Letter to Clients
December 2016

Blood on the Tracks

"Mine were of trouble,
And mine were steady;
So I was ready
When trouble came."

A.E. Housman

We have a confession to make. We still listen to rock and roll—the old school variety full of sound and a certain amount of fury. And without dating ourselves too badly, we will further admit that one of our number gained his rock spurs at a Bob Dylan concert in 1963 when he was 12 and Dylan a mere 22. So the awarding of the Nobel Prize for literature to Bob Dylan this year caught our attention. It came as quite a surprise, as the award typically goes to someone who writes good but obscure novels and comes from someplace far away. It clearly came as a surprise to the artist himself, because it took him quite a while to even acknowledge receiving it. And not to be outdone in the surprise market, those who make it their business to predict who will win that prize—and who maintain lists of "likely" winners and even assign odds—were equally caught out. We're guessing that none of them even for a moment considered him as a possibility.

Each of us tries to make sense of the world around us. That by necessity entails having certain expectations about the future. For the most part, we expect things both to operate according to an inherent logic and to follow the same arc or cycle that they've traced historically. But as Dylan's Nobel tells you, sometimes these expectations are just plain wrong.

Surprises, Part I

The idea that expectations are wrong, at least some of time, is really important to understand if you're in our business. In the stock market, expectations set prices. The price you pay for a given stock on a given day is based on the consensus belief about the future. Often that consensus assumes that what has happened in the recent past will continue indefinitely, as our (and everyone else's) expectations about the Nobel Prize illustrate. Often the consensus is somewhat optimistic, though a haze of "bad" news can dim what might have been an otherwise sunny consensus.

For us, surprises present opportunities. They serve to disrupt the simple forward projection of the past, and in doing so they can catalyze interest in an out-of-favor name or put entirely new trades within our reach. The most sensitive to abrupt changes of sentiment are overvalued or undervalued stocks. Sometimes the market regards the surprise as negative and a previously high-flying stock comes down to earth. Sometimes the market regards the surprise as positive and an underappreciated stock takes wing. The trick about surprises is that while you know there will be some, you can't anticipate what they will be.[1] As investors, we simply have to stand ready to take advantage of them when and as they come.

Chipotle Mexican Grill (CMG)

Chipotle is one of the fastest-growing quick-service restaurants (QSRs) in the United States, serving its burritos, bowls, and tacos in more than 2,000 restaurants. The company could do virtually no wrong until the fall of 2015, when an E. coli outbreak in the Northwest, followed immediately by a highly-publicized norovirus incident in Boston led to a stock price decline of nearly 50% over a six-month time frame. In relatively quick order, Chipotle made a series of changes, some far-reaching and some more modest, with the intent of overhauling procurement and personnel procedures, ingredient traceability, and supplier selection and oversight. Because it sought to implement these changes without compromising what had made it successful in the first place—great tasting "food with integrity", prepared using traditional cooking techniques—it had to go through a period of experimentation before settling on what appears to be a nicely balanced approach.

Prior to the food safety issues, we had admired from afar Chipotle's success and expansion in a domestic market where few other QSRs of size could grow store count or same-store sales. But until 2016 our love remained unrequited; the stock's lofty price violated our price discipline. While the company's turnaround as measured by customer visits so far has been slower than anticipated, we feel comfortable that Chipotle will follow the path of many of its peers that have been stung by food-borne illness: slow but steady restoration of trust and traffic in the stores, and an ultimate return to the fundamentals of the business as they existed prior to the scare. With a significantly cheaper price today than one year ago, it makes the investment significantly more attractive. The food scare offered us an opening and, after further investigation into issues of potential liability, the likelihood of recurrence and the like, we satisfied ourselves that the market was probably overreacting to the surprise events.

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[1] Although in purchasing out-of-favor stocks, we implicitly believe that at some point, the truth (as we understand it) will out, per the Benjamin Graham metaphor of the market as a voting machine in the short term and a weighing machine in the long term. Those are not the "surprises" we mean; instead, we are talking here of actual surprises, things that are outside the realm of what is reasonably predictable.

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Surprises, Part II

The Chipotle food safety scare was a surprise that affected one company. But surprises, unsurprisingly, come in all shapes and sizes, and they can affect one company, one industry, an entire sector—even whole slices of the economy. The recent election is just such an event. We're not here to opine on the events that led to the unexpected result nor are we rendering an opinion on the outcome (though like all Americans we have our private views). And our intent is certainly not to suggest that the principal significance of hotly contested elections is their impact on the stock market. Far from it. But they also do affect stock portfolios, sometimes profoundly, and that is what we would like to examine here.

In the months leading up to an election, most of us know, or think we know, who we want to win. And we also know, or think we know, who will in fact win. Each of us at Marshfield has those thoughts. But we never let any of that creep into our stock purchase or sale decisions. We have a very strong bias against making predictions and investing on the basis of those predictions. However—and mind you we are talking about a relatively short period of time here—a number of our stocks have done quite well since the election. If we aren't in the business of predicting election winners, why should that be? Is it just luck? We don't think so. We strongly believe that it is because we are deeply contrarian, and tend to fill our portfolios with out-of-favor stocks. When any party has been in power for several years, one consequence is that industries favored by that party, as evidenced by an array of policy decisions both large and small, overt and implicit, will have done well; industries that have been out of favor with that party, also as evidenced through such policy initiatives, will have done poorly. We systematically invest in companies dismissed by the market. So when there's a changing of the guard, and particularly when that change occurs in a somewhat unexpected way, we are often in a position to benefit. We follow with two examples.

Goldman Sachs (GS)

After the financial crisis, legislation was enacted to address many of the perceived flaws in the bank regulatory system that, it was believed, helped lead to the cascading series of events that claimed as their victims Lehman Brothers and Bear Stearns, among others. Goldman Sachs survived and, controversially, even made some money betting against the status quo in the form of credit default swaps (but that's a story for another day). It and Morgan Stanley were both effectively compelled to convert to a commercial bank charter, which has subjected them to a panoply of regulations in exchange for the benefits of access to the "Fed window" and other emergency safeguards. Today, Goldman is the largest pure-play investment bank, as Morgan Stanley has opted to focus more on its asset and wealth management businesses. Goldman's core businesses are debt and equity underwriting, advice on mergers and acquisitions, institutional client sales and trading of securities, investing and lending for its own book, and investment management.

The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act significantly altered the landscape in which banks and certain other large financial institutions operate. Among other things, it increased the level of capital required to be held against risky assets like loans, it set minimum standards for mortgages, it created an independent financial consumer protection agency, and it sought to eradicate the doctrine of "too big to fail", which conferred on large systemically important banks the perceived benefit of government assistance during a crisis. It also attempted to end, via the Volcker rule, trading for the bank's own book, something that was believed to increase the moral hazard posed by banks using taxpayer dollars to place risky but potentially lucrative bets. But just as important for banks as laws and rules has been the more intangible but nevertheless discernible attitudinal environment of the past eight years. Enforcement actions have proliferated and penalties have been exacted (though the public's appetite for criminal convictions has yielded little of satisfaction). Perhaps not coincidentally, the financial crisis yielded to a political environment with little use for unconstrained banking activities.

We have been buying Goldman despite the more treacherous environment in which it operates. It has been our belief that notwithstanding those headwinds, Goldman would be able to compete effectively and earn a return on capital that justified our purchase price. While investment banks may never again be as profitable as they were prior to the crisis, the competitive landscape is now significantly more favorable for Goldman than it was just a few years ago. As mentioned above, many of the major investment banks that littered the landscape have gone out of business or merged into larger operations, while others (principally in Europe) have changed their business models in order to eke out a modicum of return. Goldman has maintained its hallmark flexibility which allows it to shift capital to its most productive and profitable uses without the hangover of legacy businesses that it no longer wishes it had. Finally, we think that its risk management culture—which helped it survive the crisis—serves as a primary differentiator and keeps it away from some of the systemic problems that its competitors have faced. Goldman's stock price, in both its view and ours, has been significantly discounted, and it uses that fact to its advantage by repurchasing stock at a cheap price. In direct contrast to the market, we have viewed the opportunity in a similar way.

And that's before you get to November's "surprise". Prior to the election, the market had not only discounted Goldman's ability to thrive under the new regulatory and enforcement regime but had projected those circumstances forward indefinitely. Goldman, on the other hand, has always adopted the approach of playing one card at a time, even in the face of what might appear to be certainty. While it has played by the new rules over the last eight years, it has tried not to allow the rules to play it—and as a result, it hasn't moved to dismantle operations in advance of statutory or regulatory deadlines. Despite the deadline for Volcker rule compliance having passed, for example, it retained some of its proprietary trading apparatus in service to market making on behalf of customers and it took advantage of ambiguities in the law (some might argue it pushed the envelope) in keeping a hand in private equity and commodity investments. Whether Dodd-Frank is repealed or diluted by the new sheriffs in town, Goldman stands to benefit from any loosening of the shackles that have bound it in recent years. The market now understands this and is duly rewarding the stock.

Strayer Education (STRA)

Strayer is a for-profit education company that offers academic instruction in both classroom and online formats. While the industry of which it is a member includes numerous institutions of questionable ethics and efficacy (Corinthian and ITT, to name just two), we believe that there is a role to be played in serving the needs of working adults and others who for one reason or another missed out on getting degrees in a more traditional setting. Strayer has a strong brand name, its students fare better post-graduation than those of the vast majority of its proprietary peers, it has an online presence that enables it to compete with both for-profit and not-for-profit competitors in the space, and it has solid leadership. Strayer has an excellent business providing continuing education to employees of Fortune 500 companies, which are increasingly interested in providing education as part of a benefit package for their employees. The wonderful thing about the corporate business is that it does not rely on federal student loan dollars and so serves as a bulwark against some of the more onerous Department of Education regulations of recent vintage.

The stock has traded well below our estimate of intrinsic value for quite some time. Prior to the financial crisis, the industry had flourished, producing some responsible actors but also fueling the rise of those simply interested in pumping up enrollment in order to feed at the trough of the abundant federal dollars made available for student aid, without regard to the quality of the education they provided. The subsequent crackdown was swift and unforgiving, mandating that for-profit schools lose access to federal dollars if they failed to hit certain marks not required of their not-for-profit competitors, such as demonstrating that a certain percentage of students who graduate are able to procure gainful employment. Unlike many of its peers, Strayer was able to hit its regulatory marks fairly easily, though the threat of increasingly stringent regulation caused it to tighten up recruitment practices, reduce tuition in certain areas, and move more aggressively to a corporate funding model. The stock market, however, remained unimpressed, pricing all for-profit schools at fire sale prices on the assumption that the regulatory flame would continue to burn and ultimately consume them all.

We, however, were confident that Strayer could navigate the shoals of a hostile regulatory regime and make money in the process. Our investment thesis relied on the theory that college was in effect the new high school and that degrees were prerequisites to leading a middle class life. Strayer caters to working adults who value ease and convenience—the capital structure under which their school operates is of little interest to them. Importantly, we think that while Strayer is not a perfect business and faces competitive pressures in particular from not-for-profits like Arizona State that are making successful pushes online, the business throws off a tremendous amount of cash even during a cyclical downturn, and it has significant operating leverage.

The advent of an administration that the market believes will roll back many of the stricter regulatory requirements and usher in a generally more hospitable environment for the for-profit sector was not something we anticipated either but our willingness to defy the market's expectations put us in good position to benefit from the surprise (at least in this respect) when it came to pass.

Concluding Thoughts

So where does all this leave us? We think these examples tell you a lot about how we invest. First, while we've highlighted only three of our 20 holdings, we think the spirit that animated their purchase is present in each of our stocks. Our portfolios look nothing at all like the broader market, and that difference is particularly important at inflection points like the one we've just been through, or at times of upheaval like the downturns in 2000 and 2008. Second, our deeply contrarian, deeply skeptical approach allows—even requires—us to stay far away from stocks or industries that the market loves. In 2000 we didn't own any tech stocks. In 2008, even though we often own financials, we owned just one bank heading into the crisis. Currently, we own no utilities, no telecoms, and none of the FANGS (Facebook, Amazon, Netflix or Google, to the uninitiated). Getting back to rock and roll, Fleetwood Mac, another group one of us kind of likes (the remainder demurs), had a song in the 70's called "Go Your Own Way". That's us. We go our own way.

Marshfield Associates

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