Letter to Clients
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Let's Get Physical

"Plus ça change, plus c'est la même chose"

Jean-Baptiste Alphonse Karr

If capitalist economies tend to be characterized by creative destruction, then the meteoric rise of technology seems to have done to many business models what the K-T extinction event did to the dinosaurs.[1] Some of those traditional ways of doing business are still limping around (been to Best Buy or Sears lately?), but their days of commercial primacy are clearly over. From the perspective of an investor, taking out whole links in a long-standing value chain presents both an opportunity and a threat. Getting caught on the wrong side of economic history can extract a very heavy penalty in the form of a rapidly declining value proposition and a stock price that begins to reflect that well before the dire economic verdict is confirmed by the numbers. But siding with the "winner" is not necessarily a successful strategy either, as a new and better way of doing things often results in economic rents accruing to the consumer rather than to the owners of the company that is doing things differently and better.[2] Moreover, that new way of doing things may just be one step in a progression of change that continues to unfold. For our money, the best way to play the fast pace of change – especially technological change – is to understand and invest in what cannot change rather than in trying to discern which of the avatars of change is likeliest to win.

The irony is not lost on us that some of those companies that have misplaced their mojo due to a better, more efficient and customer-friendly way of doing business were themselves the destroyers of existing business models. The Sears catalogue revolutionized how middle class people bought everything from sewing machines to houses, bypassing the general store which had stocked and sold many of the items that could all of a sudden be bought more conveniently by

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[1] The Cretaceous-Tertiary extinction event occurred approximately 65.5 million years ago, wiping out huge swaths of plant and animal life at the end of the Mesozoic era. Scientists disagree as to the precise cause of this mass extinction but have posited such possible stressors as a massive meteorite or widespread volcanic activity. No dinosaur fossils have been traced to periods after the K-T event.
[2] The internet is littered with companies that have yet to turn a profit but that have won customers away from old-school competitors.

mail. Best Buy was in the vanguard of “big box” retailers that used their scale to negotiate better prices from suppliers and to drive efficiencies in how they ran their larger format stores, thereby hobbling both smaller and less focused competitors. Both companies had the advantage of being able to embrace a new approach without having to dismantle a legacy business at odds with it. Similarly, if Amazon and the other representatives of the new breed of e-tailer and just-in-time logistical magicians like Wal-Mart appear to be cleaning the proverbial clocks of the “old economy” dinosaurs today, it is in large part because the former were able to harness new technology without having to shed the remnants of a cumbersome pre-existing business model. The internet and digital technologies are simply the contemporary embodiment of the kind of creative destruction that is inherent in a competitive economy that rewards innovation. Accordingly, the ground today is strewn with examples of disruption caused by the advent of new technological know-how: newspapers and magazines, book publishing and even business travel have been threatened (if not yet essentially replaced) by their virtual doppelgangers. But while we may no longer read physical books and papers nor purchase compact discs for our music, we still wear clothing, drive cars, eat food and buy furniture. And every atom of those physical goods needs to be transported from one place to another – and often via warehouses, distribution centers and drop-off points at some distance from their ultimate destination.

So where do we invest if the agents of change themselves are so easily displaced by the next generation of innovators? And shouldn’t we be allying ourselves with technology rather than pitting ourselves against it? The good news is that there are certain kinds of businesses that provide services that are difficult if not impossible to displace but that are themselves able to employ technology to enhance both their operating performance and their returns on capital. Companies that move goods to and from those that use or sell them are providing a service that cannot be disintermediated (or not easily, anyway). It doesn’t take a sophisticated understanding of the law of conservation of matter to know that even in this brave new world of internet retailing and supply chain logistics, a physical good employed by a manufacturer or purchased by a customer needs to be transported by physical means.[3] Just as companies that build houses and apartments for us to live (and surf the web) in are also producing something that cannot be replaced, companies that move goods are a necessary part of the ecosystem of modern life. Until digital social networks are able to allow us to exist exclusively by virtual means and only in digital communities, we will all continue to need – and want! – the physical manifestations of a better life. While individual companies moving the goods that underpin our consuming lives are by no means guaranteed survival, and while others may figure out a better way to get the job done, the function they serve and the value they create is nevertheless impossible to do without. There is

[3] Barring, of course, the advent of 3-D printers that can turn out cars, pills and potato chips (whose constituent ingredients must nonetheless be transported to such printer)…

something irreducible about these businesses such that no change in fashion, no better mousetrap can, in the end, precipitate their extinction.

Though perhaps not as exciting as Facebook nor as groundbreaking as Google, companies like **Union Pacific**, **Expeditors International** and **C.H. Robinson** are the physical facilitators of the new economy. In an increasingly virtual world, physical reality represents a bottleneck to be dealt with as efficiently as possible. Hence the increasing importance of transportation services that streamline the process of moving goods and that allow companies to manage their inventory so as to reduce the amount of working capital they need to run the business. Union Pacific is one of seven Class I railroads operating in North America and one of only two that dominate the western half of the United States (the other is Burlington Northern, owned by **Berkshire Hathaway**). As such, it participates in an oligopoly that ships bulk goods which are difficult to transport other than by rail. While substitutes such as trucks and barges exist for some of their cargo and in certain of the geographies that they serve, much of what they convey has no realistic alternative to rail. As a result, shippers of bulk chemicals, grain, coal, pipeline construction materials, and aggregate are willing to accept rate increases, buy their own dedicated railcars (thereby saving Union Pacific that expense), and acquiesce to nighttime rather than daytime loading. Though it is clearly an "old school" transportation player, Union Pacific is no slouch in the technology department. It has leveraged advances in train and software technology to operate its trains at higher speed, move longer unit trains, maintain a superior safety record, and – perhaps most important in keeping customers from turning to more costly alternatives – increase precision in arrival times. In turn, these uses of technology and the recasting of basic railroad operations have elevated its margins and strengthened returns.

Expeditors International is a global logistics and freight forwarding company based in Seattle. It focuses on navigating the complexities of international trade, mainly on behalf of small and medium sized businesses that want to participate in the opportunities afforded by globalized commerce but without the costs associated with developing their own internal expertise. Among other services, they provide air and ocean freight consolidation and forwarding, customs clearance, and distribution and other value added logistics services. At bottom, what Expeditors does – and what to date it does better than its competitors – is facilitate the movement of goods across borders. Unlike conventional transportation companies, it does not own any vehicles, planes or ships to move the physical freight with which it is entrusted. Instead, it relies on more traditional asset-based carriers to move the goods. It employs sophisticated technology to locate the most cost- and time-efficient transportation solutions for its customers. Especially as cross-border trade becomes more pervasive and complex, with manufacturing and distribution facilities spread throughout the globe and with that the need to send and receive both component parts and finished goods to and from far-flung places, Expeditors allows smaller companies to enjoy the global reach of larger rivals. Expeditors' non-asset-based approach affords it flexibility and frees it from the heavy capital expenditures with which ocean freight companies, for example, are burdened. The main down-side of such an approach is that when carriers' capacity is constrained, Expeditors' input costs go up faster than they are able to pass along in the form of price increases to their customers. Along with slowing trade with Asia (the fear of which has weighed heavily on the stock), this mismatch accounts for the current margin contraction and softness in their business – something that has allowed us to accumulate a position in a company that we have been tracking for some time. The stock is down more than 30% since its peak in 2010, but although the business is highly cyclical, it is still able to earn high teens returns on capital (and even higher returns in more normalized environments).

C.H. Robinson is another non-asset-based transportation and third party logistics provider. It began life as a produce trucking operation, and it still sources and transports fresh produce – but the meat of its business is moving goods of all kinds via a network of more than 50,000 discrete transportation providers. Unlike Expeditors, whose business focuses mainly on air and ocean, C.H. Robinson has the largest network of motor carrier capacity in North America – for them, trucking represents about 86% of revenue. They also consolidate less than truckload freight, thereby allowing smaller shippers that want to send just a pallet or two to hitch a ride with other shippers. It has small regional sales offices throughout the world, a system that allows larger multi-location global businesses to benefit from both broad reach and localized service. The heavy sales component of the business belies its highly sophisticated use of technology to serve its customers efficiently and expertly. Like Expeditors, they consider themselves to be supply chain wizards, competing against less nimble asset-based carriers saddled with a physical fleet. While Expeditors' revenue is about three-quarters non-U.S., C.H. Robinson's revenues are mostly from within the U.S., with about 92% generated here. But while C.H. Robinson focuses on moving goods in the U.S., many of those goods have originated or are headed for elsewhere. Like Expeditors, its returns on capital are strong. Also like Expeditors, however, it is tied to a global economy that in the short run, at least, has been sputtering.

As these three companies demonstrate, you can build a better mousetrap but at the end of the day, you still have an actual mouse to catch. Creative destruction favors companies that give customers what they want in a better way. The apparently infinite malleability of cyberspace and the vast potential for digital advances have provided upstarts in numerous industries the opportunity to do this by rendering obsolete whole businesses. But while change may favor the fleet of foot and of mind, commerce can never fully rid itself of the fleet (pun intended). While the nature of goods that are produced may change (for example, electronics and their component parts have become smaller and lighter weight) or be en route to disappearing altogether (as in the case of things that themselves can be disintermediated such as CDs), the overall global demand for physical items is almost certain to increase as global GDP grows and as distant economies generate a culture of consumption. The taste for iPhones, denim jeans, pharmaceuticals, skateboards and refrigerators – perhaps adjusted for whatever the particular local tastes might be – is likelier to expand than it is to contract, as aspirational goals are what fuel a growing economy. The job of moving the materials needed to produce such items and then getting them to the ultimate customer or consumer in a timely and predictable manner is a job that can perhaps be refined through better and more sophisticated application of technology over time but that, in its broadest outlines, will remain largely unchanged. While the global economy may appear precarious right now, with Europe continuing to dither and China both decelerating and having to confront the wage demands of a rising middle class, the long-term bet that activity will once again steam forward is one we're willing to make. After all, one of the hallmarks of digital connectivity is seeing how other people live, and one of the axioms of human life (if not of physics) is coveting what other people have.

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