Marshfield Associates

Letter to Clients
February, 2020

Bondage and Discipline

"This ain't no party, this ain't no disco, this ain't no fooling around."

Talking Heads, Life During Wartime

We recently hosted a college intern for a day. His first question to us upon learning that we hadn't bought a new name in over two years was: "Don't you feel pressure to buy something?" (out of the mouths of babes, as they say.) The truthful answer is: hell, yes! But we also explained that a key element of our discipline was to learn to tolerate the discomfort of going against the flow in service to what we believe is right for our clients. Conventional wisdom is often at odds with our style; indeed, without daylight between the market consensus and our own assessment of a company, we would never have a chance to buy or sell stock in an attractive company at an attractive price. Unfortunately, however, while a divergence between how we and the market view a stock creates opportunity, it can also trigger a dearth of good, cheap equities to buy when the market is surging. Then, our only rational move is to hang tight and wait. But is there a point at which fidelity to principle goes too far—where a targeted relaxation of our discipline is preferable to sitting out a protracted buoyant market? Happily, we've seen this rodeo before. And because we've chosen to ride it out in slightly different ways over the years, we've learned a lot about the consequences of letting one's discipline slip even a little bit. Spoiler alert: given that the world has a funny habit of finding ways to make good stocks cheap at pretty regular intervals, loosening the reins of discipline out of impatience is, to our mind, neither necessary nor consistent with our mandate to protect capital.

As we use the term, "discipline" signifies a system of principles and practices that, collectively, effectuate our investment philosophy. To be "disciplined" means to adhere to such a system notwithstanding incentives to defy it. Discipline is not an end in itself; instead, it represents a tool by which an end—in our case, producing above-market returns for our clients while also seeking to preserve principal—can be achieved. To be effective, a discipline needs to have several attributes: it needs to address the root logic underlying the philosophy, it needs to be clear and repeatable, it should be able to be consistently applied, and it must be susceptible to after-the-fact audit. At bottom, discipline seeks to impose order and consistency on actions that can all too easily fall prey to whimsy and the vagaries of human emotion. In fact, we would argue that in an increasingly complex and information (not to mention disinformation!) rich world, the need for discipline in order to carve a path through the thicket of uncertainty becomes even greater. Because we here at Marshfield seek to profit from both the uncertain and the inherently unknowable—the future—we believe that the nature of our discipline and its alignment with our objectives are of particular importance. But we also know that, at the end of the day, our discipline is only as good as our ability to adhere to it and that, perversely, it is needed the most at times when it is most difficult to heed.

Building Our Discipline

Marshfield's governing philosophy holds that in order to achieve our goal of outperforming the market while safeguarding principal, our investment approach needs to be as different from the market as possible in ways that make sense on a risk-adjusted basis. Our discipline seeks to effectuate that philosophy of differentiation through the following: limiting our portfolio to a handful of stocks we understand well and that pass our stringent tests for good quality and strong returns; demanding price protection when we buy a new stock, as evidenced by a significant discount from our own estimate of intrinsic value; and selling a stock when its price is above reasonably optimistic underlying assumptions. Corollaries include a willingness to hold cash—sometimes large quantities of it—and an indifference to sector and industry diversification.[1] Each of these principles rests on a foundation compounded of both patience in awaiting opportunities that satisfy our criteria of price and quality and the willingness to tolerate the discomfort of charting our own path.[2]

A core insight animating our style of investing is that, as with all companies, the stocks of excellent ones—those that create value for their customers and in doing so are able to earn sustainably high returns for their shareholders— sometimes sell for really cheap prices. Over time, those low prices tend to revert back to something more realistic, at times even overshooting the mark and becoming overvalued. We think of stock price as similar to a bee buzzing around a flower; the bee may range wide of the mark for a while, but it will eventually circle back to the nectar, then get up and meander again. The second insight informing our investment style is that good companies hold and grow their value better and more consistently than do those in worse businesses or with worse corporate and cultural characteristics. Together, these two beliefs inform our discipline of buying demonstrably good companies for temporarily cheap prices.

When it comes to price, we tend to think of intrinsic value as a range of possible values based on assumptions spanning the spectrum from optimistic to pessimistic, with the "not too warm, not too cold" center of the range representing our best guess as to intrinsic

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1 The S & P 500 Index (a common proxy for the stock market), in comparison, is a broad measure of 500 stocks, is by definition always fully invested, includes all economic sectors, and is market capitalization weighted, with no pruning of expensive stocks and no doubling down on cheap ones.

2 By its very nature, nonconformity with the crowd, even for those of us with proclivities in that direction, can be uncomfortable, whether that takes the form of buying, selling, or simply waiting for the right opportunity.

value. By buying well below that, we do three things: we protect ourselves against an erroneous valuation, we safeguard ourselves against a misunderstanding of the company itself, and we build in a degree of immunity to unanticipated negative events. Valuation is anything but an exact science, of course. We base our valuation model on the belief that a share of stock represents a claim on a portion of a company's future free cash flow. But however good our understanding of both a company's business and its likely ability to generate profits over time, any valuation is, by definition, highly assumption-dependent.[3] We try hard to make assumptions that are grounded in some kind of objective reality and then insist on a wide discount to the value those inputs yield. To avoid situational relativism, our valuation template does not shift with the environment or the economy; its methodology is consistent across time and company type.

Unlike with valuation, we have no simple template for assessing company quality. We do, however, have a firmly held collective understanding of what makes for a good business and culture. Our process is designed specifically to flush out the relevant facts about a company, its business, the dynamics of the industry in which it operates, and its prospects over time. Through in-depth conversations with the company, the parsing of historical data and trends, a close examination of competitors, and a series of internal discussions designed to develop a conceptual bull and bear case, we believe that we can draw useful conclusions about the strength of a company's business, the resilience of its culture and practices, and its most likely future trajectory. If the key attributes of a good business and well-run company are not there, our discipline dictates that we not buy the stock. To further stiffen our spines, we employ several checklists that are designed to get to the heart of what counts. By posing questions about the structure of the industry (the level of competition, the general culture, the power of suppliers and customers, etc.) and the nature of the company itself (its strategy, management, culture, and competitive advantages), we attempt to ensure that each company goes through the same review process with the same tough qualifications demanded of it.

If a company passes our quality tests as well as our price requirement, we will buy it. If it fails either of those, we won't (though if it passes the former but not the latter, we will add it to our "buy at a price" shopping list). Perhaps one of our favorite items on our checklist is asking ourselves what biases we bring to the table. During a period of market frothiness, bias is typically made manifest in, among other things, the urge to buy something. Merely stating that aloud and in the presence of our colleagues is usually enough to break the fever. At the end of the day, our discipline and the process by which we effectuate it are

3 Notwithstanding this, we've built a model that we believe focuses on key inputs such as sales growth and margins but does not try to predict the future in too granular a manner, lest we fall prey to the "garbage in, garbage out" trap.

designed to keep us out of things every bit as much as they're designed to allow us to invest in things.

Disciplinary Probation

Of course, hewing to a discipline doesn't guarantee success; even if well suited to its goals, a discipline is merely a way to tilt the odds in favor of success, not to ensure it. Just as standardized test takers know that randomly guessing answers will create the possibility of a worse outcome than simply picking one letter and using it for every unknown answer (so long as wrong answers are not penalized)[4], so Marshfield believes that adhering to its discipline is more likely to effectuate its philosophy than adjusting its actions to change with changed circumstances. We also deeply understand that the impulse to tweak the discipline feels most urgent when that discipline is what stands in the way of doing something that might feel more comfortable in the heat of the moment. Even the most steadfast among us has fallen prey to the illusion that a small adjustment during extreme times will do more good than harm. We believe that our discipline—to the extent that we abide by it—is an effective way to counter that fantasy.

Having said that, while the point of a discipline is to stick to it, it need not be static; indeed, it should be affirmatively responsive to changed circumstances. The trick, though, is in not altering it to relieve the stress of the moment, but in allowing it to be sufficiently dynamic to account for true secular (as opposed to merely cyclical) change. We've found that striking when the iron is cold rather than hot is the best way to do that. While our discipline has sometimes been difficult to implement when it was at odds with what the market was offering up, we've understood both intellectually and viscerally that if you don't apply it when it's hard to do so, it's not really discipline. Notwithstanding that sense of restraint, however, we've experimented with incremental changes from time to time. What we've found is two things: well-considered process changes that advance our ability to apply and stick to our discipline can be positive, but fundamental conceptual changes to the discipline itself are much more dangerous—and should never be made under the pressure of a tough environment or as a response to lagging performance.

First, the process changes: while our philosophy and discipline have remained remarkably the same since our founding in 1989, our way of implementing the latter has changed over time. Increased firm size and a sympathetic ear toward input from new members of the research team trying to absorb our style and approach have led us over time to better codify and systematize our practices. In so doing, we were being responsive not to environmental pressures but rather to internal needs to have a more organized approach

4 Of course, wrong answers ARE penalized in our world, which is why (a) we like price protection and (b) we only "answer" when we're pretty sure that we're right.

than “seat of the pants.” Given that our aim is to have a process that is replicable from investment to investment as well as susceptible to post-investment audit if the investment fails, our somewhat casual approach to doing things when we were a young firm was suboptimal. Developing a process that must be fulfilled before investing and a parallel one that applies to companies already in our portfolio have worked to improve our basic blocking and tackling. Today, we know exactly where we are in the process (have we completed a valuation? asked management all of the questions we have? addressed every item on our checklist?) when we analyze a new name and we are well-positioned to make determinations along the way as to whether to continue with the process as we learn more.

Our forays into more fundamental changes to our discipline did not fare as well. In the late 1990s, when the world was awash in fancy IPOs and stratospherically priced “new technology” companies, the stock market’s high altitude ascent left us at base camp. We did then what we do now: we looked for cheap stocks that obscured good businesses. Try as we might, though, we couldn’t find things to buy that met both our price and our quality standards—and our performance suffered for it. We found ourselves behind the market—by a lot. When new accounts showed up in in the late 90s, we kept a hefty portion of the account in cash. While we earned a positive return for our accounts in 1999, they were up a mere 6.97% versus the S & P 500 Index’s heady climb of 21.04%. The complaints rolled in. If you remember those years, you’ll recall that investment clubs proliferated, with amateur investors besting many of the pros and with day traders making small fortunes. Still, we maintained our discipline.

At some point, though, it became too much; we decided to conduct an “experiment” on a modest scale, wherein we would buy “A” companies at “B” prices. In other words, we would buy what we thought of as excellence at full intrinsic value rather than at a discount to it. We tried that a few times but discovered, interestingly, that forcing ourselves to choose the “best” stock we could find caused us to let down our guard and select the kind of “consensus” stock we typically shy away from. In addition, with a gun to our head and without being forced to think hard about why a new name was cheap, we were less good at understanding why it was great. We had unwittingly created a disequilibrium in our process by breaking the link between price and quality. We ended up selling the companies we bought under this experiment after holding them a relatively short time. While we made money on the trades, we made materially less than we would have had we maintained our buy price discipline. Ultimately, the years 2000, 2001, and 2002 proved the value of our traditional approach: as the market sank by 9.10% and 11.89% in 2000 and 2001, we gained 17.57% and 4.77%, respectively. In 2002, when the market slid 22.10%, we lost only 0.85%.

Scroll forward several years to the mid-2000s and enter another free-wheeling market—the one where Chuck Prince of Citigroup ("Citi") observed that "as long as the music is playing, you've got to get up and dance." Yet again, we had no new buyable names on our dance card and were (mostly) content to be wallflowers. We were sitting on piles of cash, establishing the yet-to-be-topped high water mark of 28.3% of the portfolio. Yet again, we were struggling to find good companies to buy at prices that worked for us. Responding to the pressure to put the cash to work, we embraced another modest proposal, this time to buy "B" companies at "A" prices. Citi fit that bill nicely (though one can quarrel about whether even a grade of "B" was inflated). We had made money twice before in Citi, and so believed we were both familiar with it and appropriately cynical about its shortcomings. What we did not sufficiently appreciate was that flawed companies are more likely to be exposed to any underlying rot in the economy, something which became clear to us in 2007. Citi had pioneered the use of so- called "structured investment vehicles", or SIVs, to exploit the spread between long- and short-term instruments. To do that, many SIVs issued short-term commercial paper on the one hand, and invested in longer lived assets such as subprime mortgages on the other. When the liquidity crisis hit the commercial paper market, some of Citi's SIVs faced their own crisis, finding themselves at the mercy of a mismatch between long- and short-term securities. We sold half our position on that news, though the stock barely budged. We sold the remainder two months later, after the stock declined 20%.[5] As 2008 rolled around, we were quite happy that we held a portfolio not just of cash, but of "A" companies that were better able than their less resilient "B" and below peers to weather the storm.

Pressure to conform one's investing behavior to prevailing market norms also exists at the other end of the investing spectrum, when fear takes the place of ebullience, as it did in the midst of the financial crisis, as stock prices sank. The impulse to hoard cash—and indeed to sell stocks that seem especially exposed to risk—can feel irresistible. An important part of our discipline is to respond to opportunity as it arises, even if it feels uncomfortable as the rest of the world retreats into hiding. Accordingly, we have a list of stocks that we would buy at a pre-established price; if that price is reached, after a brief review to confirm that nothing secular has happened to undercut our investment thesis, our discipline calls for us to execute the trade. In the depths of 2008 and 2009, we were faced with just such a series of decisions. The great uncertainty at the time was how long the after-effects of the financial crisis would last and the extent to which valuations would be affected by a protracted slow growth environment (getting to the secular versus temporary question). While we resisted the temptation to sit on our cash, we did tinker with our valuations. We believe, with the full benefit of hindsight, that we should have adhered more strictly to

5 The stock has never fully recovered, trading today on a split-adjusted basis around $8 per share. We sold half at about $50 and the remainder at about $40.

our discipline and, instead of re-running our valuations with stricter growth assumptions, simply invested in those companies whose stocks were selling with the steepest discount to our pre-determined intrinsic value.

Because of our past experience, during the most recent—and lengthy—up- market cycle post-financial crisis, we knew better than to fool with our discipline as a way of responding to both external and internal pressure to put more money to work. So far, and despite the continued market surge and the discomfort of sitting on ever more cash, we've stubbornly adhered to our principles. Indeed, the impulse that we've had to work hardest to resist this go-round has been quite the opposite: the hesitation to modify our discipline in the face of objective evidence that it might be the right time to do so. Warning: this gets into some weeds, but we think it's important. One of the linchpins of our valuations is the "discount rate". The discount rate expresses the time value of money and is used in our valuations as a means of determining today's value of tomorrow's cash flow. A higher discount rate results in a lower present value and, therefore, a lower valuation. A lower discount rate results in the opposite: a higher valuation and therefore a higher price that we could, in theory, pay for a stock. For many, many years, we've used a discount rate of 11%, which is comprised of (a) the higher of a 4% risk-free rate of return or the 10-year US Treasury plus (b) an equity risk premium of 7%.[6] Given that the 10-year Treasury rate has largely been below 4% since the financial crisis, we have from time-to-time discussed whether or not this 4% rate was still appropriate. The long-term average 10-year Treasury rate has hovered around 4%, but since 2007, that rate has only been reached on a limited number of occasions.

As a result of this historical examination and a general agreement that, certainly for the short-term, likely for the intermediate-term, and possibly for the long-term, rates will be lower than the long-term historical average, we came to the reluctant conclusion that our thinking should more closely reflect the current reality. Accordingly, we implemented a change to our discount rate, pegging it at 10.5% instead of 11%. This affected our valuations, on average, by raising them between about 5 to 7%. Nothing, it should be noted, became buyable as a result of this change. Only time will tell whether we did the right thing but as of this time, we feel pretty good about it, especially since we made the change only after a lengthy review and in the midst of run of very good performance.

Self-Discipline

We've often said that good investors are born, not made. That's largely because temperament, perhaps even more than intellect, dictates the kind of investing approach

6 The equity risk premium as we define and use it is really a measure of what we are willing to accept as an appropriate return on our stock investments over time.

one is comfortable taking. With a collective inclination favoring the unconventional, coupled with a high tolerance for patience (not to mention a touch of bloody-mindedness), we are at home with our good company at bargain price formulation. But our goal isn't simply to identify good companies that we can "buy low and sell high" in order to make money on the spread; rather, it's to ensure that we have in place a critical insurance policy that can help buffer us against the consequences of any analytical inadequacies or surprise events. Investing means taking a series of calculated risks based on a careful reading of both the past and the present. But since the future is inherently unknowable, there is necessarily a predictive leap involved. Investing in the equity of even an excellent company, with all of the attributes we think critical to ongoing success (a wide competitive moat, a supportive corporate culture, excellent management, and demonstrated resilience) at a price at or above what it is worth risks a permanent loss of capital if the analysis is wrong. Together, a good price and a terrific company can go some distance toward mitigating the consequences of poor judgment or just plain bad luck.

And speaking of temperament, we know that our clients count on us to be able to withstand the myriad psychological pressures that impinge on good investment decisions. Our discipline, as supported by our process and built atop our natural inclination to stand apart from the crowd, is what helps us do that. So while it may look like we're not doing much right now, you can rest assured that we're not just fooling around.

Marshfield Associates

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