Importance of the underlying industry while investing in a business

This section was triggered by a question = what would you rather choose to own: a good business in an OK industry or an OK business in a good industry?

Going back to the topic of this section, the first question to answer is: how, and how much, does the underlying industry matter while assessing a business? Please note we use the words industry and sector interchangeably to mean the group of companies with a similar business model, catering to the same customer and/or competing with the business in question. Also, for the purpose of this section, we can refer to the industry either based on a broad or a narrow definition. That said, the narrower you consider the industry, the closer you get to the individual business, making this discussion less worthwhile.

As you can see, most of the characteristics in our framework do not directly reference the underlying industry. “Industry” only features in the second point under our third criteria of “Growth”. This observation might seem to imply that the industry does not matter much in our business assessments.

However, this is an inaccurate interpretation because the returns of any business are definitely influenced by its industry (more so as the considered industry narrows). This is best explained by Porter’s Five Forces that postulates the five key factors that impact a business: competitive intensity, power of suppliers, power of customers, barriers to entry and threat of substitutes. Clearly, all of these factors are characteristics of the industry that a business operates in.

Furthermore, there are some industries that seem to attract people of a certain disposition. Real estate and commodities are examples that come to mind. To be clear, it is certainly possible to find well-intentioned, capable and aligned promoters and management in most, if not all, industries. We are merely referring to the varying conditional probabilities of the same in different industries.

It flows from the above that all our three criteria of People, Returns and Growth are influenced by the underlying industry. **Thus, we conclude that the underlying industry does matter a lot while assessing a business.** This is hardly controversial, but was worth clarifying for what follows below.

Now, the next question becomes: once a business is assessed as high-quality, how much does the industry matter while selecting investment candidates?

Before we go further, let’s clarify some definitions that we will use to explain our thinking:

- Business
  - A great business is a business that we have assessed as high-quality, where the People, Returns and Growth are all assessed as High or Very High, as defined above.
  - A good business is a business that we have assessed as high-quality, but is not great.
  - An unacceptable business is one that is not assessed to be high-quality (at least not yet).
- Industry
  - A good industry is one where a majority of its businesses are good or great. The consumer staples industry seems to be a universally agreeable example of this.
  - Conversely, an OK industry is any industry that is not good.

As a reminder, we think that high-quality (good and great) businesses, are rare (<10% of investable universe), of which great businesses would be rarer. Hence, we would expect that a good industry should be quite rare as well, while OK industries represent the majority. Note that some businesses, and their industries, may temporarily look good, due to cyclical reasons (luck). We try to avoid these. Now, let’s look at the 6 (business, industry) combinations and understand which ones are acceptable to us (the sizes of the cells are an approximation for the frequency of the combination):

Industry / Business	Good	OK
Great	Best, rarest	Best, very rare
Good	Acceptable, very rare	Acceptable, rare
Unacceptable	Unacceptable, somewhat common	Most unacceptable, most common

With the above table, we wish to clarify that once a business is identified as high-quality (good or great), the underlying industry does not matter as much to us. Again, this is not such a controversial statement, though probably not as obvious or intuitive.

Finally, to the original question that triggered this section: what would you rather choose to own: a good business in an OK industry or an OK business in a good industry? From all that we have said so far, we are clearly not interested in investing in any OK business, assuming that an OK business is one that we have not (yet) confirmed as high-quality. So, this question is moot for us, since the former combination is acceptable, while the latter is not.

How about a variation of the same question, based on our definitions above: what would you rather choose to own: a great business in an OK industry or a good business in a good industry? This is a more interesting choice. **Consistent with the above clarification, we would rather own a great business than a good business, irrespective of the underlying industry.** We believe that a great business most probably has stronger competitive advantages compared to a good business, which is why it exhibits the better People, Returns and/or Growth characteristics. Moreover, a great business in an OK industry very likely has better competitive positioning than a good business in a good industry, as the latter competes with a higher number of good and great businesses within its industry.

As a final corollary, the (somewhat surprising) implication for the Fund would be this: We think that good businesses in OK industries will likely form the largest part of the portfolio. This is primarily because the “good business in OK industry” combination occurs more frequently compared to the other three acceptable combinations. Of course, all else equal, we would prefer to own more great businesses for aforementioned reasons. However, as indicated earlier, there are very few such great businesses, and moreover, they are seldom available even at reasonable valuations.

Eventually, the number of businesses we own in each (business, industry) combination will depend upon our circle of competence and the types of dislocations (market, sector, stock) that are available to us as we deploy our capital. To expand further, it is usually only the market-level dislocations, like the one that occurred last year, that offer opportunities to buy great businesses, especially in good industries, at attractive enough valuations.

Disclaimer: To make it abundantly clear, this is just how we choose investment candidates based on our investment philosophy – others may (and do!) think differently.