

**Letter to Clients  
October 2022**

### **Praise the Lard!**

*“Studies within the field of adipose tissue biology have most recently shown [fat] to be a premier source of cells for evolving tissue engineering and regenerative therapies.”*

#### The Evolution of Adipose Biology and Regenerative Medicine<sup>1</sup>

The admonition to “leave it all on the field” is familiar to those of us who have played sports or, indeed, engaged in any kind of competitive activity, including investing. Who can argue with giving something one’s all and taking no prisoners in the process? After all, no guts, no glory (the metaphors abound, and are typically blood-soaked or sweat-stained). The same attitude pervades the financial world. Swashbuckling CEOs who approach their expense lines like enemies to be slaughtered are beloved by Wall Street analysts. The point seems to be to strip a company of all but the most essential basics required to best the competition. In a bid to be a bit more statesmanlike, some organizations take a more nuanced rhetorical approach to budget-cutting; here, a surgical conceit holds sway, conveying a greater sense of precision and deliberateness—more scalpel than sword. In this world, public companies are expected to excise so-called fat, reprising their prowess with the knife each quarter in an endless procession of incremental margin improvements. But even this less extravagant blood-letting has its dangerous side, given the ease with which muscle can inadvertently be sliced along with the fat. Perhaps more important, though, is the fact that in business, as in the animal kingdom, some fat is necessary for survival; eliminating all of what appears to be inessential can end up undermining what is in fact at the heart of a company’s value creation.

For some time, we’ve been hailing resilience as a key quality we seek in our portfolio companies. Resilience allows a company to withstand the rigors of varied economic environments as well as one-off mishaps. It can be fostered and built into a firm’s business model through numerous mechanisms, including such measures as ensuring that no individual customer makes up more than 5-10% of its revenues; having a multiplicity of sectors into which it sells, not all of which are likely to be stressed at the same time; relying on an array of suppliers distributed across geographies; and, more generally, fostering a culture at the core of which is a kind of disciplined restraint.<sup>2</sup> What each of these factors has in common is the retention of what some might call “fat”. As in animals, where some level of fat is needed to protect vital organs, act as a store of

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<sup>1</sup> James Christian Brown and Adam J. Katz, May 22, 2020, <https://www.plasticsurgerykey.com>.

<sup>2</sup> Such restraint might find expression, for example, in a company’s unwillingness to maximize profits at market peaks, an attribute we find especially important in financial and manufacturing businesses.

energy in lean times, and insulate against harsh environmental conditions like the cold,<sup>3</sup> so in companies some slack is required in order to erect a structure not so rigid that it will topple come the high winds of challenge or change.

To be sure, much like sedentary people, organizations without fiscal discipline tend toward excess weight. As is also the case with human beings, not all of this fat is “healthy”. Sclerotic bureaucracies, competing fiefdoms scrabbling for corporate spoils, reluctance to allow technology to supplant human labor, and general inertia see to that. Finding good ways to improve margins by eliminating unnecessary expenditures can refresh a company’s focus and commitment to its key constituents, such as customers, by ensuring that internal processes and systems aren’t so laden with unproductive layers that they fail to support the company’s *raison d’être*. And yet, the almost religious zeal with which many companies undertake margin improvement belies the fact that, in our view at least, the best ways to achieve strong margins are the old-fashioned ways: having enough power vis-à-vis one’s suppliers and customers that one is able to leverage the purchasing and selling clout that come with better competitive positioning. Slashing your way to sustainable returns is rarely a path to long-lasting success.

Recent events remind us of the costs of eliminating all so-called fat in an organization (a “meta” point: if it’s necessary to the smooth functioning of an organization, is it really even “fat” in the popular sense?). **Example 1:** railroads, usually a pretty sleepy industry, have been forced to navigate some rocky terrain this year, in the course of which they felt the consequences of over-exuberant “streamlining”. As you may recall, a strike by unionized workers seeking concessions with respect to working conditions, pay, and sick leave was only narrowly averted last month. High on the list of management’s offenses in the eyes of workers were policies that penalized employees for missing work due to routine medical visits and family emergencies, as well as a refusal to expand the amount of paid time off. But preceding this dust-up, which has been at least temporarily quelled with help from the Biden Administration (though as of last count, one union has already rejected the proposed contract because the union viewed it as including a paltry-seeming one day of paid sick leave rather than the fifteen it had sought), the industry had faced other difficulties of an operational nature, also brought on in part by their own belt tightening. Stories of grain elevators bursting at their seams, flour and animal feed producers without grain to mill, and ethanol plants needing to be shuttered have abounded over the last year or so, with the consequent rage of customers reaching the boiling point.

This mess traces at least some of its roots to what was an admirable impulse to make trains run better and more efficiently. In a mostly industry-wide strategy, railways, including **Union Pacific**, sought in recent years to gain better control over their expenses by adopting “precision scheduled railroading” or PSR. The brainchild of the late Hunter Harrison, a lean operations evangelist, PSR seemed to demonstrate that by idling excess equipment, closing some freight and

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<sup>3</sup> Moreover, there is apparently such a thing as “healthy” fat in humans. According to an October 12th article in the [Washington Post](#), healthy fat has functionality even beyond that as an energy store and cold weather buffer. Small fat cells (as opposed to...fat ones) are replete with blood cells that carry oxygen and nutrients to other cells and also help fight inflammation. Perhaps unsurprisingly, healthy fat correlates with greater physical activity; in people of equal body fat percentages, those with healthy as opposed to unhealthy fat are much better off.

“hump” yards, and using fewer trains while running them on tighter schedules, the industry could lose the fat but keep the muscle. Before the introduction of PSR, freight cars moving cross country typically hitched rides on numerous trains, with sometimes lengthy stops in yards and terminals before catching the next one passing through. The switch to shipping freight more directly seemed a blessing to both customers and crews. This has largely been a good thing for industry and customer<sup>4</sup> alike, ushering in a profit boom across most of the sector.<sup>5</sup> While Union Pacific was a somewhat late adopter of the strategy, the company jumped aboard once it saw the dividends flowing to the Canadian railroads that first embraced it. It was not until recently that the downside of such energetic fat cutting became apparent: reducing headcount works so long as workers stay healthy and show up for their shifts; tighter timetables are great for reliability but struggle to meet the demands of shippers amid the current disarray in supply chains, warehouse availability, and last mile delivery; and limiting the number of rail cars in use is great—until demand peaks and there are insufficient cars to meet that demand. The introduction of so-called “monster trains”, often running multiple miles long, with a number of engines along the chain, have only added additional stress to the schedule and taxed what some have called an aging infrastructure.<sup>6</sup> If core to your value proposition is on time execution, margin advances that imperil the provision of that value turn out to be a step sideways at best. As a result, among other fixes, Union Pacific has pulled locomotives out of storage, gone on a hiring binge, and reopened its mothballed Fort Worth, Texas hump yard in order to ease switching operations further west, thereby freeing up its Colton, California yard to focus on moving cargo more efficiently. While UNP’s CEO Lance Fritz maintains that PSR’s most basic principle of touching cars “the fewest amount of times to satisfy demand”<sup>7</sup> remains an unalloyed benefit to both the company and its customers, he acknowledges having cut too much headcount in the zeal to slim down. **Lesson 1:** cutting out fat may result in an iterative process of “discovery” that leads to the correct balance between too much and not enough “fat”. Prudent and thoughtful companies that learn their lessons, like (we hope) Union Pacific, can figure out how to achieve this through a process of trial and error.

Which leads us to **Example 2**. As you know, we’re always on the prowl for new companies in which to invest. One of the metrics we look at in order to assess a company’s place in the world is operating margin. When we see an industry—or a company within a particular industry—that has been able to achieve margin expansion over time while also providing good value to its customers in what appears to be a sustainable way, we start to pay attention, even if the price doesn’t look like it’s likely to be within our buy range at the moment. As noted above, a company can achieve margin improvement in two key ways: through leveraging its market power by reducing what it pays to suppliers and/or by increasing what it charges its customers; or by

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<sup>4</sup> But not all customers—some intermodal and other customers, deemed unprofitable by the railways, were jettisoned when PSR was introduced.

<sup>5</sup> It appears that, of the large railroads, only BNSF has elected not to join the PSR party. Because it is owned by Berkshire Hathaway, the reasoning behind this is not transparent to us.

<sup>6</sup> NYT October 9, 2022, “Mismanagement and ‘Monster Trains’ Have Wrecked American Rail”.

<sup>7</sup> UP Defends Precision Scheduled Railroading Amid Service Struggles, April 21, 2022, <https://www.freightwaves.com>.

tightening its belt. It's important to understand which one is at work and, if it's the latter, what exactly is being squeezed out.

In part because of an increase in demand brought about by the pandemic and in part because of the need for food and other consumables like laundry detergent in areas underserved by the large grocery store chains, the so-called "dollar stores" (Family Dollar, Dollar General, Dollar Tree, etc.) have appeared to be cleaning up lately. We've been following this industry for some time, admiring its ability to adapt to consumer preferences and add categories like fresh produce while at the same time keeping expenses in line. One of these companies caught our eye as being better run than its peers in terms of both its operating metrics and the apparent quality of its management. In particular, we were impressed by an increase in ten-year trailing operating margin from about 6.5% to about 9% over the course of the last decade. As we dug in further, however, we discovered that this company's performance was undoubtedly being affected by what turned out to be an industry-wide deficit in the companies' concern for safety, broadly defined: for the safe storage of food kept in warehouses, for the proper operation of such things as the wiring in newly renovated stores, for the security of employees working late-night shifts, and, as an overarching matter, for the protection of customers buying those wares and shopping in those less than safe stores. In the course of just the past several months, a woman with a protection order was shot inside a Family Dollar store; another woman is facing a murder charge in a shootout at a Dollar General in Knoxville; Dollar Tree and Family Dollar were forced to recall products potentially exposed to rodents following an FDA inspection revealing "disgusting conditions"; and workers at Dollar General in Louisiana have been forced to endure unpleasantly hot conditions because their air conditioning was controlled by out-of-state management. The list goes on at (gruesome) length. What these companies, including the one that initially piqued our interest, seem to regard as fat is actually a layer of protective cushioning for some of their key stakeholders: workers and consumers. The blithe disregard for both in service to slicing expenses to the bone in a bid to whet the appetite of the analyst community turned us off; devaluing two key constituencies (however much they're willing to tolerate in order to secure access to jobs and food) in order to court the third is not, in our view, a recipe for long term success. **Lesson 2:** sometimes skin-tight expense control tells you more about the values of a company than it does about its operating prowess. As with people, when they tell you who they are—especially if they do nothing to address the ugly part—it's worth listening.

What is the right answer to overzealous slashing? In some cases, it may simply be to reabsorb a little fat into the model, as with the Union Pacific example. In others, it may require a nose-to-tail cultural reassessment. But larding the company up like a Sunday roast is also not the answer. Positioning a company to be able to meet all peaks in demand without a hitch is likely to involve long stretches with idle assets. A company might rightly question whether that's worth the cost. Just ask the companies that, back at the turn of this century and as a result of innovations in energy trading, embarked on an arms race of peaking power plant construction without understanding how much the market as a whole was likely to actually need. As a result, a kind of reverse tragedy of the commons arose, whereby instead of too many exploiting a limited common resource, leading to a depletion of that resource, too many produced a resource that too few really needed, yielding a costly surfeit. Clearly, too much fat can weigh on a company's

return on assets and starve its margins unnecessarily. Unfortunately, it can take some time before the market arrives at the solution proposed by the ancient Greeks: everything in moderation, including “redundancy”.

Different industries also require different kinds of insulation. While the dollar stores need the protective padding afforded by focusing on safety (of food, employees, and customers) in order to maintain a workforce and keep consumers coming in the door, others need to focus on such expenses as research and development, employee training, periodic refreshment of stores, and so on. What it really boils down to is recognizing where your competitive advantage lies, what value you’re providing to the customer by way of that competitive advantage, and what tools you need in order to support both. In **Example 3** we highlight two companies that proudly and openly make the case for lower margins in service to their broader goal of protecting their crown jewel: their mechanism for value creation. **Fastenal** understands that its most vital organ is its customer service operation. Disguised as a retailer for manufacturing and construction businesses (it sells what might seem like nuisance parts, such as nuts and bolts), Fastenal’s real role is that of a work flow and logistics partner to such companies. Once the operator of small stores across the U.S., it has become a net shedder of those stores, instead opting to run facilities and stock industrial vending machines on-site for customers. By embedding themselves in the work flow of large national accounts, they have taken a willing hit to their gross margins, which measure the difference between their cost of goods sold and their revenues. While much, if not all, of what they’ve lost in gross margin they’ve recaptured in operating margin (by increasing sales and reducing rent and other expenses), that fails to tell the entire story. By moving closer to their customer and becoming an effective part of the customer’s operations, Fastenal amplifies its role in the customer’s day-to-day activities, thereby increasing the stickiness—and long-term value—of the relationship. To hear the squawks and moans from the analyst community as it has struggled to understand this change in strategy, one would assume that lambs were being brought to slaughter rather than margin and inventory turns being fine-tuned.

With **Arch Capital**, the retention of protective “fat” assumes a different guise. While Fastenal caters to customers that are tremendously cyclical in their own industries, thereby making Fastenal itself economically cyclical, Arch navigates the property & casualty insurance and reinsurance cycles, which run largely independent of the broader economic cycle. When pricing is at its low ebb, typically when a disaster hasn’t occurred recently and competitors trawling for business are willing to accede to customer demands for lower rates, Arch tends to pull back and write less business. But it keeps its underwriters on staff, reassuring them that even a prolonged soft market will not result in their dismissal. Understanding, as it does, that a man or woman with a pen can make or break their business, its preference is to retain talent and to reward it for NOT writing business when the company is insufficiently compensated for the risks it would assume. What might look like fat is actually well-disguised muscle. **Lesson 3:** protecting what produces and sustains value for your company is worth the hit to margin, even if it’s hard to trace it, dollar for dollar, back to the revenue line.

In the blood sport that is capitalism, too much fat weighs you down and too little leaves you overly susceptible to the rough and tumble of competition. Those adding fat back into their diet

include companies like Apple, which is now “near-sourcing” manufacturing after decades of farming it out overseas, and internet-only retailers like Warby Parker and Bonobos, trying their hand at brick and mortar. It turns out that how well a company meets the challenge of eliminating waste while still keeping the skids of their business performance properly greased requires thought and balance as well as a healthy streak of independence. While it may be tempting to eliminate what seems extraneous, especially with a chorus of Wall Street analysts egging it on, a company can all too easily end up butchering its own competitive advantage if it fails to wield the knife with skillful restraint.

## **Marshfield Associates**

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