Letter to Clients
June 2012

A Fistful of Dollars

"There's money to be made in a place like this."

Clint Eastwood

We've been getting a lot of questions lately about the twin threats of the "fiscal cliff" and events in Europe. For determinedly fundamental investors like us, these questions pose a couple of dilemmas: first, what can we know about these macro threats that everyone else doesn't know (and can we be right, other than by luck); and, second, even if we were to believe that we knew something, what could or should we do about it?

Fortunately, we think we've gotten some good advice from some famously good investors whom we've heard talk lately. On June 5 we heard Warren Buffett at the Economic Club of Washington, and a few weeks ago we attended Leucadia's annual meeting, where we got to listen to Joe Steinberg and Ian Cumming discuss their company and respond to questions, some of which were our own.

Buffett was succinct and to the point. Although he seemed to be, as we and everyone else seem to be, worried about the mess that the Europeans are creating for themselves (and possibly others), he is optimistic about the U.S. over the medium to long term. He pointed out that real GDP per capita in this country has gone up by five times in his lifetime, notwithstanding the Great Depression and the various wars and economic downturns. As he put it, "Our country works."[1]

Joe Steinberg and Ian Cumming made a similar point, even though their political and investment philosophies are quite different from Buffett's. Cumming made a point that we agree with and feel is worth remembering: "No one I know can see the future." But he added, "What is going on in the world right now is scary." He went on to say that "[d]urable companies are important when there are ups and downs in an economic system." This concept of durable or, as we call them, resilient companies is a critically important aspect of our risk control at Marshfield. Resilience captures or reflects important aspects of companies we want to invest in: can the business be managed in such a way that it can adapt to a volatile economic environment?; is the amount of leverage appropriate given the potential volatility of the business?; and does the corporate culture foster appropriate attitudes toward risk, especially during good times?

Selling is another aspect of our risk control. Steinberg, talking about diseconomies of scale, mentioned that they had been selling off "odds and ends in the closet." (At which point Cumming quipped "Now I know what that means. It's junk.") We are constantly going through our portfolios, asking ourselves what we like least or what we're just ambivalent about and shouldn't keep. Last summer, apparently presciently, we sold our J.P. Morgan. Later last year, we sold both Assured Guaranty (too much tail risk)

[1] All quotes are from our notes of what people said. We've tried to be faithful to the spirit of the actual words spoken, but complete accuracy is not guaranteed.

and Vulcan Materials (too much leverage, essentially the same thing). This year, where we owned it, we have significantly cut back our Yum! Brands position (China risk and over-valuation).

A final element of our risk control is our process of continuous review and re-evaluation. We are always looking for anomalies (i.e., when something happens at one of our companies that we wouldn't have expected) and new ways of understanding what can go wrong. Currently, for example, we are going over the valuations of the companies we own, looking at not just what they are likely to be worth, but also what they would be worth in the event of a prolonged downturn.

Going back to Berkshire and Leucadia, what they have in common and why we trust them with some of our money is that each seems to be an extraordinarily prudent bet on an eventual future economic upturn in the U.S. They own companies that make real things and provide real services, and a lot of what they own will do better when and if all of us buy more cars, houses, etc. In the meantime, however, their balance sheets are quite conservatively positioned. As Cumming said, "Right now, we are trying to get to where we are 'fortress' Leucadia." With that in mind, they paid down a quarter of their debt in the first quarter.

So to get back to the question we posed at the beginning: how do we respond to or prepare for macro risks, including not just the ones identified above but also others? We buy resilient companies run by people who understand that the world is always an unpredictable and dangerous place. That way, when things go wrong, which they inevitably do, we tend to own the survivors, who can often benefit from the chaos. We sell companies in which we've invested but which turn out not to measure up, even if we realize a loss in the process. And we continually look for unintentional or unanticipated risks in the portfolio.

At the same time, we aren't unmindful of the opportunities that macro events can present, and having a little spending money on hand is invariably a good thing. Cumming was asked, "What advice do you have for people who aspire to invest like you?" His response: "Sit on the porch and watch the world go by. Something succulent passes, jump on it."

Marshfield Associates