Letter to Clients
April 2020

To Catch a Falling Butter Knife

"Let's play Twister, let's play Risk....
*See you in heaven if you make the list...."**

R.E.M.

As each of us experiences days that feel more like years while under the cloud of fear and anxiety produced by Covid-19, we thought it would be useful to let you know in greater detail how we at Marshfield are approaching this crisis. To be sure, each of us, individually, is striving to keep ourselves, our families, and our colleagues as safe as possible. In terms of work, that means operating remotely—but not being remote in our approach to operations: we remain intellectually all-in, with arms linked and all hands on deck, supporting one another to the same (or even greater!) extent as when we're all physically together in the office. Yes, we take breaks to send around pet pictures, and we're working on the logistics of holding virtual birthday celebrations. But we all know that at the heart of what we do is safeguarding client assets and investing them prudently in anticipation of attractive risk-adjusted future returns. Unfortunately, and as is typical given our investment style, it is during times of turmoil and deep uncertainty that many of the best opportunities for taking advantage of stock market misjudgments can be found. While every crisis is unique in its origin, contours, and duration, each is identical in providing multiple ways to catch what are colorfully known in the business as "falling knives"—investments that look like great opportunities but that end up slicing through your savings. While we can't promise not to catch a falling knife (we will!), we spend a lot of time testing how sharp the blade is. If we do our jobs right, we will assuredly catch some knives, as it's impossible to predict a stock's bottom, but we will try very hard to grab only those with blunt edges.

Perversely, we seem at long last to have resoundingly answered the question that has been hanging in the air (and sometimes loudly aired!) during the last several years: what will we do if the stock market never goes down? In addition to permitting ourselves a sardonic chuckle or two, we are now getting down to the business of taking advantage of buying opportunities that have been out of reach for quite literally years. But while it may seem as though we should have an embarrassment of riches from which to choose today, our good company/good price discipline is such that notwithstanding the sharp market decline, many stocks remain out of reach and others seem to take pleasure in flirting with our buy price and then flitting off. We have worked hard to build reasonable conservatism into our valuations and the fact that a 20+% decline in the stock market has been insufficient to empty our cash coffers is testament to that, we think. As always, we remain content to wait.

What we are also trying very hard to do is to prevent the dramatic nature of current events from coloring our attitude toward spending our reserves. As Chris has told some of you: "We love our cash, we want to hug our cash; but we know we need to deploy it as opportunities present themselves." While we are fully aware of the potential for the pandemic to engender extreme economic repercussions both now and down the road (not to mention the devastating public and private health consequences), we also believe that the resilient, well-capitalized, and resourceful companies on our buy list will survive these dark days and continue to flourish over time, if perhaps not in the immediate term. Nevertheless, we understand those who ask us how, given the seemingly apocalyptic nature of these events, we can buy stock in companies that have no immunity to the downturn to come?

Our answer is: we do it in the same way we always have during times of great (apparent) market opportunity. We turn to our carefully compiled shopping list and buy only what we have fully vetted, at pre-established and deeply discounted prices. And, true to our long-established practice, we will only buy where we continue to have unanimity among our research principals.

There is a fine line between using current dire circumstances as an excuse to "hug" our cash and doing a last sweep of due diligence in advance of our final decision to send that cash out the door. The truth is that we almost always put our shopping list of stocks to buy at a price together at a time when the events that make the stock a bargain are not even a glimmer in our eye. But by the time a stock is cheap enough to purchase, it's typically surrounded by a cloud of deep popular distaste. At that point, it's up to us to make the final check in order to demonstrate to ourselves that the trouble the market perceives, whether real or imagined, is quite likely to be transitory in nature. So even in "normal" times when a stock like **Chipotle** becomes cheap due to issues surrounding food poisoning, we don't automatically buy if our buy price is hit. Instead, we will run our traps in response to that particular concern to determine whether it's likely to be temporary and have no lasting consequences (such as material exposure to lawsuits or enduring damage to the brand) before executing the transaction. In the case of an overall market rout reflecting real concerns about the economy, as we are experiencing now, we also check certain things before mashing the buy button: does the company in question have access to sufficient liquidity to survive a severe downturn? What kinds of things could cause a capital event that might threaten insolvency? Is the business particularly vulnerable to what's driving the negative economic forces right now? But if we've done our jobs correctly in the run up to this moment in time, we have already stress-tested the valuation and theory of the investment, we have already accounted for reasonably deep cyclicality in the coming years, and we have already anticipated a future where the sun is not always shining.

What we do not do (and here's where that fine line comes in) is totally re-underwrite the name based on current fears and biases. The fear of catching a falling knife, even for those of us trained to hold our fears at bay, can threaten to overwhelm any objective reassessment, carrying with it a constant (and consistently more conservative) recalibration of when it's "safe" to buy. That would threaten to undercut our discipline just as thoroughly as chasing high valuations would have two months ago. Moreover, and notwithstanding the possibility of a protracted period of ugliness right now, we all remain incapable of accurately predicting what will happen—and even if we knew what was going to happen, we couldn't anticipate how the market would react. Case in point: on March 26th, when it was reported that unemployment claims had soared to over 3 million, the stock market gained more than 6 percent. Acting as though we can foretell the future may be alluring to some but has always seemed to us a trap into which we don't want to fall, especially during the fog of war that envelops us all during a crisis. So while we are not averse to considering subtle adjustments to buttress our guardrails, such as sizing positions to limit certain exposures, we're taking care not to turn tail and run for the hills.

This doesn't mean, though, that we shouldn't air and explore our concerns. As noted above, while we're in the falling knife game, we like to think that the knives we're trying to catch are butter knives rather than carving knives. This is why, among other things, we look for companies that are resilient and that are willing to pull their punches as needed during the good times in order to preserve their menu of choices during the bad times. It's also why we have been spending the last several weeks touching base with our companies to assess their readiness for what might come. Perhaps most important, it's why we ourselves are prepared to pull our own punches unless the stars are properly aligned for us.

We long ago resigned ourselves to the fact that we weren't going to keep up with the cool kids either at the top or the bottom of the market by doing everything they were, whether it was buying fancy names in a go-go environment or pulling back entirely in a scary one. This reminds us of an acronym that was coined about ten years ago: FOMO, or fear of missing out. FOMO reflected the preoccupations of people on social media seeing that their friends were doing something that was way more fun than what they were doing. At Marshfield, we are long accustomed to missing out on many "fun" investments, because our careful, skeptical approach leads us to not purchase stocks whose stories do not seem justified when we do our analysis.

https://www.buzzfeednews.com/article/katienotopoulos/a-guide-to-the-latest-internetacronyms-yolo-vs

Almost a hundred years ago, two mathematicians (Jerzy Neyman and Egon Pearson) carefully considered the nature of hypothesis testing and recognized that there were two types of errors, that they called type I and type II errors. From our perspective, we think of these mistakes as errors of omission and errors of commission. Errors of omission occur when we do not buy a stock that we should have bought. Our rigorous process eliminates many companies that would seem reasonable at first glance but that reveal issues that make us uncomfortable with buying them when we go through our process. Errors of commission occur when after doing our extensive research process we decide to buy a stock that we should not have bought, either because our theory ends up not being supported by the facts on the ground or because the price we paid turns out to have been too high. Even with our lengthy process, there are sometimes cases where we buy something that we regret buying. We try to correct these errors as soon as we can and then we study this error in order to avoid repeating it.

What Neyman and Pearson realized is that there is a tradeoff between the two types of errors. If you think about, for example, a criminal trial, the error of omission is when you fail to convict a guilty party. An error of commission would be the conviction of someone who is innocent. Different types of rules govern different types of courts. Different societies and cultures place different weights (implicitly or explicitly) on the two types of errors. Courts with very tough rules on allowable testimony and evidence might avoid convicting the innocent at a cost of letting many guilty parties avoid conviction. Courts that allow prosecutors to use marginal evidence might sweep up the guilty at the price of convicting some of the innocent as well.

Similarly, in the world of medicine, some tests falsely identify too many people as suffering from a communicable condition, while others fail to identify people with that illness. In such situations, a test that renders too many errors of commission might be the better test. If a test identifies everyone with a disease (as well as falsely identifying some who do not have the disease), then we can quarantine all those identified as having the disease and perform additional testing to determine whom to treat and whom to release. As we can all viscerally feel today, a test that fails to identify some people who have the disease and releases them into the general public would not be as valuable.

No test is perfect in correctly identifying who is innocent and who is guilty, who is sick and who is well, and which companies we should invest in and which we should not. We, like legal systems and medical testing firms, continuously refine our methods to make fewer errors of both kinds than we made in the past. And yet our strong bias is toward avoiding errors of commission. The price of that bias is that we commit more frequent errors of omission. Up until a few weeks ago, almost every client meeting featured a discussion of what was doing well in the market recently and why we hadn't bought it. This was usually not because we hadn't thought hard about it; we run through our process on many stocks that are suggested to us. Some of them are fine companies whose price is out of line with our margin of safety (these companies often make their way onto our "buy at a price" shopping list). Others have been doing brilliantly, but we have been and continue to be uncomfortable projecting as rosy a future for them as their past might predict given the evolution of the market and economy over longer periods of time. Today, we find ourselves in the diametrically opposite position, with questions raised about whether it's safe to be in the market at all. But the same reasoning applies now as applied four weeks ago, albeit turned on its head. Perhaps counterintuitively, the error of commission in our case would be to come out the other side of this not having taken advantage of the buying opportunities presenting themselves. As noted above, however, that does not preclude us from making sure that what is spooking the market is something transient rather than intrinsic to the company or our theory of it.

In a recent conversation with Chipotle, which was reassuring on many levels, including with respect to both the company's food safety and financial preparedness, their head of Investor Relations said of the company's top management team that: "they debate, they align, and then they move". We think that's an apt characterization for how we at Marshfield operate. And as those of us at home play Twister and Risk with our families (what, you don't?), we will try very hard not to allow this crisis to cause us to twist away from our mandate or to assume more risk than we should as we catch those falling butter knives.

Marshfield Associates

* "Man on the Moon" Automatic for the People Concord Records 1992