Marshfield Associates

Letter to Clients
September, 2019

The Human League

"Men at some time are masters of their fates: The fault, dear Brutus, is not in our stars, but in ourselves, that we are underlings".

Julius Caesar, Act I, Sc. 2
William Shakespeare

It's no secret that competitive advantages, whether they flow from scale, technology, patent protection, network effects, or some other set of attributes or capabilities, help companies stave off competition and protect and grow market share. The relative strength and durability of those advantages are critical to determining whether a company has a true "moat" that allows it to sustain its competitive position vis-à-vis its rivals, both existing and potential. Industry structure also plays a role; natural monopolies or oligopolies such as railroads (where the original competitive advantage was getting there first with the capital needed to build out the network) help shield members from having to engage new entrants in an ongoing battle for position. While only one variable among many that make for a good company, competitive moats nevertheless tend to beget better margins and lay the groundwork for better returns. For investors, though, clear competitive advantages often don't come at cheap prices, especially when they're married to high-return businesses. So what's a value- minded investor looking for excellent companies to do? Our answer is to focus on "soft skills", those intangible attributes flowing directly from the human element in institutions. Soft skills can be just as durable and potent against competitors and would-be entrants as "harder" assets like technological prowess. They also offer other advantages, both to companies in the heat of competitive battle and to us as investors: they enable a company to differentiate itself in industries where technology has otherwise leveled the playing field; they can be very difficult to replicate; and, as an added bonus, they can be tough for other investors to understand and appreciate.

Penny pinchers that we are (and mindful of our own need to pursue a differentiated strategy), we therefore look not just for companies in structurally attractive industries such as payments (**Visa** and **Mastercard**), railroads (**Union Pacific**) and ratings (**Moody's**) or for companies that have strong intellectual property protection (**Waters**), but we also scout out high performing companies in industries that might at first look like they're purely commodity in nature. Just because the product or service a company provides is not easily differentiated from that of its competitors doesn't mean that the company and how it conducts its business are without singularity, however—or that such differentiation can't function as a moat. Industries like insurance, fast food, and certain kinds of retail are notoriously easy to enter but correspondingly difficult to succeed in at scale. The difference is that their advantages tend to reside in less visible attributes such as execution, discipline, the effective deployment of human resources and capital, and corporate culture.

When it comes to the sustainability of a competitive advantage, a technological edge is not always what it's cracked up to be. While we like technological barriers to entry just fine, the whiz-bang element can obscure the fact that some innovations have a pretty short half-life that's hard to distinguish from something more enduring. The same can be said for intellectual property, where patent protection is both time-limited and, at least in some areas such as small molecule pharmaceuticals, increasingly subject to limitations on green spaces in which to innovate. Moreover, what is often lost in all the hoopla surrounding technological innovation and the development and application of tools such as artificial intelligence and robotics is that technology, over time, is fundamentally a democratizing force. While first mover (or second mover) advantages may accrue for some period of time to those at the leading edge of adoption, much technology ultimately reaches all who can afford to deploy it, with any competitive advantage it confers fading as its use becomes pervasive within an industry. Areas as diverse as supply chain management, connectivity with customers, and marketing outreach have all benefited from the development of technologies that have eventually diffused to even the smallest players within a competitive set. What was once a point of differentiation, such as the ability to efficiently source just-in-time inventory from suppliers half a world away, has become standard practice, even if the particular technology and logistics services used (or the decision of whether to make them in-house or buy them through a third-party vendor) might differ. By its nature, though, competition never rests; it merely refocuses. And as the focus of competitive combat shifts away from problems (relatively) easily solved by technology, it moves toward problems less susceptible to technological fixes, either because they're more complex or because those problems, at bottom, are not ones that technology alone can readily address.

However advanced technology has become and however many elements of corporate activity are susceptible to technological solutions, there remain certain tasks that are irreducibly human (or at least will likely remain so during our investment timeframe). While this is no doubt an oversimplification of a far more complex reality, there is little doubt that at least some of the advantages of scale, ingenuity, and expertise, such as the abilities to attract customers at a distance and to source hard-to-find components have been diminished (in both cases, thanks to the internet). This is particularly true in commodity businesses. But as new opportunities open up for those formerly foreclosed by lack of reach or knowhow, the battleground shifts both to how well those new technologies are deployed and to areas outside technology's current ambit, thereby resetting the critical challenges facing today's companies. Increasingly, it seems, the battle is joined in areas that are distinctly <u>human</u> rather than technological in origin. The good news is that this is largely within a company's control; the bad news is that so few companies have a clue as to how to meet that challenge.

We were asked recently why we like the fast food industry when so few barriers to entry exist in the dining space—pretty much anyone can open a restaurant, successful food concepts can be mimicked, and the technology enabling both speed of service and supply chain efficiency is widely available. Not only that, but the array of competitors broadly defined is vast, encompassing pre-made meals in grocery stores, home delivery (enabled by advances in technology and third- party delivery services), and even easy-to-prepare meal kits. What's not as visible, though, is how difficult it is to achieve scale, to create and nourish a brand that stands for something the consumer values, and to get all of the minutiae right in the business. Scale still really matters in this business: it's what's needed to achieve purchasing economies, including everything from food and cleaning products to real estate and advertising, not to mention the reinforcing "success to the successful" network effects that ubiquity and consistency of product generate. Technology may make it easier for those without scale to access tools like scheduling software, but it's no match for the power of actual heft when it comes to procurement. Brand is built through the thoughtful creation of a resonant concept, consistency of experience, intelligent marketing, and an organizational commitment to reinforce the brand image in everything the company does—no mean feat for any business. And finally, deft execution: it may sound simple, but it's anything but easy. One of the reasons that we liked **Yum! Brands** for so long was the recognition that attention to details like clean bathrooms and employees with laundered uniforms, as reinforced by a culture that rewarded performance and fostered a sense of pride and ownership, were critical to success. Corporate management supported store management, allowing autonomy within the confines of a very encompassing culture. Turns out, the secret sauce is really not so secret, but the ingredients are notoriously hard to come by: discipline, a sense of common purpose and ownership of results, and the ability to block and tackle like pros.

When we sold Yum!, we did so partly in response to its stratospheric stock price, but also because we believed that the company was fundamentally changing as it morphed into a pure franchise operation. The top brass at the company are no longer the nitty gritty operating folks but instead come from the finance side of the business. While we have no particular beef with finance folks (!), it has, in our experience, been the exception when a former CFO is able successfully to transition to the role of CEO, especially in a business that's more about execution than financial gearing. From our point of view, the culture that prized operational excellence above all else—as epitomized by the joyful recitation of the Yum! cheer at annual meetings—looked to be (and, it turns out, was) imperiled. When a company's main responsibility becomes capital allocation rather than hands-on operations, it morphs into an essentially different enterprise, requiring a different set of skills. Were the company to get cheap again, we could see buying it—if management shows itself to be a top-notch capital allocator. But it would be an intrinsically different business from the one in which we originally invested.

With **Chipotle**, however, we believe we still have a fast food giant that will be run like a restaurant, not an annuity stream. Brian Niccol, the successor to the company's charismatic founder and himself a guy with long experience in the fast food industry from the brand management and marketing side of things (most recently, as the chief of Taco Bell), seems to have found the right balance between entrepreneurial energy and executional efficiency, taking an iconic brand beloved by millennials and making it run better and faster—but without losing its focus on good food in nice surroundings. It seems to have cracked the code on pick-up as well as delivery, and it still has plenty of room to grow, both here and abroad. Niccol has eschewed franchising, at least for the time being, with all restaurants continuing to be owned by the company. Although it has achieved sizeable scale, its approximately 2500 restaurants pale in comparison to Yum!'s roughly 49,000 and McDonald's roughly 38,000 global units. While it continues to have a culture that emphasizes employee empowerment and advancement, it doesn't promote that to the detriment of the consistency and integrity of the company's core products: the food and the experience. At its heart, Chipotle is a company in a commodity business that distinguishes itself by the seamless interaction of human and technological capabilities.

Ross Stores, an off-price apparel and home goods retailer, has been eating department and specialty stores' lunch for some time now. As a savvy deployer of technology, Ross operates a complex supply chain that stretches globally and is able to provide its 1500 or so stores fresh inventory from thousands of vendors on a continuous basis—new merchandise is received three to six times per week at the stores—in order to fuel the treasure hunt spirit that drives traffic to the chain. But while state-of-the-art technology is important to the business, what seems to really drive sales and operate as a moat to limit serious competition is its experienced team of nearly 1000 buyers (or "merchants", in the Ross lexicon) who operate out of bases in New York and Los Angeles, where they can keep their fingers on the pulse of fashion. The buyers are extensively trained and mentored on an ongoing basis by longer tenured members of the team. The company's culture is one of buyer empowerment and accountability, where merchants are encouraged to develop relationships with vendors and to exercise judgment and discretion, but are taught to do so within certain well understood parameters. In making opportunistic purchases of brand-name goods at substantial discounts relative to department and specialty store prices, they leverage both their fashion judgment and their financial acumen to find things that will sell at price points that help fuel the company's robust combination of inventory turns and relatively strong margins. By reviewing the merchandise assortments on a weekly basis, they're able to fine-tune the offerings by adjusting their assortment on a store-by-store basis. The collective knowledge and well-honed sensibility of Ross's merchant force is a competitive moat that allows Ross (and TJX, another fine competitor) to continue to take share from old line full price stores and to repel the advances of online merchants at the same time. Technology alone would not be up to that task.

Another adept user of technology in the retail space is **O'Reilly Automotive**. O'Reilly excels at getting the right auto part—however obscure—to the mechanics it serves quickly and seamlessly, allowing jobs to be finished with little down time. Less visible, though no less critical to its ability to take share and post industry-leading margins, however, is its excellent deployment of human resources. With over 5000 locations, it employs significant human labor in order to serve both the commercial "do it for me" market as well as the retail "do it yourself" market. A big part of O'Reilly's value proposition is expert personal service and assistance, both to the DIYer and to the professional. Stop by an O'Reilly any day of the week and you'll likely see an employee in the parking lot helping a customer swap out a battery or change an alternator. The company's culture of service (and recognition for it) is front and center and all employees understand and embrace it. But what really distinguishes O'Reilly is its long-time practice of promoting from within. Scratch the surface of management and you'll see people who started out sweeping floors, stocking shelves, and manning the registers. A company that distinguishes itself by hands-on service and deep knowledge of parts benefits from an employee force up and down the line that understands the customer's needs at a granular level. We believe that the company's ongoing theft of share from competitors in an industry that's not growing very much is in no small part attributable to this "soft" but strong competitive advantage.

We've talked a lot over the years about property and casualty insurance and how discipline, that most ineffable of qualities, is critical to success over time. Talk of discipline by industry members is rampant (and quite cheap), but the actual exercise of discipline is rarely in evidence, mainly because it's hard to put into practice. It means shrinking the business when pricing gets soft and either shifting capital to better uses internally or returning it to shareholders. **Arch Capital**, our lone insurance holding, puts its business where its mouth is. When pricing is inadequate to justify writing the policy, Arch puts down its pen. But it's particularly thoughtful about how it effectuates that pullback: it doesn't fire or furlough its underwriters, as that would incent those on the front lines of underwriting risk to keep writing policies lest they be laid off. As Dinos Iordanou, the former CEO, once told us, Arch is not so much in the insurance business as it is in the business of manufacturing decisions. Putting an emphasis on the human part of the business—the manufacture of decisions by people whose judgments will make or break the company—and aligning culture, compensation, and operations to support that is what has propelled Arch to the forefront of the specialty insurance and reinsurance industry. And it's what has allowed it to grow book value at double-digit annual rates. One of the key ideas in the insurance business is to be able to pick the best risks and to let others have the comparatively poor ones. Adverse selection of risks is an ever-present danger for those who are careless in their underwriting. For Arch to allow its competitors to take on the risks it declines represents a great source of competitive strength. Moreover, because Arch is not reluctant to reallocate capital to more profitable uses, it has successfully entered lines of business such as mortgage insurance in which competitors had been underperforming for years. Through better judgment and insight, Arch has been able to cherry pick risks and thereby undermine the competitive positions of others in the MI industry, thus gaining an advantage for itself in an otherwise pure commodity business. Although Arch uses forecasting models, data, and sophisticated analytics with the best of them, at bottom, its enterprise is a human one and rises and falls on the people applying those tools to make better judgments.

Non-asset-based logistics is an industry that is witnessing a fair amount of entry of late. But **Expeditors International** continues to gain share by taking on profitable customers that it helps navigate through the often chaotic world of air and ocean transport and customs and import requirements. Expeditors was the pioneer in eschewing ownership of assets (e.g., boats and planes) in this space, but competitors with even leaner operations (read: fewer human assets) have emerged in recent years. Interestingly, though, Expeditors' high touch approach is the margin leader, with 30% margins notwithstanding its continued reliance on people. The customs brokerage business, which accounts for almost 50% of Expeditors' net revenues and has higher margins than its transport business, is dependent on the expertise and experience of its employee base—especially in a turbulent trade environment such as this. The company's transport-matching and freight-forwarding business is similarly dependent on personnel: as Peter Rose, the company's founder, once put it, a package isn't like a person; it can't argue its own case, it needs an ombudsman for that. Excellent customer service and relationships with air and ocean transport partners keep customers coming back. Expeditors is so convinced that it's the people that matter most that the company's leaders consider their compensation structure a competitive advantage in itself. An incentive-based system that relies on both the profitability of the local business unit and the total company's operating profit, it rewards an employee for a combination of individual, regional, and collective results. While Expeditors is certainly no slouch in the technology department, to which its capex testifies, there is no doubt that the cultural and human elements on which the company relies are essential to its continued ability to command a premium for its services.

Investing is an (often frustrating) exercise in determining what matters and what doesn't. The information available on industries and companies is orders of magnitude greater than what is ultimately essential to an informed investment decision. Unfortunately, though, complicating the exercise of separating the analytical wheat from the chaff is the fact that not all relevant information is subject to quantification or neat, objective analysis. Much of it is inherently subjective and beyond that, pretty nuanced in nature. Let us go even further and assert the heretical: some information is better perceived and understood at a gut or instinctive level than an intellectual one. As an investor, one has to be receptive to the subtleties of a company's culture, the character and integrity of management, and the less visible capabilities bound up in its human assets. In the end, you have to be able to understand and gauge when a company's competitive advantage lies outside the analytically more accessible construct of (for example) industry structure, technological prowess, or intellectual property protection. We last wrote about culture and its particular importance to certain of our companies in 2015. Technology has advanced enormously since then, but the primacy of the human element in those and others of our companies has remained unchallenged. They are, to a great extent, masters of their fates.

A final thought: investing is also undergoing its own technological transformation. Passive management strategies like indexes and ETFs requiring little to no human input are expanding seemingly exponentially, factor investing, which algorithmically seeks to exploit systematic anomalies and correlations is on the rise, and "touch, experience, and judgment"-oriented active management is increasingly perceived as adding insufficient value to justify its cost. We would argue, though, that as computer programs continue to supplant human management, those elements unripe for technological applications become ever more important. The ability to understand and add value as to those elements rises commensurately. To date, computers have not progressed to the point that they can discern a good culture, assess the pros and cons of a management shuffle, or get a feel for what the uniquely human attributes within a company impart to the operational and strategic processes of that organization. We at Marshfield talk a great deal about how we're differentiated from our peers; we won't review that bidding here but will say that we believe that an appreciation and feel for the intangibles of a company is one of the most important of those ways. And just as our companies do, we intend to be thoughtful about how we meet and adjust to change in order to maintain that differentiated edge. We know our performance depends on it, and, ultimately, that's the value we provide our investors.

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