Marshfield Associates

Letter to Clients
September 2021

Breaking Up is Hard to Do

"To have you in my life is wondrous,
Yet all good things, allegedly, come to an end.
Piffle, says I, for you, undoubtedly,
Will forever be my lover and best friend."
~ John Walter Bratton

Few things make us feel more optimistic or see more goodness in the world than new love. Not just the moment of an initial spark or the flutters of a first date, but those glorious days during which we discover a meaningful connection, when we learn how this other person thinks and feels and dreams. During this magical time, we can scarcely imagine some hypothetical later time when we will no longer be entranced by this person's charms. *This* is going to last.

Likewise, when we add a company to our portfolio, we do so with the intent of holding it indefinitely. By the time we decide to buy a stock, we're well past the initial spark. We've spent time with the company; we've learned how it operates from the inside out. We've read about it, conversed with leadership, spoken to peers and competitors, conducted a valuation, and put it through the rigors of our checklists. When we've done all that and decided we still want to take the step of buying shares in the company, we believe this one will last.

And yet, in our investing lives, even if not in our personal ones, we enter each new relationship knowing full well that most matches are not made to last forever, however much we might long for them to endure.

In our last letter (**Living in the Past**, April 2021), we discussed three significant cognitive biases (anchoring bias, confirmation bias, and availability bias) and how we work to prevent them from tainting our process. In this letter, we'll continue the conversation about biases, but with a focus on one particular aspect of our work: selling. As we broach this fraught topic, we do so aware of the fact that, by its nature, every break-up — at its core, every sale is a break-up of sorts — is an emotionally charged event. As such, we are mindful not only of the cognitive biases that can infiltrate our process, but also of equally powerful emotional biases. Whereas cognitive biases generally involve shortcuts in our thinking that we all share to one degree or another, emotional biases involve personal feelings that are rooted in each individual's unique experience and psychological makeup, thereby making the misjudgments they provoke harder to tease out. Ultimately, whatever their origin, such biases need to be identified, called out, and neutralized.[1]

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[1] As contemporary neuroscientists have demonstrated, emotion is inextricably intertwined with, and essential to, cognition. In his seminal book, *Descartes' Error: Emotion, Reason, and the Human Brain* (Penguin Books, 1994), neuroscientist Antonio Damasio discusses how his research led him to conclude that cognition is imbued with emotion. Or, as David Berreby put it in his review of Dan Ariely's book, *Predictably Irrational*,

Though romantic relationships may end for any one or more of innumerable reasons, we typically sell in one of three circumstances: (1) the company, industry, or environment in which they operate has changed in a way that has caused us to fall out of love; (2) we come to the realization that we never should have fallen in love in the first place; or (3) our love prevails, but — for reasons that are purely valuation based (i.e., the stock is, by our standards, too expensive) — the time has come to end the relationship. Each one has the potential to provoke powerful responses that, left unexamined or unmitigated, can impede one's willingness to pull the trigger on a sale. To paraphrase (and sanitize) Philip Larkin, selling does more than invoke our inherent mental biases or prompt us to rely on intellectual shortcuts; it adds some extra emotional content, as well, just (it sometimes feels) to mess with us.

<u>You've Changed</u>

"You've changed.
The sparkle in your eyes is gone,
Your smile is just a careless yawn,
You're breaking my heart.
You've changed."
~ Billie Holiday[2]

Occasionally, a company passes all of our tests when we buy it, but over time, either circumstances change within the company or its industry, or evolution occurs in the ecosystem in which the firm does business, resulting in a company that no longer meets the high bar for remaining in our portfolio. When we first bought **Yum! Brands** in 1997, for example, we were impressed by a strong management team that instilled a restaurant- and people-focused culture across its three brands. Then, in 2015 and 2016, acting under pressure from an activist investor, the company's new leadership announced a series of significant changes, including the spin-off of Yum! China, increased franchise ownership of its restaurants (with the goal of reducing company ownership to a meager 2%), and a recapitalization that added substantial debt to the company's balance sheet. In the process, the new management transformed the company's once unique, high-spirited culture into one that was more staid, corporate, and focused on financial engineering. So when the company's stock hit a price that caused us to consider at least paring back our position, we decided instead to liquidate the entire holding.

Looking back, we remain comfortable in our decision to sell Yum!, but it's easy to see how powerful biases and emotional imperatives could have crept in to lull us into holding onto the stock.

"[w]e aren't cool calculators of self-interest who sometimes go crazy; we're crazies who are, under special circumstances, sometimes rational." Berreby, David, "Emonomics," *The New York Times*, March 16, 2008 (available at: https://www.nytimes.com/2008/03/16/books/review/Berreby-t.html).

[2] Billie Holiday, *Lady in Satin*, Columbia, 1958.

First and foremost, there's the "**but it's so much easier this way**" **(aka status quo) bias**. Doing things is harder than not doing things and change is uncomfortable. We are all hard-wired to be inclined to maintain the status quo, and with good reason — compared to the unknowable, different future, the status quo feels not just easier, but safer. Even for the most ambitious and energetic among us, in life, in relationships, and yes, sometimes in investing, it's tempting to want to keep things the way they are simply to avoid the discomfort and challenges presented by change.[3] This is particularly true when the status quo is … just fine, thank you. Yum! had performed very well over its history with us (by June 2019, the price of the stock was about 20 times what it was when we bought it!), and our growing dissatisfaction, while conceptually defensible, wasn't so palpable at the time of our sale as to set off loud alarm bells. Moreover, Yum! gave our portfolio balance and made us more comfortable with other more cyclical holdings; as a relatively recession-resistant company, it mitigated certain risks in the portfolio we had sought to smooth out. And yet, while staying together might have been an appealing cop-out for us, we were willing to do the hard work of balancing risks and returns and admitting that we just weren't that into Yum! anymore.

Our decision to sell might also have been thwarted by **conservatism bias**, which refers to the tendency to insufficiently revise a belief about something in the face of new evidence. Conservatism bias is a close relative of what Charlie Munger referred to as **first conclusion bias**, or what we affectionately refer to as "**but my mind was already made up!**" **bias**. First conclusion bias can be thought of as the belief that our first conclusion about something is the right conclusion, a sort of conceptual form of anchoring bias and kissing cousins with confirmation bias, both of which we discussed in our last newsletter. Both of these biases spring from a reflexive hesitancy to revise one's opinions. In this way, they're also spiritually related to status quo bias, just slightly different flavors of it.

We're saved from being subject to these biases largely by setting our expectations appropriately when we enter into a position. When we buy something, even if our first conclusion is to love the stock without reservation, we typically acknowledge that we will someday disengage from it. This was true with Yum!, as it is with all of our holdings. By our very nature, we're always on the lookout for new disconfirming information. As a result, if we're going to get tripped up on a sale, that's far more likely to happen not because we fail to seek out new information or fail to acknowledge its existence but, rather, because we may insufficiently accept the gravity of the new information and revise our views in the face of it. As psychologist Ward Edwards put it, "it takes anywhere from two to five observations to do one observation's worth of work in inducing a subject to change his opinions."[4]

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[3] To give just one example, most of us are permitted to change our healthcare plans at least once per year, but few of us actually take advantage of that opportunity, even when a more suitable plan is available. At least one study found that "a plan with significantly more favorable premiums and deductibles had a growing market share among new employees, but a significantly lower share among older enrollees," suggesting that what prevents greater enrollment among more tenured enrollees are not the terms of the plan but simply the need to make a change. See discussion of Status Quo Bias, available at: https://www.behavioraleconomics.com/resources/mini-encyclopedia-of-be/status-quo-bias/.

[4] Edwards, W. (1982). Conservatism in human information processing. In D. Kahneman, P. Slovic, & A. Tversky (Eds.), *Judgment under Uncertainty: Heuristics and Biases* (pp. 359-369). Cambridge: Cambridge University Press. doi:10.1017/CBO9780511809477.026.

Apart from the initial setting of expectations, how do we overcome these biases and how did we sidestep them in the case of Yum!? By regularly reviewing the companies in our portfolio and asking ourselves difficult questions about them, including questions that force us to confront the biases that are most likely to creep into our decision-making. Are we ignoring relevant facts because it's easier to maintain the status quo? Are we reading this situation more favorably than we would for a company we hadn't previously decided we liked enough to buy? Does this merger/leadership change/earnings release/ presentation/ *whatever* conflict with our fundamental beliefs about the company? If so, what does that tell us about our previously established beliefs? If we didn't already own the company and it became available at a good (i.e., cheap) price, would we want to buy it now? We also look into our own hearts, if you will, and ask ourselves questions that call upon us to take our emotional temperature: are we being influenced by sentimentality or a fear of displeasing a management we've come to know? Or, on the other hand, are we overly angered by an imperfection we only now detect? These and other similar questions were the ones with which we grappled when we decided to sell our position in Yum!. They are the types of questions we regularly ask ourselves about all of our holdings in our quest to challenge our views about our companies and prevent ourselves from slipping into complacency.[5]

<u>I Knew You Were Trouble</u>

"I knew you were trouble when you walked in,
So shame on me."
~Taylor Swift[6]

As some of us have learned the hard way, the most painful relationship is often the one we knew we shouldn't have gotten into in the first place. Against our better judgment, we forged ahead, ignoring the voice telling us this was not the partner for us. But we know this dalliance can only end one way, and it's not in happily ever after. We hope these ill-fated relationships make up only a small part of the tapestry of our lives (especially since, unlike Taylor Swift, most of us are unable to turn heartache into chart-topping, hip shaking hits). But mistakes happen, in love … and in investing.

Fortunately, we think we can fairly say these inauspicious investments have made up a small portion of our holdings over the years, but we have nonetheless had a few of them.[7] Perhaps the most vivid of these was our investment in **Devon Energy**. We had been

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[5] Also in this category of change sufficient to prompt a sale lie holdings in industries that have lost or are losing their mojo. A good example is newspaper stocks which, once upon a time, we held dear for their lock on local news and classified advertising. We saw trouble approaching in the form of other (and more attractive) suitors for the public's attention — namely, the internet and, at the time, Craigslist in particular — and so we bid the likes of the Washington Post and Gannett adieu.

[6] Taylor Swift, *Red*, Big Machine Records, 2012.

[7] And in truth, such misbegotten couplings have not been without their up-sides. As we like to say (with some exaggeration), everything we don't do we've done before. This is one of the reasons a margin of safety is such a wonderful thing; it allows for lessons to be learned without exacting too injurious a cost.

interested in Devon for a number of reasons, but even before we made our investment, we had a few nagging concerns, most significantly that investing in an oil and gas company required flouting a long-standing (if unofficial) policy of ours — refraining from investing in businesses in which revenue and profitability are driven almost entirely by volatile commodity prices over which the company has no control (and which we have no particular ability to predict). But faced with a company that had distinguished itself in a number of ways, particularly what appeared to be a strong capital allocation discipline, and was available at what appeared to be a great price, we ignored that gnawing concern and purchased a small position.

A few years later, having watched the price of both oil and gas as well as Devon's stock swing unpredictably, we had to confront the fact that the voice in our heads had been right. The fundamental supply and demand dynamics that drove the business were extremely difficult to forecast, making our valuation of the business particularly complicated and essentially eradicating the knowledge advantage we like to have when we invest in a company. Add to that the profligacy of a management we had mistakenly believed to be prudent in the face of the cowboy-like culture of its industry (boy, were we wrong), and we knew we had a dud on our hands. Less than five years after we first bought shares of Devon, we sold out of our position (at essentially break-even but, perhaps obviously, that's not what we're here to do).

The bias many investors face in considering whether to sell a company like Devon is an emotional response we (not so) affectionately refer to as a "**no one likes being wrong**" **bias**. Sure, on some level, we all know that we are fallible. Yet, many of us fall prey to a natural tendency to resist admitting mistakes. For us, though, the more likely source of tension when we sell a company we know in our bones we never should have bought is that a kind of **cognitive dissonance** is at play. Once we've added a company to our concentrated portfolio, we've announced to the world our unalloyed love and affection for it. Deciding that we should no longer own it (for reasons other than price) requires us not only to acknowledge an isolated error in judgment (embarrassing!) but to assert two inconsistent truths at the same time: (1) we maintain a high bar for our holdings and, after extensive research and application of our professional judgment, the company met that high bar; and (2) this company does not meet our high bar. Both cannot possibly be true, and it's potentially easier (on the ego, in the short term, at least), if not intellectually honest, to decide that the second statement is the one that is false.

Benjamin Franklin wisely advised that "an ounce of prevention is worth a pound of cure." Certainly, we would all much prefer simply to avoid making investment mistakes than to have to correct them later. But no human being can ever achieve perfection. So when a mistake happens, we remind ourselves of that and try not to let either emotion or cognitive dissonance get in the way of doing what is right. We do that by adhering to the same process we do for all of our companies — regularly talking to leadership, carefully analyzing results, asking ourselves difficult questions, and, when we have to, giving ourselves a variation of the speech Marcellus Wallace famously gave to Butch Coolidge, the aging boxer in *Pulp Fiction* — "[Forget] pride! Pride only hurts, it never helps." In the case of Devon, the passage of time between the buy and sell decision and the intervening performance of the company and its industry rendered Marcellus Wallace's exhortation unnecessary; when the time came to sell, pride was not an issue. To the contrary (and perhaps we shouldn't admit this, but surely we're not alone), we took a certain pleasure in kicking the disappointing object of our affection to the curb after we discovered they'd done us wrong.

<u>All Things Must Pass</u>

"None of life's strings can last
So I must be on my way
And face another day."
~ George Harrison[8]

Accepting that someone has changed is hard. Admitting that we were wrong is harder. But recognizing that it's time to say goodbye when nothing at all is wrong is the hardest kind of break-up of all.

In the movies, these break-ups are usually precipitated by one person finally, *finally* being offered their dream job … across the globe. In life, they're often caused by the more banal grind of work and family obligations. And in investing — at least, investing with Marshfield — they're prompted by a stock trading at a price that we believe to be significantly above its intrinsic value, as was recently the case with both **Chipotle** and **Deere & Co**.[9]

This kind of break-up is heart-wrenching. When you're still in love, it's hard to see the upside of letting go. There is no relief of being done with the painful relationship, no patting yourself on the back for finally standing up for what's best for *you*. There is only sadness born of losing something wonderful.

We're not ashamed to admit that we feel this pain when we sell a company purely for valuation reasons. It's the "**but we're still in love**" **bias**, a bias compounded of both emotional proclivities and deep-seated cognitive shortcuts. Chipotle had (and still has) an elegant strategy, strong leadership, and battle scars that help it not only survive but thrive in a time of crisis. Chipotle brought us joy (and capital appreciation). Letting go of a company like that hurts, especially when it occurs, as is typical, when the company is at the top of its game, so it can be tempting to search for reasons not to have to let go. What's more, cognitive biases disguised as reasons not to let go abound.

"Buy low, sell high" is perhaps the most fundamental principle within the investing canon, but "selling high" is far from easy. To state what is perhaps obvious, while we can understand what "high" looks like through our valuation process, we can't possibly know prospectively at what point a stock will reach its "top". We may know that a price is higher than what we paid when we bought; we may believe that it would be irrational for the price

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[8] George Harrison, *All Things Must Pass*, EMI, 1970.

[9] As a company's stock price increases, we also typically trim our position in the company, selling off a portion of our holding before we reach the point of selling out of it completely. For purposes of this letter, however, we're concerned with the final sale when we liquidate a position, though even selling a portion of an otherwise admirable investment can trigger regret.

to go much higher; but we don't *know* that it won't continue to climb. As a result, it would be easy, when faced with a stock whose price is climbing, to be paralyzed by "**FOMO**" **(fear of missing out) bias**, the fear that we'll sell too soon and will miss out on untold riches. This emotional reaction is exacerbated by an innate cognitive **social proof bias**, the natural tendency to be inclined to do what others are doing, especially if those others are perceived as authorities.

The power of the social proof bias was demonstrated in a classic 1962 episode of *Candid Camera* that tested the conformity theories put forth by psychologist Solomon Asch. In the episode, three accomplices get in an elevator and stand facing the back. When they do, the lone individual in the elevator visibly fights to maintain his individuality and remain facing forward, but within mere seconds, he turns around (though only after scratching his nose and checking his watch in a failed attempt to provide some pretext for his repositioning). Subsequent trials of the same experiment have similar (hilarious) results.[10] Likewise, when other investors are buying a stock in droves, which by definition is what happens when a stock shoots past our "hold" range, it's only natural for us to question our decision to sell it.[11]

We're able to combat our fears and biases primarily by relying on two distinct parts of our process. Part one is knowing the company and understanding its value really well. We will have analyzed the company and made a careful, rational determination about the prices above which we believe we should first start to prune it and ultimately sell it outright. Part two is initiating the sale as soon as a stock hits those pre-determined prices rather than allowing ourselves to be swayed by bias or emotion in the moment.

What aids us most significantly in overcoming both FOMO and social proof biases is that we actually embrace them rather than running away from them. Instead of fearing that we may miss out on some profit, we embrace the fact that we likely *will* miss out on some profit. But we see this as a feature, not a bug, as it's a natural result of our ultimate goal of capital preservation and an acknowledgment of our inability to "call the top" (spoiler alert: no one can). When we buy a stock, our goal is not to buy at its lowest point but, rather, to buy at a price that is inexpensive enough to allow room for error. Likewise, in deciding when to sell, our goal is not to pinpoint a stock's peak and sell at exactly that moment, but to sell at a point that strikes the right balance between maximizing gains and minimizing the risk of retracing its trajectory.

Happily, no stranger to breakups of this sort, we've learned over time that saying "it's not you, it's me", is an acceptable way to part ways. Rather than fearing being different, we pride ourselves on the fact that we are different in ways that add value for our clients over the long term. We know that to outperform the market, we can't look like the market; we

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[10] A video clip of the key portion of the episode is available at: https://vimeo.com/277929528.

[11] The flip side of this, of course, is when we buy a stock that the rest of the world seems to despise; social proof can make us question our eyesight when we find something beautiful that everyone else, including those whose opinion we respect, thinks is ugly.

can't buy what everyone else is buying when they buy it or sell what everyone else is selling when they sell it. Instead, we embrace the discomfort of being different, knowing that walking away from what others are running toward is what makes us who we are.

<u>The Irreplaceability Fallacy</u>

"So don't you ever for a second get
To thinking you're irreplaceable."
~ Beyonce[12]

For some investors, the scariest thing about selling is the worry that they'll never find as good a company to fill the newly created space in their portfolio. At Marshfield, we don't need to meet someone new and fabulous before giving our old flame the heave-ho. In our history, we've never sold so we can buy nor felt that we needed to find something new right away; we sell when it's the right time to sell (and buy when it's the right time to buy). But that doesn't mean we don't think about how each sale changes the composition of our portfolio. We do and, each time, somewhere in the back of our heads, we worry about whether we'll ever find another great company to fill the spot vacated by the one we just sold — an uneasiness that is compounded by the nagging concern that the market will take away our best stocks through price appreciation, leaving a residue of lesser names for us to babysit. This "**irreplaceability fallacy**," the misguided belief that we'll never find something as good as the thing we're selling, is insecurity and FOMO and status quo and probably many more emotional responses and cognitive biases all rolled into one. Our job is to quiet that worry by placing our faith in both history (we've always found worthy stocks given time and patience!) and the wisdom of Queen Bey — nothing is irreplaceable.

The truth is, as investors (and human beings, to boot), cognitive and emotional biases can creep in not just when it comes time to sell, but at any point in our process. And while biases and cognitive shortcuts serve some useful purposes, they don't always lead to the best possible outcomes. So we do our best to recognize them for what they are, overcome them by remaining disciplined and adhering to our process, and, when we have to, standing up and calling each other out to make sure we do what needs to be done.

And when the pain of selling does hit, we remember that, sometimes, the best way to soothe ourselves is with a good old-fashioned break-up song.

Marshfield Associates

[12] Beyonce, *B'day*, Columbia, 2006.