Hosking Partners®

Hosking Post
The Capital Cycle Way

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THE CAPITAL CYCLE WAY

"Your goal as an investor should be simply to purchase, at a rational price, a part interest in an easily understood business whose earnings are virtually certain to be materially higher, five, ten, and twenty years from now."

Berkshire Hathaway, 1996 Chairman's Letter

Portfolio Manager Omar Malik recently had the privilege of speaking at the 22nd Annual Value Investor Conference in Omaha, Nebraska in May 2025. We were impressed by the community of value investors that Bob Miles has gathered, spanning 27 countries at this year's event. As we watched Warren Buffett announce his retirement at the Berkshire Hathaway Annual Meeting the following day, we felt the speech below was a fitting tribute to the Oracle of Omaha and how we at Hosking Partners have taken inspiration from his unparalleled, dynamic, unconstrained and contrarian approach to investing.

I feel very fortunate to be speaking amongst some great investors and thinkers today. I couldn't help but make a personal connection to my journey as an investor, especially with Robert Hagstrom speaking later today. Robert's book *The Warren Buffett Way* was the first book I read on value investing at age 17.

I had found myself trading markets over that year and, unsurprisingly, was left deeply frustrated that I could not find a strategy that worked. I had heard of Warren Buffett, so I went onto Amazon and ordered the book at the top of the list. And this book changed my life. I realised that the stocks I was frantically trading had an underlying value and that, with a longer-term mindset, I could buy companies with a margin of safety. The light bulb went off, and I never looked back.

The book also has a link to what I want to talk about today – the 'Capital Cycle Way.' Robert ends the preface of his book with this quote from the 1996 Berkshire annual report, summarising Buffett's approach in a single line: "Your goal as an investor should be simply to purchase, at a rational price, a part interest in an easily understood business whose earnings are virtually certain to be materially higher, five, ten, and twenty years from now."

I call this the 10-year question because I have repeatedly heard some of the best investors ask slightly different versions of the same question. Venture Capitalist Peter Thiel stated, "Whether a business will still be here in a decade dominates the value equation." And he went on to say that "Silicon Valley overvalues growth rates and undervalues durability."

Nick Sleep, a member of Jeremy Hosking's global team at Marathon Asset Management and Co-Founder of the Nomad Partnership, asked, "What is the intended destination for this business in 10- or 20- years' time?"

And I thought it was interesting that in this room only yesterday, someone asked Charles Jennings, founder of Stone House, what lens he uses to analyse investments. His answer was, "Would I want to be a shareholder in this company in 10 years?"

It is a deceptively simple question. But if one is being intellectually honest, it is extremely hard to predict what a business will earn in 10 years. Also, Buffett sets a high bar - how can you be *virtually certain*?

Most investors in today's markets do not even attempt to predict the 10-year destination. An entire industry has been built around predicting the next few quarters, but even many serious investment firms focus on the next one to three years. The challenge lies in uncovering the insight into a business model that explains how it can endure the brutal forces of capitalism for the next decade. It is significantly easier to forecast a surge in demand over the next two years due to the release of a new product or the implementation of a new government policy.

Hosking Partners' capital cycle investment approach was formulated nearly four decades ago to address this very question, "How do you make long-term forecasts?". Jeremy Hosking had lived through a difficult period, having managed a technology fund invested in computer-related companies in the '80s. He had seen the folly of making demand forecasts firsthand. He and his partners were asking themselves what sort of approach would have credibility and a chance of success for three people sitting in London, with no army of analysts, and a small amount of AUM? This was in 1987, pre-Internet and the information age, and the world seemed like a very big place. The capital cycle approach, best captured in two books written by Edward Chancellor – *Capital Account* and *Capital Returns* - was his answer to this question.

Just as Robert Hagstrom laid out the principles of value investing and demonstrated how Buffett has applied them in *The Warren Buffett Way*, I will aim to lay out what I view as the key tenets of the 'Capital Cycle Way' today, and I will highlight how I think Buffett uses a similar lens to look at investments.

TENET 1: FOCUS ON SUPPLY

I would argue that the reason Warren Buffett is able to make these 10- to 20-year forecasts is by concentrating on supply rather than demand. The capital cycle best explains how changes in the amount of capital employed within an industry will impact profits and future returns on capital.

Central to the capital cycle approach is the observation that an industry with high returns on capital tends to attract new entrants. For incumbents, high profitability loosens discipline because management incentives often align with growth. Therefore, both groups will increase spending to capture those high returns. The behavioural pattern of herding often means all the players in an industry invest simultaneously. Other actors, such as investment bankers, act as a lubricant to the cycle, helping firms to expand capacity during the boom.

A key characteristic of this cycle is the delay between the investment decision and the new supply coming online. By the time the new supply arrives, historical demand forecasts are often shown to have been overly optimistic, creating an overhang. This causes returns on capital to fall below the cost of capital. As profits collapse, management teams are changed, spending is slashed, and the industry begins to consolidate. That contraction in supply eventually paves the way for a recovery in returns.

But how does this framework help you answer the 10-year question? Supply dynamics are more certain than demand and therefore easier to forecast. This is because increases in industry supply are often well-flagged by management teams. In certain industries, such as aircraft manufacturing and shipbuilding, the supply pipelines are well-known. New entrants will noisily announce their arrival into an industry. Other indicators of supply include the number of IPOs, secondary share issuances, and rising debt levels. As an analyst, putting all this together can provide an accurate picture of supply over the next 5-10 years.

The speed at which this supply comes online varies by industry. In the most extreme example, it can take nearly a decade for a new copper mine to start producing. This lag effect allows a supply-side investor to anticipate a glut before it hits the market.

It is also important to highlight the contrary scenario. Studying the supply side can help you identify companies that are likely to sustain their high returns for decades to come. The lack of competition due to a competitive moat prevents the supply side from shifting in response to high profitability and defies the typical mean revision in returns.

These cycles can take a long time to unfold. From new players entering to an influx of additional supply coming online, leading to profits being eroded and ultimately driving the consolidation phase, the process can take up to a decade. As an analytical tool, it is aligned with long-term investing.

All of this leads to insights with a long shelf life that are often contrarian, as you are drawn to areas with low returns today while avoiding popular industries that are benefitting from strong levels of current demand.

Focus on Supply Case Studies

The Warren Buffett Way: Railroads

Buffett's investment cases are often predicated on a supply-side focus, and his acquisition of BNSF Railway is a good example. In his own words, the railroad industry had a ‘terrible century’ leading up to his investment. But after following the industry from a young age, he became interested in 2006, why?

The industry had rationalised from over 100 players in the 1960s to just five. In the 1990s, a final wave of consolidation led to the formation of today's giants. The relative competitive position of railroads versus trucking had improved as oil prices rose, making the railroads the lowest-cost way to move heavy freight. No new capacity was being built. And after consolidating, driving efficiency became the focus, with the labour force falling by 90% and the introduction of new innovations, such as double stacking.

Putting that all together, as long as you believed that the US economy would grow over the coming decades, the structurally improved supply-side dynamics would lead to higher returns on capital in the future. He was not focused on demand because he acquired BNSF during the global financial crisis (GFC), the worst economic crisis since the Great Depression.

The Capital Cycle Way: Energy

At Hosking Partners, we observe a similar dynamic in the oil and gas industry today. The industry had a terrible decade during the shale boom and subsequent bust in 2016. Capex dropped 70% from the peak and has not recovered. Over the last two years, there has been consolidation, particularly in North America, driven by concerns around remaining inventory lives.

Given the amount of capital destroyed in the boom, management teams are now incentivised to return excess capital to shareholders. Importantly, for the global market, US shale has accounted for 80% of the new supply over the last decade, and we believe this expansion is plateauing due to increased capital discipline. As a result, we believe the companies we own in the energy space will generate attractive returns on capital over the next decade.

TENET 2: IGNORE THE EARNINGS GAME

If there is one quote from this presentation that I want you to remember, it's this one from Edward Chancellor, written in *Capital Account*. It is the essence of the capital cycle in two sentences: "Over the long run, it is a company's return on capital, not changes in quarterly earnings, which primarily determines the direction of its share price. The return on capital of any company is largely subject to the state of competition within its industry."

It is very contrary to the earnings game that most investors are playing. The market is obsessed with quarterly earnings. Companies set guidance, which forms the basis of 'consensus expectations', and every quarter, share prices react to beats and misses versus those expectations. This dominates all the news flow for four to five months of the year.

In three decades of annual meetings, we cannot recall hearing Buffett mention any part of this quarterly game. Instead, when talking about industries and companies, he most frequently references return on capital trends, accompanied by a view on competitive dynamics and the moat.

By ignoring short-term earnings and shifting our attention to where the return on invested capital for a business will be in five years, we naturally begin to focus on a different set of considerations.

Ignore the Earnings Game Case Studies:

The Warren Buffett Way: American Express

Source: FactSet. Price in USD for the period 31 Dec 1994 to 31 Mar 2025. The portfolio holds this security. Past Performance is not a reliable guide to future performance.

I believe Buffett's investment in American Express is the best example of ignoring the earnings game. It has been an outstanding investment. His cost was $1.3bn in 1995, and today the stake is worth $39bn. Including dividends, that is a ~33x in 30 years!

Over that period, there have been approximately 120 quarterly earnings calls with sell-side analysts fretting about the latest consumer trends and the macroeconomic cycle. Buffett held American Express through three recessions, including the GFC, and four peak-to-trough declines of 50% in the share price. And this is not a utility or consumer staple business. The noise level around the stock would have been difficult to ignore. He could only do this if he had a strong view on the supply side of the credit card business, just like in the railroads example. In this case, the strength of the 100-year-old American Express brand and network, as well as the model of charging premium fees and recycling that into better benefits for members, makes it extremely difficult to disrupt. In his own words, "It would be hard to think of anything that would destroy the brand."

The Capital Cycle Way: TSMC

Source: FactSet. Price in USD for the period 31 Dec 2013 to 31 Mar 2025. The portfolio holds this security. Past Performance is not a reliable guide to future performance

We have held TSMC since Hosking Partners' inception in 2013 — in fact, it dates back even earlier, if you include the years at Marathon.

The semiconductor industry is highly cyclical, and the news flow around the cycle is immense. Analysts are obsessed with questions such as: Are we at a peak or trough earnings cycle? Was that the last cut or the last beat? How many quarters will the trough last?

Our thesis for the last 15 years has been based on a simple insight: the foundry business would consolidate over time, given the ever-rising cost of advancing Moore's law. And that TSMC had the superior model, as a pure-play foundry, creating a true alignment with the customer, completely agnostic to the end market. Today, we feel that insight still holds. The scale advantage of TSMC's model has only grown as the industry has gone from over 20 players to just three.

It does not mean it has been an easy stock to hold. However, we have tried our best to ignore the earnings game and stay focused on the supply side. Over time, industry events continued to reinforce that insight. TSMC's position today looks stronger than ever.

TENET 3: FIND THE .400 HITTERS

The first two tenets of the Capital Cycle Way are focused on the trajectory of profits, but what the management team does with those profits is an enormous factor if you intend to hold the shares for a decade. Berkshire was created so Buffett could make those all-important decisions. But when he doesn't have control, he has an exceptional record of finding best-in-class management teams, about which he has said, "The important thing we do with managers, generally, is to find the .400 hitters and then not tell them how to swing."

After applying the capital cycle for decades, we have come to appreciate this too. How a management team responds to the capital cycle in their industry is critical. If they can act counter-cyclically, pull back when others are adding supply, and take advantage of downturns, they can create significant value.

The way I think about it is if you find one of these outlier teams, you can subcontract the capital allocation decisions to them. You can trust them to navigate the cycles instead of trying to time the buy and sell decisions. Peter Thiel says, "Many of the great companies that have been built over the last two decades were founded by people whose identities were deeply connected to their company. It was their life's project." For me, that has been a great clue for finding these outliers—someone with a great track record but also a deep passion for their industry. When you find these types of managers, you can trust them to make the right decision for the next decade.

Find the .400 Hitters Case Studies:

The Warren Buffett Way: Apple

With Apple, Buffett found his .400 hitter in Tim Cook. The following quote from Buffett on why he bought Apple brings it all together – the supply side and capital allocation: "I didn't go into Apple because it was a tech stock. I went into Apple because I came to certain conclusions about both the intelligence with which the capital would be deployed, but more important, about the value of an ecosystem and how permanent that ecosystem could be, and what the threats were to it."

At the time Buffett started buying his stake, the iPhone had already been around for a decade. The industry structure had stabilised from the supply side, Apple dominated the high-end smartphone market with >70% share, Blackberry had exited, and Android was struggling to make inroads.

By observing the behaviour of family members and customers at the Nebraska Furniture Mart, Buffett realised that the smartphone had become an integral part of people's lives, and the ecosystem Apple built around its products locked in the customer. Analysts underappreciated this insight and focused instead on a weak iPhone cycle in 2016, and so the stock fell to only 10x earnings.

But that alone would not have been enough for Buffett to invest. One of the simple but powerful patterns you see repeatedly in Buffett's public investments is entering at an inflection point in how capital is allocated, especially towards buybacks. Examples include Apple, Coca-Cola, American Express, General Dynamics, and many of his partnership investments. It reduces the risk of misallocation into a new business area or acquisition. And if the shares are cheap and you are right about the durability of the franchise, your ownership in the company rises over time.

Over the last decade, Tim Cook has overseen the largest share buyback in history, spending over $500bn, retiring close to 40% of the shares.

The Capital Cycle Way: Coupang and Altius

Here are two outliers I've discovered over the last three years in two very different industries.

Bom Kim, Founder and CEO of Coupang: Bom Kim's story is an incredible one. In 2010, he dropped out of Harvard to launch the Korean Groupon, which became the number one player but faced intense competition. In 2013, six months into an IPO process, he postponed the IPO indefinitely, recognising the flaws in the current model. He made his first pivot to a 3P eBay-like model, which he quickly recognised provided an inconsistent customer experience. At this point, he made his second pivot to a 1P Amazon-like model, but this involves building an entire logistics and fulfilment network because there is no UPS/FedEx equivalent in Korea. He raised billions from Softbank (pre-Vision Fund) and other VCs and spent the next eight years building an unparalleled customer experience from scratch that far surpasses the experience offered by Amazon today. If you order before midnight, the goods will be at your door by 6:00 AM the next morning. They will collect returns from your doorstep in recycled packaging. The delivery trucks can transport both goods and groceries, and the membership includes Coupang's restaurant food delivery service. In 2021, Bom made his latest pivot towards profitability, from losing $1bn a year to generating a higher margin than Amazon ever achieved in its home market of North America.

Brian Dalton, President and CEO of Altius Materials: Brian Dalton founded Altius when he was in university at the age of 17. At IPO, the only people to buy shares were his parents. The shares have since compounded at >20% for 30 years by originating and countercyclically acquiring very long-life royalties on base metals: copper, potash, and iron ore. By 2011, the company had built up a significant cash pile by monetising some assets. Brian then sat on the cash for *three years* waiting for the right opportunity. In 2014, his moment came with a crisis in the mining industry. He aggressively acquired three major assets, which set up the company for the next decade.

In both cases, we expect to partner with these managers for many years to come. We have a view on the supply side for each. In Coupang's case, the assets are irreplaceable, and Bom Kim will find more ways to extract the value from them over time. In Altius's case, we view the underlying commodities as underinvested. At the helm are two great capital allocators we trust to navigate the cycles for us.

TENET 4: REMEMBER REPLACEMENT VALUE

Even if you have a fix on the supply side for the next decade and you trust management to allocate capital well, you still need to buy at the right price! That brings me to the fourth tenet – remember replacement value.

It is a simple concept: how much would it cost to reproduce or replicate this asset? It is the driving force of the capital cycle. When companies are valued at a premium to replacement cost in the equity market, it creates an incentive to invest and capture that arbitrage. That is why venture capital and private equity funding is tied to equity market valuations.

It is far easier to calculate replacement value in asset-intensive industries with readily available data. But it is more of an art in other sectors, where the model is asset-light with a greater share of intangibles. In such cases, a question I often think about is, “Should we compete with this business instead of buying it?”

We have repeatedly seen that the market struggles to value an asset when the earnings are depressed. This is when you can buy at a big discount to replacement value, especially if there is no identifiable catalyst for improvement in the next 12 months. These big discounts drive consolidation at the bottom of the cycle. Strategic players with a longer time horizon have a better understanding of the costs associated with replicating a mine, factory, or intellectual property.

While I have not seen Buffett explicitly discuss replacement value, I will highlight two examples that demonstrate this concept is part of his thinking about valuation.

Remember Replacement Value Case Studies:

The Warren Buffett Way: Coca-Cola and Disney

In the case of Coca-Cola, Buffett thought about how much it would cost to compete with Coke and replicate their leadership. He said, “If you gave me a $100bn and said, 'Take away the soft-drink leadership of Coca-Cola in the world,' I'd give it back to you and say it can't be done."

In another quote, he discusses Coke's market capitalisation being $14bn at the time Berkshire acquired its stake. Buffett said if Philip Morris had tried to buy Coke then, they would have offered $30bn, which he doesn’t think they would have accepted. So, the shares were trading at 50c on the dollar, and Coke was buying back shares.

In the case of Disney, Buffett bought a 5% stake when the entire company was valued at $80mn. When released in 1964, the Mary Poppins movie generated record profits as the highest grossing film of all time, and investors were concerned that Disney could not replicate its success.

In describing the investment, Buffett felt that Mr. Market was valuing their vast film library, 300 acres of land, and Disneyland at zero. Again, he believed that if Walt Disney had gone to a strategic player, they would have paid $300-400mn. Disney was trading well below any sense of replacement value, and one could argue that the IP was irreplaceable.

The Capital Cycle Way: Coupang

Picking back up on the example of Coupang, how did we think about the replacement value?

Coupang operates over 130 fulfilment centres across South Korea, covering more than 47mn square feet. Over 70% of the population lives within seven miles of a warehouse, in a country with a shortage of usable land that is not mountainous or forested. In addition to its warehouse network, the company established a UPS/FedEx equivalent in Korea, employing over 15,000 drivers and a substantial fleet.

In total, we estimate it cost $9bn to build with no value ascribed to the brand, given that Coupang raised $5bn pre-IPO and spent another $4bn in capex post IPO. This took over a decade to build during a period of abundant liquidity with interest rates near zero. When we first identified the opportunity, the enterprise value was $18bn. I thought it was impossible to replicate the infrastructure, and if one were to try, it would cost significantly more than $18bn.

TENET 5: ALLOCATE DYNAMICALLY

Given the framework outlined above, how does a capital cycle investor allocate capital and build a portfolio? And are there any similarities to Buffett's approach?

Most would summarise Buffett's approach as concentrating heavily on single stocks. And there is no denying that he has done that successfully over and over again. But investors sometimes miss how dynamic his approach has been over time. We have observed him employ several tactics that we at Hosking Partners use when constructing our portfolio.

First, we concentrate a portion of the portfolio in a relatively small number of larger positions in what we call the 'top of the capital cycle' businesses. These are companies that are able to resist competitive industry forces to sustain high returns on capital. And we tend to own those winners for decades. Recent studies of Buffett's public portfolio show a high turnover in the number of holdings, but there are a few big holdings that he has held for a very, very long time. Buffett and Munger have been reluctant to sell what they consider an 'inevitable' business. In fact, when I asked Jeremy Hosking, a die-hard contrarian deep value investor, what the biggest lesson of his career was, I was surprised to hear him say that it was always a mistake to trim back the great businesses.

Second, we utilise smaller 'tail positions' to capitalise on opportunities with higher idiosyncratic risk that others cannot access, especially since most investors have confined themselves to a specific market cap range or style category. Buffett's 13F filings and the snapshots in appendix of *The Warren Buffett Way* show he has consistently held many small positions over time alongside the big ones. He clearly finds it hard to resist the opportunity to make money when he sees it.

Third, we often employ baskets to build a high-conviction exposure to attractive capital cycles that are best expressed with more than one company. I will expand on this point in the examples because I think most investors underutilise this tool.

Allocate Dynamically Case Studies:

The Warren Buffett Way: Baskets in Airlines, Railroads, Pharmaceuticals and Japanese Trading Houses

There are at least four examples of Buffett using (or considering using) baskets of stocks to express his thesis: airlines, railroads, pharmaceuticals, and Japanese trading houses.

Why use the basket? In Buffett's own words, “Sometimes it is hard to distinguish which players will do best.” But you may have a favourable view on the industry returns on capital after, say, a long period of consolidation, as he saw in the case of airlines and railroads.

Some may not be aware of this, but in Q1 2007, he initially purchased three railroad stocks and later consolidated his position to BNSF as he saw an opportunity to acquire one.

In the pharma example, Berkshire never executed it. However, he talked about weighing the decision to buy a “group of leading pharmaceutical companies at a below-market multiple. We had the opportunity to do it in 1992, but we blew it.” He again talked about how it would have been impossible to pick the winner, but as a group, they would do well over time.

The Japanese trading houses are the most recent high-profile example. It's challenging to differentiate between them, as each owns a wide variety of businesses. But all five traded at about 7x earnings, with a consistent record of growth and returning capital to shareholders through dividends and buybacks.

For me, this is the ultimate example of dynamic investing: How many investors do you know who like to buy great franchises would also buy a basket of five Japanese trading houses at deep value prices? And he was aggressively buying this basket during the Covid pandemic, when everyone was obsessed with technology companies.

The Capital Cycle Way: Amazon

The most vivid example of Hosking Partners combining tail positions and letting winners emerge was our team’s purchase of Amazon in the fallout of the tech bubble in 2002. Most are not aware of this, but Nick Sleep and Jeremy Hosking originally purchased Amazon in their Marathon days as a small tail position because it was difficult to fully appreciate the strength of the business model. Still, they saw something special there, and the valuation was very low! Over a few years, they worked out what Bezos was trying to build by recycling the benefits of scale into lower prices, and the rest is history. We still hold Amazon 20 years later.

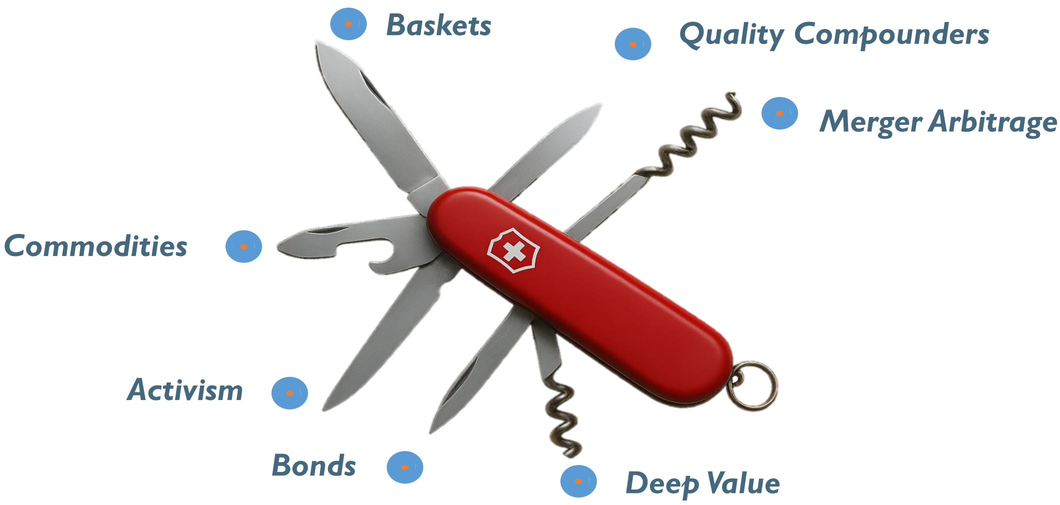
TENET 6: PURSUE THE BEHAVIOURAL EDGE

The final tenet is to pursue the behavioural edge. Buffett has proven his ability to be a contrarian and go against the prevailing tide countless times. This isn't easy to do. For me, the capital cycle provides the guardrails for being a contrarian. It can give you the intellectual backing to take the other side.

It naturally draws you to parts of the market where returns are depressed. Often, the demand picture will look terrible. But if you spot something positive on the supply side, you could anticipate an improvement before others and avoid parts of the market where others are extrapolating high demand and valuations are well above replacement value.

This investing style requires patience and a certain doggedness because you are often early, and these cycles take a long time to play out.

Buffett: The Swiss Army knife investor



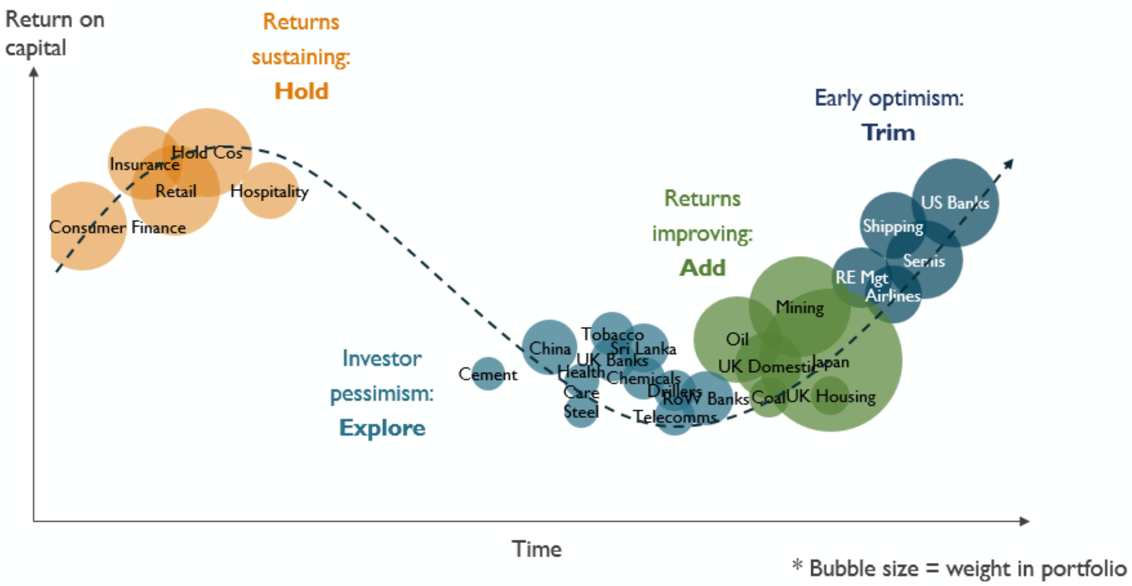
Source: Hosking Partners.

The final point I'll leave you with is that we are all guilty, including myself today, of singling out the parts of Buffett's approach that appeal to us. It is natural, as we all look for confirmation in the tough pursuit of outperforming. I am convinced that the capital cycle lens is one of Buffett's big mental models for the world.

But my ultimate takeaway from studying Buffett and attending these annual meetings is that he is the Swiss Army Knife of investing. Over his long career, Buffett has successfully invested in great compounders across a wide range of industries (i.e., Coke, Amex, Apple); deep value (i.e., PetroChina on a 3x P/E, as well as all the early partnership investments); activism (i.e., Sanborn maps, Berkshire Hathaway); baskets (i.e., Korean stocks, railroads, airlines, Japanese trading houses); merger arbitrage (i.e. Activision Blizzard); bonds (i.e., high-yield bonds in the fallout of the tech bubble); commodities (i.e., oil futures, silver, and more recently Occidental), among others.

Inspiration for a different way of investing

This unconstrained, dynamic and contrarian approach has been an inspiration for a different way of investing at Hosking Partners. The diagram below is a snapshot of our portfolio in May 2025.



Source: Hosking Partners. Cycle position is determined qualitatively. Weighting, May 2025

As you can see, at the top, we own bigger positions in great franchises that can defy the mean revision in returns when we can find them at value prices. We often hold these companies for a decade or more. But the majority of the portfolio sits at the bottom of the capital cycle, where we often start with tail positions and scale up over time. These two halves make us agnostic to "value" and "growth" labels. We often employ baskets when we see an entire industry undergoing supply-side reform. And venture in small caps and holding companies, where we often find some of the greatest inefficiencies. We invest globally, including frontier markets, to access the broadest opportunity set. And we occasionally taken an activist stance as long-term owners.

In my journey as an investor, both Warren Buffett and the Capital Cycle Way have been the inspiration for a different way of investing.

OMAR MALIK

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