty. We live in a probabilistic world. Accepting this reality requires humility and adopting a margin of safety.

In my humble opinion, the next act in this play is likely to be a drawn out bear market marked by the worst recession since the 1970s. That is a guess, not a guarantee. The model portfolio is designed to *survive* such a scenario, not bet it all on black. The probability that you, dear reader, assign to such a scenario is subjective, as is your plan of action.

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This is not to suggest that investors crawl under a rock. As always, we will keep searching for high quality businesses trading at a discount. Such bargains are far more likely to surface when the tide goes out. As John Templeton would say, "For those properly prepared in advance, a bear market in stocks is not a calamity but an opportunity."

The Coffee Can Portfolio

Kevin Duffy, editor
West Chester, PA

The Coffee Can Portfolio is part diary, part wisdom gained from over 40 years in the investment game meant to be shared with others. Trust me, I've made every mistake in the book. That doesn't mean you need to repeat every one of them. Failure is unavoidable, an essential part of the learning process. Embrace it!

I plan to publish every two months. The cost of an annual subscription is $109 which includes six issues as well as email alerts. If you wish to subscribe, go to www.thecoffeecanportfolio.com.

One goal in writing this letter is to build a network of like-minded people following a similar process. If you have feedback, a topic you'd like discussed, or an investment insight you'd like to share, drop me a note!

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RULES OF THE INVESTING GAME

1. FIND THE PARADE AND GET OUT IN FRONT.
2. PAY ATTENTION TO ADDICTIVE CONSUMER BRANDS.
3. GROWTH CAN HAVE A LONG RUNWAY WHEN BRANDS EXPAND NATIONALLY AND INTERNATIONALLY.
4. WHEN ANALYZING FAST GROWING COMPANIES, IGNORE EARNINGS AND FOCUS ON INVESTMENT.
5. BUY RIGHT AND SIT TIGHT.
6. ALIGN YOURSELF WITH PEOPLE WHO HAVE SKIN IN THE GAME.
7. AVOID THE CROWD AT ALL COSTS.
8. IT'S A MARKET OF STOCKS, NOT A STOCK MARKET.
9. IN A PANIC ALL CORRELATIONS GO TO 1. PANICS ALWAYS CREATE BUYING OPPORTUNITIES.
10. ADVERSITY REMOVES THE FRAGILE AND SPARES THE ROBUST.
11. CUI BONO? IN POLITICS, CONSIDER WHO BENEFITS.
12. THE RETAIL INVESTOR IS ALWAYS LATE TO THE PARTY.
13. BUBBLES ARE THE MOST DESTRUCTIVE FORCE KNOWN TO MANKIND.
14. SELL THE SHORTAGE, BUY THE GLUT.
15. BEWARE SIMPLE NARRATIVES.
16. BUY ON THE CANNONS, SELL ON THE TRUMPETS.