Letter to Clients
July 2016

Wall Street Stories

"All great literature is one of two stories; a man goes on a journey or a stranger comes to town."

Leo Tolstoy

One of the core elements of Marshfield's research process is our checklist. Before we buy a stock and after our research team has read, probed, debated, and analyzed to the point where we feel we are ready to make a decision, we run through our checklist to make sure we haven't missed anything critical. One of the deceptively simple questions on that list is whether we're investing in the story/concept or the company itself.

Investing is necessarily an exercise in extrapolation; some form of story-telling is intrinsic to the endeavor. Recognizing that, we try to distinguish between a *roman à clef*, which largely follows the breadcrumb trail of established fact to reach a satisfying conclusion, and a fairy tale that relies on the existence of a fairy godmother or prince charming to achieve its happily ever after. In essence, the distinction boils down to a determination of what must occur in the future in order for the investment to succeed; the more heroic or speculative the assumptions, the closer to fantasy the investment. There is, however, one way in which investing folktales and the narratives of our companies are similar: when their plots are stripped down to the conceptual essentials, both tend to follow a handful of familiar story lines.

True Stories

Build a Wall

An oligopoly, kind of a "monopoly lite", is an industry in which a handful of players, typically shielded from the rigors of competitive entry, compete in a rational and disciplined manner. An industry structure that settles naturally around a few incumbents and walls them off from new entrants tends to have greater stability than one rife with ruinous or irrational competitive behavior. While not all oligopolies have compelling economics (think utilities with heavy-handed rate regulation), many allow participants to earn high returns on capital over long periods of time. Among our holdings, **Visa**, **MasterCard**, **Moody's**, and **Union Pacific** operate within oligopolistic industries.

Visa and MasterCard are the Frankenstein monsters created cooperatively by banks in the early days of electronic payments as a means of authenticating and ensuring the integrity of credit card transactions. They performed their job well, but as cooperatives they had little incentive to maximize profit. Once spun off from the banks, though, they began to wield the power with which they'd been imbued. Today, their dominance of payments continues unabated, despite considerable ferment within the space. While new players focus on isolated components of the payments value chain such as merchant processing and mobile wallets, and while merchants persist in their complaints about the costs of the system, Visa and MasterCard continue to own the networks that route information among the various participants and, in our view, charge appropriately for their use. The two companies compete against one another with gusto but with an underlying rationality that precludes catastrophic warfare. In recognition of their centrality to the system, they earn operating margins in the mid-50s and higher. It doesn't seem much of a stretch to expect that as cash, their most significant competitor, gradually loses share, the leverage inherent in those margins should help them grow earnings relatively briskly over time. And while we anticipate that potential competitors and existing customers will continue to storm the gates of the castle, we think their supremacy is likely to hold.

Upstarts tilting impotently at incumbents features in the Moody's story as well. Breaking into the ratings business is demonstrably difficult; in the wake of the financial crisis, several firms attempted it—with much encouragement by legislators and regulators—but none was more than marginally successful. The grip on the industry by Moody's and S & P (as well as a handful of specialty raters focused on specific industries) remains tight. As a result, Moody's enjoys operating margins in the low 40s and a seemingly secure place in the ratings ecosystem going forward. Even with the recent withdrawal of much of the reliance on ratings embedded in laws and regulations, a Moody's rating continues to be viewed by the markets as necessary, while the companies that use or seek their ratings see no value in experimenting with alternatives. We believe that the persistence of this oligopoly is likely and that as global economic activity increases over time (and we think it will, despite such backward-looking expressions of public anxiety as Brexit and the attendant reactions thereto), Moody's is well positioned to share in the spoils.

The mere thought of creating a new railroad of size is laughable. Union Pacific is one of only two long-haul railroads with end-to-end networks in the western half of the United States. While the dominance of rail along certain routes has invited continued governmental regulation and rate scrutiny, railroads were largely deregulated back in 1980, reawakening their profit maximizing spirit. For certain products and commodities, rail transport continues to be the only viable means of long-haul transport. So long as people in this country continue to make and consume goods and require energy to fuel their daily lives, railroads should retain some degree of pricing power. Couple this with continuing (though perhaps more moderate) improvements in operating efficiencies, and you have a story that relies on rather modest assumptions about the future. Union Pacific is thoughtfully run (and competes with the other most thoughtfully run railroad in

the US, Berkshire Hathaway's Burlington Northern) and has a bountiful route map that gives it access to both industrial and agricultural markets, making for a story with little romance but lots of resonance.

Grow the Pie

There are no geese that lay golden eggs, but there are pies that grow faster than population and GDP. Companies blessed to find themselves in such industries are largely insulated from having to eke out good growth from share gains, a tough, bare-knuckle (and zero sum) game that can end up bloodying all participants. By contrast, companies whose end markets are likely to expand at a reasonably nice clip and whose unit economics are favorable are pretty easy to like. The key here, though, is that the pie expansion needs to rest on something other than pie-in-the-sky speculation. We need to see demonstrable evidence that not only has demand over time been growing faster than supply, but also that the factors responsible for that supply/demand imbalance are likely to persist into the future. And even then, in order to give wide berth to fantasy when we run our valuation model, we typically assume a growth rate below what the company itself believes to be achievable. We put **Deere**, **Strayer** and **YUM! Brands** into this narrative category.

There are a lot of twists and turns in the Deere story, but we believe our investment thesis is based more on time-tested reality than illusion. Deere has been mightily challenged in recent years by the opposite of what we just said we look for, as global demand for agricultural commodities has failed to outstrip supply. Historically, farm income has driven the purchase of farm equipment, especially the kind of big fancy machines that Deere manufactures. Perhaps counterintuitively, farm income can actually decline if there's a strong harvest in a crop for which demand is inelastic (i.e., lower prices don't cause people to consume much more of them). Because weather pretty much everywhere has been ideal for growing corn, wheat, and soybeans recently, farm income has languished. But you don't have to look far back in time to see starkly different growing conditions, making it essential not to confuse volatility due to the agricultural cycle with longer term trends. Far more important than cyclical volatility for farm income over longer periods is global GDP growth. But if we were simply talking about GDP growth, this story would be a yawn. In this case, though, higher global GDP begets increased food consumption featuring diets higher in proteins, which are far more grain-intensive to produce. You don't have to believe in enchantment in order to project that, over cycles, the pie will grow and if Deere maintains its market share, its slice of the pie will grow too.

If Strayer were a fairy tale, it would be the Ugly Duckling. What allows it to transcend its less than perfectly attractive industry is the fact that, notwithstanding the rain of plagues deluging the for-profit education sector, Strayer has worked diligently (and successfully) to transform itself into a company that is attuned to the needs of its students, that is less dependent on government funding than its peers and more heavily tied to corporate partnerships, and that hits its regulatory marks with a comfortable margin for error. If this were the full story, though, it might be a little too dull even for us. What makes

Strayer's an interesting tale is the growth in demand for post-secondary degrees (as well as for non-degree certificates) and the fact that in today's economy college has become the new high school—the degree without which it's very difficult to get a middle class job. Strayer's demonstrated appeal to older students in particular makes it especially appealing to us. There is little doubt both that excesses in the for-profit education industry have sullied the name of even those participants who take their scholastic mission seriously and that non-profit schools are making inroads into adult and online education. Still, while a growing pie will no longer feed all those vying for a seat at the table, it will likely sustain those who come with clean hands to partake.

As the global pie expands (and spawns such delicacies as the Chee-Zee Marmite Stuffed Crust Pizza in New Zealand), YUM doesn't have to do much to ensure its slice of the pizza keeps pace. The YUM story is a simple one, and we've owned it long enough to see it unfold largely as anticipated. YUM's US business is relatively stable, with the three brand concepts, Pizza Hut, KFC and Taco Bell variously contributing to or modestly detracting from sales at different points in time. Overseas is a different story. The narrative has been similar to that of Deere: as markets develop and tastes grow less regional, YUM benefits. While China's meteoric growth prior to the current slowdown supercharged YUM's expansion, we never believed that such growth was sustainable indefinitely into the future. More realistic is a reasonable but steady expansion as it builds its network of restaurants around the world, both in established and developing markets. Its strategy is one of sharp execution mixed with menu flexibility in order to cater to local tastes. It's simple to articulate but difficult to get right and, more often than not, YUM gets it more right than its competitors.

Maintain Discipline

We like to think of these companies as the strong, silent types. Discipline and resilience might not be exciting, but they are both essential and rare. Discipline in particular is absolutely mission-critical in financial businesses; we believe it to be the key to understanding why **Goldman Sachs**, **Wells Fargo**, **US Bancorp** and **Arch Capital** are simply better than their rivals. While discipline alone can't produce returns and negate the dampening impact on them of higher capital standards and prolonged low interest rates, it can confer a competitive advantage that allows for best in class ROEs and growth in book value. It can also ensure that the kinds of mistakes made while dancing until the music stops (in the immortal words of Citi's ousted CEO Chuck Prince) are mistakes made by others, not by them.

Discipline is hard to spot unless you know what to look for. It's a culture-driven quality that derives both from the individuals occupying the C-suite and from the general tone of the organization. While you can find evidence of it in the numbers, you can also get a feel for it from the way management expresses itself, the way the company responds to competition, and the kinds of (and prices paid for) acquisitions. Discipline is intangible but betrayed by actions, both those taken and those not. Each of our three bank holdings is characterized by a strong risk culture, a commitment to telling themselves the truth about those risks and an almost gleeful willingness to lose share when risk

outpaces reward. Goldman Sachs marks its book to market daily, with declines in the value of unhedged assets directly and immediately impacting their earnings, intent as it is on understanding the depth and breadth of any lurking hazards. Arch approaches its insurance operations with a finely tuned appreciation for risk; if prices fail to justify assuming it, they send their underwriters off to play golf. Both Wells and US Bancorp were happy to cede to Countrywide and Washington Mutual the market in exotic subprime mortgages and felt no need to follow them into the abyss. A culture of discipline cannot be thrust on a company like a mantle; it needs to develop and spread throughout an organization and be reinforced over time. Notwithstanding the fine sentiments expressed by their respective CEOs, a belief that Citi or Bank of America will be able to grow a shell of discipline, is, we think, as fanciful as expecting them to metamorphose into a giant insect.

Go Lightly

A lot has been written about new economy companies versus old economy companies, much of it farcical nonsense attempting to justify the high P/E at which certain tech stocks trade. And yet there is a certain truth to the characterization that some hidebound companies are so locked into old school strategies that they lack the flexibility to navigate an economy that, through the power of technology, has opened new pathways to create and deliver value. Companies that have found ways to shed the shackles of costly asset ownership and that have discovered how to exploit discontinuities in their industry value chain tell a story that's interesting to us. But that story must be buttressed by the prosaic details of meticulous execution and a deep understanding of what their customer wants. **Expeditors**, **Ross Stores** and **NVR** all fall into this category.

Expeditors, a non-asset based logistics company, caters to the needs of shippers without owning any of the underlying modes of transport such as trucks, ships and planes. It focuses on the consolidation and forwarding of air and ocean freight, customs brokerage, vendor consolidation, and cargo insurance, among other services integral to the movement of stuff around the globe. Expeditors' basic MO is to pick and choose from among carriers with the right price (which is constantly changing) and type of service (which is highly specific to the particular cargo involved) in order to transport goods efficiently and safely, while also shepherding customers through the gnarly process of customs regulations. By not owning the hard assets, Expeditors is able to flex and contract as business requires and also to exploit opportunities in the marketplace that it would otherwise have to bypass in favor of its own equipment. It is highly customer-focused, with a demonstrable culture of service, supported by an empowered global corps of employees. We believe that long-standing operating margins in the high 20s to low 30s, combined with the limited likelihood of another company being able to replicate its combination of asset-light but culture-intense give us reason to embrace the Expeditors story as one well-grounded in reality.

The off-price retailer Ross Stores follows a similar strategy by exploiting disruptions and discontinuities in the apparel and home goods value chains. Expeditors, though, is asset light; Ross is commitment-light. Rather than ordering all of its apparel months in advance of the season for which it was designed, Ross dips in and out of the marketplace, buying overstock unsold or unclaimed by its more traditional rivals. Although it is a brick and mortar mainstay of strip malls, its average basket is sufficiently low in cost that the Internet is unlikely to displace it, while its stock turns are sufficiently high as to foster a treasure hunt mentality among its customers. Paradoxically, the existence of a similarly oriented competitor only seems to enhance its status as the place to head for one-off bargains, as TJX frequently locates its stores (and vice versa) near those of Ross, enhancing and extending the pleasure of the hunt for their customers. As stores like Macy's and Nordstrom attempt to mimic the Ross strategy, we anticipate that they will find themselves not only competing against a buying organization honed over decades but also struggling to address the conflict inherent in running a full price business as well. Projecting that Ross can continue to execute and that the world, awash in overstock, will continue to be well supplied seems less fairy tale than reasonable expectation.

It continues to mystify us why no other publicly traded homebuilder has sought to replicate NVR's strategy of optioning rather than owning land. NVR's death and resurrection in the early 1990s taught it the hard way that being long land was a double-edged sword, and that its job is to build houses, not to speculate on the price of real estate. Liberated from the burdens of land ownership, NVR has been able to expand and contract in response to the highly cyclical demand for new construction. Having made money in every quarter save the fourth quarter of 2008 despite the worst housing crisis in recent memory, it remains one of the most resilient of our holdings. While we certainly understand that what is past is not necessarily prologue, it definitely skews the odds. We feel comfortable that NVR will be likely to continue growing revenues and earnings nicely over the course of a cycle.

Fairy Tales

Of course, classic investment fairy tales also conform to a series of archetypes:

Little Red Riding Hood

At points of inflection such as management changes and strategic turnarounds it might be tempting to assume either continuity in the case of the former or likely success in the case of the latter. But risk abounds when a critical component of a company's constitution undergoes a transformation. Material change can presage trouble; at best, it represents a leap into the unknown. One of the reasons that we sold Brown & Brown, having originally bought it because of its focused and cost-conscious acquisition and operating strategy, as further reinforced by its strong and effective sales culture, is that the dynamic founding CEO retired…and after a long search, settled upon a close relative as the best candidate to replace himself. While this did not have to be the case, the new CEO turned out to indeed have had a gift…of superficial impressionism: he

talked the talk, complete with resonant references to the storied culture of the organization. But his actions told a different tale. He overpaid for progressively larger acquisitions and oversaw the departure of a series of experienced managers. In short, though he sounded like grandma, he was really just a wolf dressed up in her nightclothes.

Jack and the Beanstalk

Companies' revenues don't grow to the sky. If nothing else, the law of large numbers—not to mention competition—will see to that. Sometimes this is just a point about valuation and sometimes it is more profoundly a point about the fanciful nature of the underlying analysis. Once upon a time, Coke asserted that it would essentially sell a can of Coke to every man, woman and child on earth. And its market cap suggested that investors were drinking the Kool Aid too. Several million bottles of water later, it appears that the company's bean counters were basing their projections on the magic kind.

Rumpelstiltskin

Variations on the tale of spinning straw into gold abound in the investing world. It serves as the basis for many a fraud plot but also as the foundation for the more banal story line that the future will surely be better than the past. We ourselves have been beguiled from time to time by the conviction that a seemingly underpriced company, with the right management and incentives in place, would be able to make something more of itself. The most recent such case in point was Leucadia National, where CEO Richard Handler replaced founders Joe Steinberg and Ian Cumming several years ago. Handler was the longtime head of Jefferies, one of Leucadia's biggest holdings, and, according to Steinberg, someone who had been responsible for sourcing a series of hits for Leucadia. The problem was that Jefferies, an investment bank, had never earned very good returns on equity. Our assumptions that the new world order of more stringent regulation would jump-start the less regulated Jefferies and that Handler would be able to reprise his role as the source for excellent merchant banking ideas turned out to have been wishful thinking. Having made decent money over a long period of time with Leucadia, it took us a while to be convinced, but we finally understood that we were being spun a yarn. Happily, we sold the stock after giving up a necklace and a ring but before having to proffer our first-born child.

The Three Billy Goats Gruff

There is a paradox central to the understanding of certain industries in which the rational actions of participants lead to a result that is at odds with the interests of those same rational actors. What we refer to at Marshfield as the collective action problem is really a close cousin to the tragedy of the commons, wherein a shared but limited resource gets depleted because immediate self-interest is in conflict with the longer term common good. The limited resource in the collective action problem, however, is

not a physical good such as pasture land overgrazed by sheep or goats but something more ephemeral, namely demand. Take, for example, the case of growth in the number of people engaged in travel: this growth leads quite rationally to more hotel rooms being built. But there is no perfect way short of violating the antitrust rules against collusion for this to be accomplished without the risk of overbuilding. So while it is in the individual interest of Hilton and Marriott, for example, to encourage an increase in the number of rooms in a particular location when demand surges, the fact that they are both doing so simultaneously might actually work to their collective detriment. This problem is only intensified where there is a long lead time for new capacity to be brought on line. We saw something similar occur some years ago in the power generation industry, when regulations allowed power to be traded and new plants arose to capture demand for peaking power, resulting in enormous overcapacity in that industry that had to be absorbed over time. The trick in industries such as these, to the extent that their economics are otherwise attractive (yes, in the case of well-run hotel brands, no in the case of power generation) is to time investment to coincide with the height of the overcapacity and to sell before the next round of excess. The fantasy underlying ill-timed investments in such industries is the growing pie; but rather than a pie, it's really a rising soufflé—and we all know where that leads. Expecting a company to escape punishment after either overburdening limited resources or overproducing supply is to underestimate the nastiness of the troll beneath the bridge.

There is a reason that these fairy tales are so tantalizing: flights of fancy in investing appeal to the romantic in each of us at the same time as expressing an optimism about the future that the companies themselves work hard to make us all buy into. But we consider our role to be that of the grim empiricist, resisting tales confected from pretty theories and derring-do and embracing only those that are grounded in demonstrable fact. While the future is necessarily uncertain and the facts of yesterday and today might yield to the unanticipated realities of tomorrow, we believe that the stories our companies tell require relatively little in the way of fancy embellishment to make them compelling. And while our companies could always fall prey to the hungry wolf, angry giant, dastardly imp or pugnacious troll, our reading of the evidence suggests that a happier ending is more likely to await them.

Marshfield Associates

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