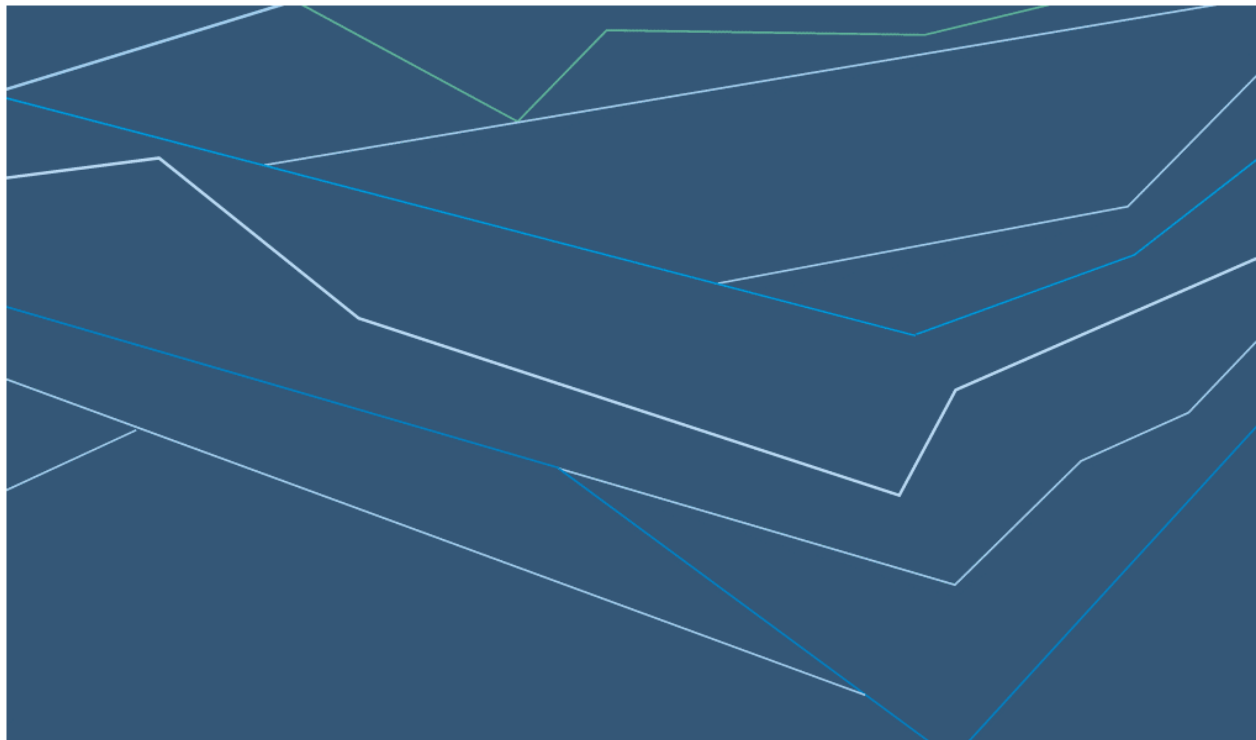
SPRING 2021

Graham & Doddsville

An investment newsletter from the students of Columbia Business School



/ Inside this issue

Brian Bares, Bares Capital Management — *P. 4*

CBS Students Investment Ideas — *P. 22*

Sean Stannard-Stockton, Ensemble Capital — *P. 26*

Dan Rasmussen, Verdad Advisers — *P. 48*

/ Editors

Rodrigo De Paula, MBA 2021

Matt Habig, MBA 2021

Alison Tien, MBA 2021

Bill Ledley, MBA 2022

Tom Moore, MBA 2022

Franklin Shieh, MBA 2022

Visit Us /

grahamanddodd.com
csima.info

Welcome to Graham & Doddsville

Meredith Trivedi, Managing Director of the Heilbrunn Center. Meredith leads the Center, cultivating strong relationships with some of the world´s most experienced value investors and creating numerous learning opportunities for students interested in value investing.

We are pleased to bring you the 42nd edition of Graham & Doddsville. This student-led investment publication of Columbia Business School (CBS) is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA). In this issue, we were lucky to be joined by three entrepreneurial investors who all started their own funds.

We first interviewed **Brian Bares,** founder of Bares Capital Management. We discussed Mr. Bares's early interest in investing, experience with launching and running his own fund, understanding of institutional allocation, and his first-principles based approach to fundamental analysis. Mr. Bares lays out his process, which focuses heavily on business and management quality. Brian is also the author of "The Small-Cap Advantage", published in 2011.

Next, we interviewed **Sean Stannard-Stockton**, CIO and co-founder of Ensemble Capital Management. Mr. Stannard-Stockton walks through Ensemble's Venn diagram for investing, which focuses on the overlap between management, competitive moats, and "forecastability". Sean also shares case studies of successful (Mastercard) and unsuccessful investments (Time Warner), with interesting learnings in both cases.

Lastly, we interviewed **Dan Rasmussen**, founder of Verdad Advisers. We discussed Mr. Rasmussen's early investing influences, approach to small-cap value investing, and contrarian thoughts on the value of fundamental forecasting. Our conversation about "Superforecasting", narrative shifts, and current market trends is a fun and timely read.

We continue to bring you stock pitches from current CBS students. In this issue, we feature the winners of the 14th Annual Pershing Square Challenge. 1st place winners Paul Chandler ('21), Jack Devine ('21), and David Kilgariff ('21) share their buy thesis on Dolby (NYSE: DLB), presenting a compelling case based on DLB's underappreciated transformation. 2nd place winners Bill Henry ('22), Tom Moore ('22), and Dickson Pau ('22) present their buy thesis on Angi (NASDAQ: ANGI) and walk through ANGI's improving economics as it transitions towards pre-priced transactions.

Lastly, you can find more interviews on the *Value Investing with Legends* podcast, hosted by Professor Tano Santos. Professor Santos has recently conducted interviews with guests including Anne-Sophie d'Andlau, Florian Schuhbauer and Klaus Roehrig, Elizabeth Lilly, and Anna Nikolayevsky ('98).

We thank our interviewees for contributing their time and insights not only to us, but to the whole investing community.

G&Dsville Editors

Professor Tano Santos, the Faculty Director of the Heilbrunn Center. The Center sponsors the Value Investing Program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry´s best practitioners. The classes sponsored by the Heilbrunn Center are among the most heavily demanded and highly rated classes at Columbia Business School.

Columbia Business School
AT THE VERY CENTER OF BUSINESS™
The Heilbrunn Center for Graham & Dodd Investing

CSIMA Columbia Student Investment Management Association

The Heilbrunn Center
for Graham & Dodd Investing

SAVE THE DATE

The Heilbrunn Center for Graham & Dodd Investing at
Columbia Business School presents

THE 31st ANNUAL

Graham & Dodd Breakfast

Featuring:

Kim Lew,
President and CEO, Columbia Investment Management Company

Date: October 29, 2021

Tickets to go on sale in August

www.grahamanddodd.com

For inquiries, please contact: valueinvesting@gsb.columbia.edu

Sean Stannard-Stockton, Ensemble Capital

Sean Stannard -Stockton, Ensemble Capital

Sean Stannard-Stockton is the president and chief investment officer of Ensemble Capital Management, which he co-founded in 2004, and portfolio manager of the Ensemble Fund (ENSBX).

Ensemble Capital manages $1.4 billion in separately managed accounts, on behalf of private clients and institutions. Ensemble's equity investment strategy focuses on owning a concentrated portfolio of competitively advantaged companies.

Editor's Note: This interview took place on March 26th, 2021.

Graham & Doddsville (G&D): To start, can you walk us through your background and how you got interested in investing in the first place?

Sean Stannard-Stockton (SSS): I was that kid who was 13 years old, found a book on stock-picking, gave it a read, knew nothing about it at all, but instantly fell in love. As I was going through high school, I discovered economics and loved it and went off to college knowing I wanted to pick stocks for a living. I went through college with that in mind and spent a lot of time reading about investing. After college, I worked at Scudder Investments in Boston for a handful of years and then moved to what was then called Curtis Brown & Company, which was the predecessor to Ensemble Capital. Our founder Curt, who's now retired, had formed a sole proprietorship and was running about $65 million in friends and family money for 15 clients, and I joined him.

It was just the two of us. We formed Ensemble Capital as a partnership in 2004 and then we built the business up over time. As far as my evolution as an investor is concerned, like a lot of young investors, I started with traditional deep value as many do. Munger talks about the "value inoculation" and the idea that investing should be about gaining access to a stream of cash flows, and that you pay less than that cash flow is worth in order to outperform, just intuitively made sense to me right away.

Back then, like a lot of younger investors, I didn't have the skillset to think about deep competitive advantage analysis and was instead drawn to the quantitative work of people like David Dreman and Jim O'Shaughnessy, whose book "What Works on Wall Street" was a great early read. I started trying to understand, "Well, what does the evidence say is the best way to do this process?" A lot of that evidence points to discounted valuation methods, although O'Shaughnessy's book also pointed to momentum as being an important factor and that growth really does drive value. Those concepts stuck with me early on.

> *"Over time, I've really developed a process that's about trying to understand the future of a business. As much as we hate making forecasts, it's inevitable that the only value of a stock is its future cashflow. If you think you can't forecast that, then just go buy a different stock.*

Curt was more of a classic growth investor, but always with a valuation sensitivity to his analysis. As we started working together, I started really developing my own philosophy of what is it that makes a great business and recognizing that historical results of a company or value on its balance sheet are relevant indicators to future value, but they are not the same thing as future value. Over time, I've really developed a process that's about trying to understand the future of a business. As much as we hate making forecasts, it's inevitable

(Continued on page 27)

Sean Stannard-Stockton, Ensemble Capital

that the only value of a stock is its future cashflow. If you think you can't forecast that, then just go buy a different stock.

G&D: Was there a particular investment or set of investments when you got to Curtis Brown & Co that really showed you the power of investing in these competitively advantaged businesses?

SSS: I think most of my early lessons were mistakes I made on my own that taught me what not to do. My very first stock pick ever when I was just out of college was an investment in Tommy Hilfiger made simply because it was trading at eight times earnings. I figured I had found a cheap stock and thought, "Well, then I'm a genius and obviously it's going to go up a lot because it's so cheap." And it was a total disaster of an investment, thank goodness!

I always think if you ever go to Vegas, you have to pray that you lose big the first time, because if you win on your first trip to Vegas, you think you're brilliant and you keep going back until they take all your money. So having your first stock pick work out is a terrible disadvantage because it makes you think that you know what you're doing and having your first stock pick blow up on you is really important because it teaches you that you have no idea what you're doing, which is always the case with your first stock pick.

At Curtis Brown & Co, I was also participating in building a business. The only operational experience I have is in operating Ensemble Capital, but Ensemble Capital is not just a team of analysts who sit around with spreadsheets. It's an organization that serves 220 private clients, it meets with people, interacts with markets, and has an HR function. Building that business definitely taught me that there is very nuanced strategic analysis that is the heart of running a business. The heart of any investment that you make is trying to understand those strategic issues and what it means to run these businesses. The statistical data that you can get out of Bloomberg tells you next to nothing about those things.

"At the end of the day, we think that the practice of investing is fundamentally a qualitative process. It is fundamentally about trying to understand the future."

G&D: What were some of the key learnings as the business evolved from when you joined in 2004 to what we know it has today? And what do you think it is about the way that your firm is structured and the way the analysts work together that creates a competitive advantage for you as a business, for you as a firm?

SSS: I think that the biggest thing that's evolved at Ensemble over the last nearly 20 years is more and more focus on building a systematic discipline to how we do things. At the end of the day, we think that the practice of investing is fundamentally a qualitative process. It is fundamentally about trying to understand the future. You can draw on lots of quantitative data to help inform your outlook, but at the end of the day, you have to make a judgment call. And that judgment can draw on quantitative inputs, but it is absolutely based on qualitative insights as well. And yet, the problem with qualitative analysis is you can have a lot of bias and a lot of noise that creeps into that process, especially as you build a team of people.

So each individual analyst has various biases that they may or may not be aware of and there's a degree of noise in their decision-making or in the inputs that they assume. The evidence is overwhelming that if you give an analyst the same company and have them do the work at different times of day, like after

(Continued on page 28)

Sean Stannard-Stockton, Ensemble Capital

lunch, rather than right after their coffee in the morning, you can get very different answers. That's noise.

As we've built from a couple individuals into an organization of nearly 20 people, I've really been focused on doing everything we can to create a systematic process that honors the qualitative nature of what we do, but also seeks to reduce bias and noise in our individual and joint decision-making. This is why on the one hand, we have a very qualitative process around analyzing the competitive context in which businesses operate. And yet the other hand, we basically use an algorithm to manage position sizing in the portfolio (although that algorithm is drawing on qualitative inputs that we transform into quantitative data that we feed to the algorithm.)

G&D: How do you split up responsibilities between you and the other two analysts on your team?

SSS: I play the role of analyst, not just CIO. I think of myself as like a player-manager, in that, yes, I am the CIO, but I'm also one of the analysts. Arif Karim, Todd Wenning and I each are the lead analyst on about a third of the portfolio, and then it's incumbent on the lead analyst to share and defend their analysis with the rest of the team. We collectively sign off on valuation models, so there's a lead who's developing that, but each analyst is going to review it as well. We might ask questions about it or challenge it. At the end of the day, if we're trading on a stock at a certain valuation, the entire team has accepted it and given the okay.

There might be some difference of opinions, but nobody's saying, "No, we shouldn't but this, our valuation is wrong." On the more qualitative side, we have a process for force ranking each company in our portfolio, seven different critical questions that we think inform our ability to assess the business over the long-term. The lead and the secondary analysts all make those ratings, so everyone has to know enough about the business to understand questions like, "What is the likelihood that this business's products and services remain relevant over a 10 year or longer time period?" But that does not mean you need to know all the intricacies of the accounting of every business that you're not the lead on. So it is very much a joint process.

G&D: You have a great Venn diagram on Twitter which outlines your investment philosophy at Ensemble ***(see following page)***. Could you walk us through how you came up with this?

SSS: It came about through just doing this qualitative work and thinking about what the key considerations are in any business. Every business is unique, but there are certain types of questions we find ourselves asking repeatedly.

Todd Wenning on our team had developed a Venn diagram of this sort to describe his own personal investment philosophy prior to joining us. I was an admirer of the simplicity and conciseness of how he had illustrated his thinking and he developed this version of the diagram a few years ago to describe our approach.

I think of our process as always evolving. I know that some people say, "We want everyone to have a process and stick to it forever." But if you stick to a process in a period of disruption, like the one that we are in right now, and you don't ever evolve, you're just going to fall behind. So if are not constantly evolving your process, then you're basically just slowly dying. Because reality is changing, your fixed process is going to get out of sync, unless you're constantly revising it.

Our process as we implement it today was really formalized about a decade ago, but it continuously evolves. The different factors that we look at in this Venn diagram are not rocket science. We essentially think about the horse and the jockey, or the

(Continued on page 29)

Sean Stannard-Stockton, Ensemble Capital

VALUE CREATION
Does management understand and execute on creating economic value?

CAPITAL ALLOCATION
Does management thoughtfully weigh dividends, buybacks, M&A, and debt repayment?

INTEGRITY

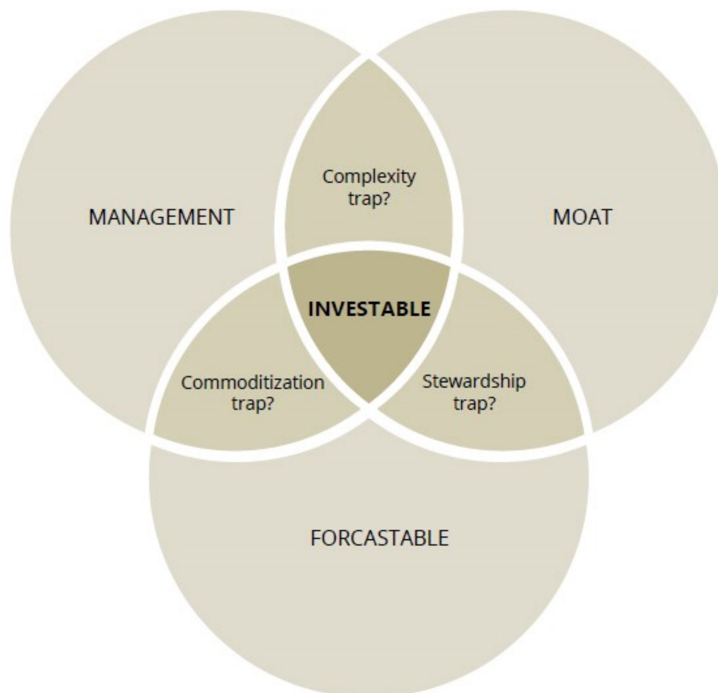
CULTURE

STAKEHOLDER ANALYSIS

ROIC & GROWTH FOCUS

VISIONARY/OPTIMIZER

UNDERSTANDABLE
Do the business dynamics of the company match our investment team's expertise?



DURABILITY
How likely will the moat be intact in 10 years?

RELEVANCE
How likely will customers value the product/service in 10 years?

IDIOSYNCRATIC BUSINESS

PRICING POWER

REINVESTMENT MOAT VS LEGACY MOAT

EMERGING MOAT

FORCASTABILITY
Does the business lend itself to accurate forecasting of long-term outcomes?

business and the management team. Moat and relevance are the horse, the company. Management is the jockey.

The third pillar is what we call forecastability. What we mean by that is both our circle of competence, but also the intrinsic forecastability of a business. There are some businesses that are just intrinsically more forecastable where there's just little debate about what growth rates are going to be, and then there are other businesses in which you have huge skews. We've owned Netflix for five years. There have been a lot of investors who thought that the business was a zero and not financially viable. You don't see the same arguments taking place with Pepsi, for example. Some businesses are more or less intrinsically forecastable.

G&D: Great. Delving into moat first – you highlight the difference between the durability of a business and the relevance of it in the mind of the customer. What do you mean by that?

SSS: When you think about the durability of the competitive advantage or the moat, there's how wide the moat is right now and then the durability of the moat over time. All businesses are constantly being attacked a little bit, so there is an element of entropy in which moats are slowly decaying at all times. To a large degree, as much as you'd say, "Well, I want my business to be building their moats bigger and bigger," a lot of the work is actually just trying to maintain the moat and fend off the entropy of business competition.

Management's behavior makes a big difference here as well. Over time we've put more and more value on culture and recognize that there are businesses in which it's structurally possible for competition to come along, but it's not going to happen for societal or cultural reasons. We've talked about First Republic a lot, and their levels of customer service. In theory, you'd say, "Well, the big banks can just replicate a high customer service environment for high net worth clients." And the answer is, "Yeah, but they're not going to." Banking is an industry that has a terrible long-term track record of customer service. You would really need to take a generation to refocus the big banks to compete with First Republic. There's

(Continued on page 30)

Sean Stannard-Stockton, Ensemble Capital

nothing structural, but there's real cultural reasons why it doesn't happen.

The concept of relevance relates to the idea that a moat is great, but what if your customers don't care about what it is you do? Then it doesn't matter that nobody can compete with you. Off the top of my head, think of an example like traditional sugared Coca-Cola soda. It's not like other companies came along and breached Coke's moat. It's that Americans and people around the world started caring less and less about carbonated sugar water. That's a decline in relevance.

One of the things that we've tried to emphasize in our writing is the difference between recognizability and relevance. Everybody in the world recognizes the Coke brand just as much as they did 20 years ago. But the relevance of the core sugared Coca-Cola drink is far lower today than it was in the past. It's very difficult to forecast relevance over a 10-year time period, but that's part of what we're paid to do. One way to think about it is we're trying to avoid the value traps, or businesses that are decaying.

G&D: In the past you've talked about looking for companies that are growing in excess of GDP. Does that mean you look for a healthy balance of volume and pricing growth as opposed to a business that might not be growing much volume, but is increasing pricing? And maybe you can tie in your thoughts on the concept of mortgaging the moat into that as well.

"Over time we've put more and more value on culture and recognize that there are businesses in which it's structurally possible for competition to come along, but it's not going to happen for societal or cultural reasons. We've talked about First Republic a lot, and their levels of customer service. In theory, you'd say, "Well, the big banks can just replicate a high customer service environment for high net worth clients." And the answer is, "Yeah, but they're not going to.""

SSS: In theory, you don't need to be growing to have value. Let's say you have a business with a 12% distributable free cash flow yield and guaranteed flat free cash flow forever. Well, that's a great investment - 12% annualized returns. But in reality, there's just no guarantee. And businesses that grow at very low rates are losing wallet share of GDP, so they are intrinsically losing relevance relative to other economic activities. We believe that that those businesses face the risk of hitting a stall speed. You see this phenomenon a lot in nature, where basically you're either you're growing or you're dying. We think of businesses the same way.

We don't want to invest in dying businesses, even if it's going to be a long time before they die. So, the nominal GDP growth rate hurdle we require is really just a way to avoid stall speed risk. As to price versus unit growth, in theory, you'd say, "Well, it's all revenue. So who cares?" or that price alone is best as there are not associated cost of goods sold. But it's unusual to be able to raise prices forever. At some point, you hit a terminal level in which you are constrained by the level of inflation.

Everybody loves pricing power. Warren Buffett has said that the most important indicator of whether a business has a competitive advantage is whether they have pricing power. And we think that's right, for sure. However, one set of businesses that exhibit pricing power are

(Continued on page 31)

Sean Stannard-Stockton, Ensemble Capital

those that have trapped their customers. It's not that they have pricing power because their customers like what they do so much – it's that their customers are trapped. Every time they raise pricing, their customers accept it, but they hate the company just a little bit more. And when you do that, you keep pushing up the price and you push up the opportunity for a disruptor to come in underneath you. We think of it as each year, that company is actually creating an off-balance sheet liability and is exposing itself to competition. They are mortgaging their moat.

"We really differentiate between pricing power that comes from trapped customers versus pricing power that comes from delighting customers so much that they're happy to pay more. When Netflix raises its price by a dollar, people don't immediately churn off – instead they say, "Oh my gosh, I can't believe I get all of this content for 12 bucks a month. I'm not worried about it being $13.""

One of the businesses that clarified this idea for us was Live Nation, whose Ticketmaster business has a lock on concert ticket sales. We initially looked at it and thought to ourselves, "What an incredible business!" I should note – I haven't followed it for a number of years, so it's possible that things have changed. But after we dug deeper, we realized, "Everybody hates them."

Everyone who attends the concert is mad they paid such excessive amounts in fees. The artists also hate Ticketmaster. Live Nation is supposed to be about connecting people and benefitting the artists who are putting on the concert. If both sides of that equation don't like the company, well, that means that they are going to become more and more incentivized to try something else.

You might say, "Yeah, but they can't." But over time humanity solves problems, even insurmountable, intractable ones. So we just don't want to be investing in businesses in which customers and others in the ecosystem are incentivized to try and exit the relationship with the company. Even we think it can't happen. We just say, "You know what? It will at some point."

We really differentiate between pricing power that comes from trapped customers versus pricing power that comes from delighting customers so much that they're happy to pay more. When Netflix raises its price by a dollar, people don't immediately churn off – instead they say, "Oh my gosh, I can't believe I get all of this content for 12 bucks a month. I'm not worried about it being $13." Same thing with Apple – they have the price of phones up to $1,000 and people still can't wait to buy one. It's totally different than old school cable companies taking cable bills up so high that people were just enraged. That's what we're trying to avoid.

G&D: Yeah. If you're actually improving your product or upgrading your product to your customer, that's creating value and you can charge a higher price for that. Whereas if you're just providing the same exact product year after year and not making any changes, but the customer has no choice, over time you're becoming more fragile.

SSS: That's right. Fragile is a good way to think about it. When you mortgage your moat, you are becoming more fragile. And that's the off-balance sheet liability. It's hard to quantify, it's hard to see, but it's there. It's very real.

G&D: You've also written about an inverse concept, which is latent pricing power and you've

(Continued on page 32)

Sean Stannard-Stockton, Ensemble Capital

used Netflix as an example of a company that could raise price more, but chooses not to. How do you make sure that a company actually has latent pricing power and is creating a value surplus for customers versus just the inability to take price due to competition or other factors?

SSS: Yeah, that's a great question. The idea of latent pricing power as very much a function of the economy becoming more of an intangible economy. If you're in a tangible business, selling tangible things, you can't afford to set price too low because it costs you something just to make the product and get it to somebody, right? So you're constrained by how low you can set pricing. But when you're selling an intangible item, the incremental costs of each new sale may be very, very low.

For instance, with the Netflix example, when they add a new subscriber, there are some minuscule costs to the server levels they need, and support levels they need – maintenance spend. It's not that there is no cost, but it's very, very low because they don't have to go out and buy content for that individual subscriber and give it to them. The content has already been purchased. When you have that dynamic, you have the ability to set pricing at much lower levels than might be considered normal or full levels. I think it has become more and more important for investors to understand this dynamic and understand that current pricing may not reflect long-term pricing.

I've said in the past that, one of the insights for me on this was when Facebook bought Instagram for a billion dollars. And I very foolishly thought that it was like the dumbest acquisition ever because they paid a billion dollars for a business that had no revenue and only 17 employees. But what I didn't appreciate and was naïve on at the time was the idea that Instagram could charge for the service they were providing if they wanted to.

They have all these users and they're just choosing not to add any ad load to the product yet, but it doesn't mean that they can't, right? Therefore you have this kind of step change in revenue over time as the business is monetized more fully, which has been our thesis on Netflix. But to your point, you can't tell it for sure. We use the rule of being generally correct rather than precisely wrong when figuring out what normalized pricing power is.

G&D: Switching gears to the management pillar, how have your views on management evaluation have evolved over time? And what have you found to be most helpful in evaluating a company that actually has a great culture and a great ecosystem around it?

SSS: Earlier in my career I was more focused on just the shareholder's perspective on management decisions – for example, the need to be good capital allocators, they need to be strategic masterminds in terms of building the business and all that sort of stuff. Over time my thought process has evolved to recognize that's all super important but the shareholders' participation in value creation is the last step in the process. You have to create value first and foremost for your customer. And then once you do that, then there may be value that can accrue to shareholders. Even if you're creating value for your customers, you need to have other players in your business, all your other stakeholders, your employees most importantly, but also vendors and other people that you might engage with to do your business. They also need to have a value creative relationship with you.

Over time we put more and more emphasis on those elements and got more disciplined. We recently shared on Twitter an article from around 2003 showing Wall Street analysts criticizing Costco for paying their employees too much and giving them too many benefits. The idea was that such

(Continued on page 33)

Sean Stannard-Stockton, Ensemble Capital

behavior was bad for shareholders. But of course, Costco has just trounced Walmart from a stock performance standpoint, even though Walmart is probably the best in the business at constraining the value that accrues to their employees. We owned Costco back then and took the other side of that trade.

"We recently shared on Twitter an article from around 2003 showing Wall Street analysts criticizing Costco for paying their employees too much and giving them too many benefits. The idea was that such behavior was bad for shareholders. But of course, Costco has just trounced Walmart from a stock performance standpoint, even though Walmart is probably the best in the business at constraining the value that accrues to their employees. We owned Costco back then and took the other side of that trade."

Today we have a much more formal process. We've recently published how we think about stakeholder value creation. For us, all of this is completely aligned with shareholder value. So many people act like things like ESG analysis is somehow in parallel or unrelated or even contradictory to shareholder value creation. From our perspective, that's just wrong. There are certainly things companies may do that are purely charitable, but stakeholder value is not about charity. Stakeholder value is about creating win-win relationships with all of the players in your ecosystem. That's how shareholders make the most money – once those relationships are all going in a positive way, then the shareholder then has the opportunity to claim their share of that value creation.

G&D: Relating to the Costco example, is lot of times these sorts of decisions are very unpopular because they may result in earnings miss by investing through the income statement, right? Do you actively look for CEOs who are willing to really invest for the long-term and forgo short-term earnings?

SSS: 100%, I think that when you're doing idea generation in our space, a lot of it is pattern recognition. We're trying to identify some signals that a company, that we don't yet know very much about, may fit into the process we're talking about. There's a widespread understanding that owner-operated businesses tend to be good businesses, and I think the reason for that is that owner-operators intrinsically understand stakeholder value generation. Because this is their own business and they're the operator, so they know in the real world you want your employees delighted with their relationship with you. You don't want to keep their pay as low as possible so that they are just barely on the brink of leaving at any given moment. Owner-operators understand that.

Family-owned businesses in particular understand multi-generational stakeholder value and can make decisions that may not seem optimal, but only because they're playing on a different time frame. Anytime we hear CEOs talking authentically about the importance of employees and taking actions that reward them, not out of a sense of generosity or charity, but out of a sense that these people are doing great work, we pay attention. If somebody at Ensemble gets a big bonus they often say, "Well, thank you." And my feeling is like, "Thank me? You earned this. You created all this value and that's why your bonus is so big."

(Continued on page 34)

Sean Stannard-Stockton, Ensemble Capital

COVID was a test of management teams to see how they really think about stakeholder value. There was a company in our portfolio that we wrote about that in April 2020 came out and said to their entire staff, "Volumes are down 50% in the last two to three weeks, but we're going to have no layoffs for the next quarter until we get a better sense of what's going on." A quarter is not a very long time, but in April of 2020, a quarter was a very long time. But they told their employees, "There's just won't be any layoffs. And we can't tell you beyond that yet, but for the next three months, just know you're good."

Meanwhile, their main competitor reduced staffing by 20% on the same day and promised shareholders that they would strive to be profitable in all operating environments. You want to optimize for long-term profitability, not profitability every single moment in time.

Home Depot is another example of the mentality we look for. They spent $2 billion in additional compensation for their employees who went to work while the rest of us were cowering in our homes. These are frontline employees operating an essential business who had to go to work in April when we were all horrified. That's exactly what you want to see. Recognition that investing in your people because they're creating value for the company and the company is going to create value for them.

"For example, when we first invested in Landstar Systems, which is a third-party logistics company for trucking, it struck me a lot like Charles Schwab & Co and company's institutional business for RIAs and investors. These are totally different industries, but we recognized the concept of a network and pleasing different people in different parts of the network to create a flywheel."

G&D: The final pillar of your framework is forecastability. Can you talk more about how you think about that across different sectors, from the more predictable ones to the more dynamic ones?

SSS: I mentioned there's two elements to that, the first being intrinsic forecastability. For example, a raw commodity seller is obviously very variable. But if a business has high cyclicality but still has a steady longer-term cycle, that doesn't bother us at all. We'll buy a cyclical as long as we know generally where we are in the cycle and understand it's going to move up and down. But there are some cyclicals that are just super erratic cycles and you don't know what the long-term trend is. That's the sort of business that we're going to avoid.

The second element of forecastability is really our own circle of competence. We're a generalist team and we think that there is a lot of value to being a generalist. For instance, you'll often hear us comparing stocks or companies in our portfolio to companies from other sectors. For example, when we first invested in Landstar Systems, which is a third -party logistics company for trucking, it struck me a lot like Charles Schwab & Co and company's institutional business for RIAs and investors. These are totally different industries, but we recognized the concept of a network and pleasing different people in different parts of the network to create a flywheel. I think that the generalist view is a really important one and one that we really embrace. We won't own the sorts of businesses that really require domain expertise at a deep, deep level to get comfortable.

G&D: You've also mentioned the concept of finding idiosyncratic businesses that look like one thing but are

(Continued on page 35)

Sean Stannard-Stockton, Ensemble Capital

actually another. Could you walk us through what this means?

SSS: Ferrari is a great example of this. If you look at Ferrari you could say, "Well, clearly it's a car company." And it's true that they sell cars. Yet, the economics look nothing like other car companies, which tells you they are doing something different. In fact, it's basically a luxury company. They are selling multi-million dollar mechanical works of art. So it is much more like a luxury company and yet you can't neatly compare it to car companies or jewelry companies or handbag companies.

Businesses like that that will often be assigned to domain-focused analysts. So you end up with a bunch of car analysts analyzing Ferrari, and they just don't have the expertise and even worse, they apply what they know about car businesses to this business that is not a car company, which creates a systematic mis-valuation. But it also doesn't make sense for the luxury analysts either because it sells cars, and they just might not appreciate certain technical aspects of what Ferrari does.

So really, there are two elements of these idiosyncratic businesses that we're attracted to. One is that they are often misunderstood because the use of peer groups and peer multiples is so common that if you have a business that doesn't have a peer group, you create price inefficiency in the market that we hope to take advantage of. The second element is that idiosyncratic businesses by their nature don't have a competitive peer set and therefore are competitively advantaged. Every business has some level of competition. But if you have a business that's doing the same thing as its competitors, then it has more competition than a business that is doing something very different from everyone else.

G&D: After you look at those three pillars how does valuation come into play? How do you ensure, especially over the past 10 years where multiples for these kinds of compounders have increased so much, that you're paying a fair price today and not overpaying?

SSS: It's just a point of fact that the value of a stock is the present value of the future, pro-rata share of cash flows from the company. Assessing that is difficult! But at the end of the day, whether you use a P/E ratio, a DCF model or some industry specific valuation metric, all you're doing is trying to approximate that same question - what's the present value of all this future cash flow? If you're doing something else, then you're playing a totally different game than we do and you're probably speculating.

"So really, there are two elements of these idiosyncratic businesses that we're attracted to. One is that they are often misunderstood because the use of peer groups and peer multiples is so common that if you have a business that doesn't have a peer group, you create price inefficiency in the market that we hope to take advantage of. The second element is that idiosyncratic businesses by their nature don't have a competitive peer set and therefore are competitively advantaged."

Our process revolves around trying to estimate those future cash flows, find the present value and pay less than that. It's not simple, it's not easy, but that's what we're trying to do. Many of the companies in our portfolio trade at P/E ratios or other simplistic valuation measures that are higher than the

(Continued on page 36)

Sean Stannard-Stockton, Ensemble Capital

overall market. If you took a quick look you might say, "Well, they aren't very focused on value. Look at the multiples on their stocks." But remember that we're exclusively trying to invest in businesses that are deeply competitively advantaged and that generate high levels of free cashflow.

When you have a high return on invested capital, you don't have to invest as much to grow at any given rate. Therefore, on average, our companies generate more free cash flow per dollar of earnings than the average company. And since we care about the cash flow, not the earnings, we'll pay a higher multiple on earnings for a business that has higher free cash flow per dollar of earnings. But none of that says that we can't mis-value a stock. Certainly in the environment that we're in today, we are focused on trying to avoid overvaluing companies.

G&D: How do you decide when to sell a company?

SSS: There are three reasons that we sell. One, our thesis falls apart. When we think about these different conviction buckets that we talked about earlier in the interview, there's a threshold requirement for each of those. If any company in the portfolio has even one of those questions fall below a threshold, we're out. For example, if the moat is great, our understanding is great, but management is starting to really abuse the relationship with customers, we're out. In this scenario, our valuation process breaks down, so we just drop the stock.

"We want to be in our best ideas with the least risk and the most upside. Our turnover in the portfolio has averaged around 40% - 50% in recent years, which is higher than most other investors using our kind of approach, but most of it is what we call internal turnover. Rebalancing our position sizes within our portfolio."

The second scenario is a stock becomes overvalued. We have a an approximation of fair value that we track for each company, and we don't sell a stock just because it's trading at fair value. We recognize that our fair value is just a central tendency of a cloud of possibilities. We're trying to predict the future here. So we can't say, "this stock is worth exactly $100." If we have a $100 fair value on a company, it probably means it's worth something between $80 and $120. Hopefully it's concentrated around $100 but there's some variability.

When most businesses get taken out or sell out through an acquisition, they sell at a premium, right? If you're running a really good company, you don't want to be offered fair value and say, "Okay, sure. I'll take cash." You want a premium bid in order to give up a valuable, high-quality asset. Similarly, we require a premium bid to give up our companies. There is a threshold at which we will just exit but it's above our assessment of fair value. If something is only 10% above our fair value, there's still a meaningful likelihood that it is actually undervalued. If it is 50% above our fair value, the likelihood that it's undervalued is much lower.

The final reason we sell is relative opportunity within the portfolio. We have a very disciplined, quantitative, systematic position sizing framework, and we are constantly evaluating all of our holdings versus each other. We want to be in our best ideas with the least risk and the most upside. Our turnover in the portfolio has averaged around 40% - 50% in recent years, which is higher than most other investors using our kind of approach, but most of

(Continued on page 37)

Sean Stannard-Stockton, Ensemble Capital

it is what we call internal turnover. Rebalancing our position sizes within our portfolio. We're only exiting about 10% of our holdings fully to bring in another company. The rest of the turnover is internal to the portfolio.

G&D: Does the macro environment or the market environment, whether it's speculation or froth in certain areas, factor in at all to whether it's a decision to hold more cash or to invest in a certain type of business versus another?

SSS: The macro environment does, but not really the market environment. If stocks that we don't own are trading at crazy levels, it's not really relevant to us. Might the crash in those stocks cause our stock prices to decline? Maybe, but I don't know that we can forecast that with any level of certainty, so generally we're ignoring the market environment. That said, the market environment drives our trading behavior because if the market environment is optimistic, then we're probably going to own less of any given stock. But we're not going to change our portfolio because we think the market is due for a correction.

On the macro level, we would like to be kind of macro-agnostic at all times. We'd rather just spend time focused on individual businesses and just assume that the economy is at a mid-cycle point, operating normally. There are times when that's how we operate. But certainly the last year has not been one of those times. I think that it would be deeply naive to have spent the last year being macro agnostic. For instance, in early March of 2020 we came to the realization that we needed to observe what was actually going on right in front of us from a macro perspective.

"At the time we bought MasterCard everybody knew it was a great business. Everybody knew it was going to grow for a long period of time and everyone understood the profit margins were great. But I don't think many people appreciated just how valuable the business was and what valuation it should trade at. Sometimes we go back and retroactively analyze what P/E ratio a business would have had to trade at to generate a market rate of return."

It didn't require a forecast to recognize that Americans could be mandated to stay in their homes. And not recognizing that that would impact the economy and business conditions would be naive. The flip side of that is right now to look at $2 trillion of increased cash in American household bank accounts versus a year ago. It would be deeply naive to say, "Well, that isn't really relevant." Of course it's relevant! Consumers are the customers spending the money. And a lot of them have a lot of cash all of a sudden.

So we don't spend time thinking about what is GDP or inflation or interest rates going to be over the next year or two, but we spend a lot of time trying to think about long-term macro-economic variables, like what might interest rates or inflation or real GDP growth be like over the next five to 10-year time period and where are we within that cycle? I think many investors mistakenly believe that they can avoid having macro-economic assumptions, but we think the only way to avoid it is to have implicit ones that you are not aware of.

If an investor says they don't care about macro but they are using a normalized P/E ratio of 16, well, why is that P/E ratio 16? If you disassemble it, you'll find that there's an interest

(Continued on page 38)

Sean Stannard-Stockton, Ensemble Capital

rate and inflation and real GDP assumptions embedded in there. You just don't know what they are. And we'd rather be explicit in our assumptions.

G&D: Could you walk us through a case study of a successful investment that you've had in the past, and what you saw that others didn't at the time of the investment?

SSS: MasterCard is a good example. We've owned it for about a decade now. At the time we bought MasterCard everybody knew it was a great business. Everybody knew it was going to grow for a long period of time and everyone understood the profit margins were great. But I don't think many people appreciated just how valuable the business was and what valuation it should trade at. Sometimes we go back and retroactively analyze what P/E ratio a business would have had to trade at to generate a market rate of return. Costco is a good example. You'll find that historically Costco could generally have been bought at a P/E of 40 to generate a market return, but at the time saying it was worth 40x would have been crazy and seemed too high. And yet, in retrospect, we know that was actually the fair value.

I think that was very true about MasterCard when we first invested in it and we think continues to be true today. It's understood to be a high-quality business with an amazing business model, but people haven't fully appreciated what happens to value when a business has this high of a return invested capital, as low a cost of capital through access to debt as they have, and this long a duration of growth opportunity.

The core insight we had in MasterCard was just a recognition that this was a much more valuable business. This was complemented by the fact that there was market concern about the technological disruption of the payment rails. Our view was that technology disruption was going occur on top of the platform that Visa and MasterCard built rather than disrupting their platforms. We didn't know this for sure, but we believed it to be the case. When Apple was preparing to launch Apple Pay, we were initially nervous. We were long Apple at the time too, but we were nervous for Mastercard. Apple had a lot of cash and a lot of smart people, and they had connections to customers' credit and debit cards and bank accounts via iTunes. We were thinking they could really launch their own payment rail system by leveraging the installed base of iPhones.

But what did Apple decide to do? They just built on top of the existing rails. So when you use your Apple watch to get on the New York subway, what are you doing? You're just using a credit card. The innovation just enabled Visa and MasterCard's payment rails to be used for smaller and smaller micro-transactions, and it has been very beneficial to them. That doesn't mean that their rails will never be disrupted. But I think in retrospect, we can say that we were correct in our assessment that technology disruptors were not actually attacking the rails. They were building on top of the rails.

G&D: Any investments over the last five or so years that stand out as particularly painful mistakes and what did you get wrong when you made the investment?

SSS: So I think one mistake that led to an important learning was Time Warner. We invested in them prior to them being acquired by AT&T. This was around 2015, prior to us owning Netflix. Back then, there was the idea that Netflix was going to become HBO before HBO became Netflix, which played out, but that didn't mean HBO couldn't also be super successful. So five to six years ago, we thought HBO could become a global powerhouse. We thought Time Warner could bring it all around the world, use a super low price point, get tons of subscribers, and invest in content - basically the whole game plan that Netflix ended up executing.

(Continued on page 39)

Sean Stannard-Stockton, Ensemble Capital

But what we didn't fully appreciate was that the Time Warner management team was so constrained by their devotion to the dividend, that they were unable to make the investments that they needed to make. We exited the stock and then not long after that, they sold to AT&T at a nice premium to where we had sold. But we viewed that sale as Time Warner essentially throwing in the towel. HBO Max is taking off now, but they could've launched that a long time ago, and we think they would be a much more successful media business if they had done that. We didn't appreciate the non-logical devotion to dividends. We get that people don't like dividends to be cut, but I would much rather a company cut its dividend to invest in an opportunity and defend its long term future.

That's a good trade-off because if you pay out the dividend, what am I going to do? Reinvest it in something else. If you have a better opportunity, go do that. They were institutionally constrained from doing that. When we talked earlier in the interview about some businesses are competitively protected for institutional reasons or cultural reasons, as opposed to anything really structural, the reverse can also be true. Sometimes doing the right thing is too hard for a company for institutional reasons. But the good thing about that experience is that it made us realize Netflix was going to win because Time Warner and other legacy media companies were not willing to compete.

When we realized that was the case and that Netflix had already been raising price at about a 7% rate in a no-inflation environment, that really gave us the confidence to invest in Netflix. Interestingly, look at what has Disney done now – cut the dividend and invest in Disney Plus. They learned the lesson too, but five years is a long time to wait when a disruptor is eating your lunch.

G&D: You've written about the difference between optimizers, which are businesses that are more mature and are making decisions for a steady state, versus visionary CEOs that are looking at where the puck is going. Did this example make you have an even greater preference for investing in the visionary category? Or do you think this was just a one-off example of mismanagement in this particular case?

SSS: We don't have a strict preference for visionaries over optimizers. It's that we want the right style of team running the right business at the right time in its lifecycle. For legacy media companies optimizing their business model in a cable TV environment, there were big competitive moats, and optimizing and milking what you had built for as much cash as possible was great. That was smart. It's only because a disruptor came along that a far-sighted media team should have recognized the real threat. It should have triggered the media teams to reorient away from optimization, towards being more visionary and thinking more about the long-term. That's what Disney is doing now brilliantly. They should've started a long time ago, but they're making the right transition. We felt Time Warner had been optimizing their business, but clearly should have switched into visionary mode, but they couldn't do it.

"Interestingly, look at what has Disney done now – cut the dividend and invest in Disney Plus. They learned the lesson too, but five years is a long time to wait when a disruptor is eating your lunch."

It is the rare management team that can switch back and forth between vision and optimization. I do think that a lot of very successful visionary CEOs have been paired with an optimizer, but the optimizer often

(Continued on page 40)

Sean Stannard-Stockton, Ensemble Capital

doesn't get the credit. Think about Steve Jobs and Tim Cook, or Walt and Roy Disney. There's lots of pairs out there in which the visionary is the big charismatic face of the business, but the management team understands optimization too. We think both are important and you just need to know the right mix at the right time.

G&D: How do you approach that from the individual business perspective, where a holding might have a unit that is an optimization phase and then other parts of the business that are more high growth? One example that comes to mind from your portfolio is Alphabet.

SSS: What makes business and investing so hard is that you need to balance everything exactly right all the time. We've been long Alphabet for about a decade now, and when Ruth Porat came in as CFO, we were of the opinion that it was good because the business needed to focus more on optimization. This was still a high growth, highly dynamic industry, so certainly you don't want an optimizer being the CEO and calling all the shots. But Alphabet was producing so much more cashflow than they had anything to do with that we thought it would be good to optimize along the way too.

The whole reason to be visionary and to identify some giant future profit pools is to then go capture those profit pools. When you find one, you have to attack it and feed at the profit pool. We were a bit disappointed that after some initial signs of Ruth Porat being successful in that, it seemed to recede a bit, but it has now come more back to the forefront. Now Alphabet is spending about three quarters of earnings to buy back stock. We absolutely believe that they should have a very large strategic cash war chest on their balance sheet, in excess of any operating cash that they need. That's absolutely the right thing to do given their business and the competition. But they don't need as much as they have today. And even buying back the amount of stock they're doing now, they still are having cash build higher. To me, that's a whole bunch of the market cap sitting there in cash, earning cash rates of return.

If they don't have anything to do with it, they should give it to us because we've got stocks to go buy with it! We only partner with management teams that we trust. We are very likely to defer to their decision-making there, but we also rate companies at different levels on different metrics. So we would say that Alphabet has fantastic management on a whole lot of metrics, but on capital allocation questions, it has not been so great. Although they must be given credit for the fact that they've done two or three of the best M&A deals in the history of technology space, so I also don't think you can call them bad capital allocators.

G&D: Could you walk us through a stock pitch of an existing idea that you're excited about?

SSS: Let's talk about Home Depot. We took a small position in Home Depot prior to COVID and we had a number of housing related investments prior to COVID. When we initially made the investment, we were of the view that the level of housing activity was at subnormal levels ever since the housing bust. The levels of existing home turnover and volume of new homes being built were both at low levels. This initial macro view made us think that even if the economy grows at just whatever an average growth rate is, that housing would grow faster because it was starting from a depressed base.

I would never in a million years have guessed that a pandemic would unleash housing activity. It's almost the opposite of what we would have thought, and yet that's exactly what happened. Everybody loves to buy a cheap stock with a catalyst, but we don't actually spend a lot of time thinking about catalysts because we think that the things that actually cause a

(Continued on page 41)

Sean Stannard-Stockton, Ensemble Capital

stock to rerate higher tend to be pretty unpredictable. But in Home Depot's case, we upsized the position significantly and made it into one of our largest holding in the month or two after COVID hit, as housing activity started storming back and it became clear that the pandemic was actually a positive catalyst.

If we were all trapped in our homes for a long period of time, and we needed to start working there, we would use it differently. We're all using our appliances at levels that we haven't in the past. We've done a lot more home maintenance than normal because we're just using everything a whole lot more. And instead of going traveling, which a lot of homeowners would do over the summer, people decided to spend that money on their backyard instead. You couldn't find somebody to install a pool last summer because demand was so high.

As a side note, I think this is fascinating. There will be pandemic scares in the future for sure. Maybe next time there is a scare, we'll see fast food stocks or housing stocks rallying on concerns about a pandemic. We've all learned that like with most every crisis, there are always certain industries that thrive in a crisis.

So with Home Depot, we believe that the economic conditions are such that there's a real tailwind to the housing industry. But the thing that makes Home Depot an idiosyncratic business, as we talked about earlier, is that 4% of their customers are pro contractors. And those customers generate 45% of the revenue of the business. Most people think of Home Depot as a do-it-yourself home improvement retailer for homeowners, like Lowe's, but only half of their businesses is that. The other half of their business is being a mission critical supplier in a B2B relationship with a fragmented end market. Those are conditions for fantastic competitive advantages.

When you talk to small contractors, at almost every job, there's something they don't have on hand that they need and they need to obtain from a nearby location. There are a ton of Home Depots in the country. Individual contractors will drive past a Lowe's to get to a Home Depot that's a few miles further away because it's just their preferred place for shopping. Any time you are a platform to another business, the business that is built on top of your business doesn't want to switch. They just want to make sure they're treated well so they can go do their own thing, and those are really great businesses.

This is the same dynamic I mentioned earlier with Schwab's RIA business. Of course, some other retail broker could come out and steal some market share, but on the institutional side with RIAs, the value proposition improvement to try and move all your clients to a different custodian would have to be so large, it's almost unthinkable. Being a B2B service provider can be hyper-lucrative if you're really mission critical and if the cost is a low portion of your business customers' overall expense structure.

> ***"The thing that makes Home Depot an idiosyncratic business, as we talked about earlier, is that 4% of their customers are pro contractors. And those customers generate 45% of the revenue of the business...Being a mission critical supplier in a B2B relationship with a fragmented end market are conditions for fantastic competitive advantages."***

G&D: What do Home Depot's contractor customers care most about between

(Continued on page 42)

Sean Stannard-Stockton, Ensemble Capital

convenience, selection, and price?

SSS: I think price is the least important because home improvement contractors usually have parts and labor billing. If you need certain parts, whether one part is a little bit more or less expensive is not the needle-mover for the contractors themselves. They can basically pass along the cost to the homeowner. So it's about selection and it is also about the total ability to serve customers. Home Depot has their pro-desk, which is their online platform customized for contractors. If you go onto Amazon, both business customers and individual customers of Amazon get the exact same interface to buy stuff from, but businesses have different needs than individuals do. A contractor might need to download all of their transactions into QuickBooks. The Home Depot interface allows that. A consumer-facing e-commerce site doesn't have that sort of feature.

You could also go to Amazon and ship stuff to other addresses, but if you pick lots and lots of different addresses, pretty quickly it triggers fraud alerts. But contractors have jobs sites all over the place and they need stuff shipped to those job sites. Home Depot understands that. I think that it is that total service experience, selection, and being able to meet customer needs that is most important, and price is least important.

Home Depot has pricing power, but not because the customer is trapped; rather, because it's not the key variable that the customer is optimizing for. Does that mean that Home Depot can charge a lot higher prices? Well, they have slightly higher gross margins than Lowe's but I think that the bigger thing is that they're able to move a lot more revenue for any given store, which generates much higher asset turnover and higher returns on invested capital. So Home Depot actually shouldn't optimize for margin – they should optimize for return on invested capital. Those are both important, which is why you can have low margin businesses like Costco that are fantastic businesses. And you have very high margin businesses that are not good investments because they are so capital intensive that it doesn't matter if the margins are high.

G&D: What do you think about Home Depot's growth runway? And what should they be doing with their capital between building stores, repurchasing shares, etc.?

SSS: One thing that's fascinating is that in the 10 years since the housing bust bottomed, Home Depot's revenue has almost doubled while their store count is only up 2%. Part of that had to do with aggressive building of stores during the housing bubble and a recognition that they had overbuilt. So what they're seeing is higher and higher levels of revenue per store. I think that it's likely that they are getting close to having their stores running at really full capacity. We think that there is opportunity for them to go back to building more stores over time. Not some huge number of new stores, but to add slightly to growth through that lever. But most importantly, when we think about growth, we think about the simple fact that people live in houses. That's not going to change. Those houses depreciate. That's not going to change. And people want to live in nice places! The desire to maintain your home is encoded in our DNA. Coming back to the concept of forecastability - we have no concerns that say, 20 years from now, that people are just not going to care about what their home looks like. We think that a large part of the growth is just tied to GDP.

What would concern us is if Home Depot started hitting a stall speed; for example, if people started losing interest in home improvement relative to everything else. But we don't think that's the case – we think that in aggregate, home improvement will

(Continued on page 43)

Sean Stannard-Stockton, Ensemble Capital

grow with people's spending power.

"So Home Depot actually shouldn't optimize for margin – they should optimize for return on invested capital. Those are both important, which is why you can have low margin businesses like Costco that are fantastic businesses. And you have very high margin businesses that are not good investments because they are so capital intensive that it doesn't matter if the margins are high."

Because we believe that home improvement activity levels had been below normal for a long time, there is a tailwind from that as well. In the very short term, Home Depot is going up against 25% same-store sales comps from last summer, which was about five years of expected growth that played out in just a few months. So the comps are going to be very tough as they roll through 2021. But we think that it wasn't just a one-time event – we think that Americans had been disengaged with home improvement for a long period of time and that this pandemic created an experience of becoming re-engaged. People have now regained the habit of home improvement.

In the years ahead, people will just be more likely to notice something in their house that they wish was different. And since they had done a bunch of home improvement last year, they'll say, "Oh yeah, well, I should just call up the contractor. I should just go to Home Depot myself and take care of this." Housing also has the additional benefit of the millennial cohort. The year with the most millennials being born was 1990, meaning that those people turned 30 years old during the pandemic. They're entering the prime home buyer period and we think that you're going to have a lot of millennials who are now earning at high enough levels to be in a position to buy homes and spend on home improvement.

G&D: What's your assessment of the management team there and the culture of the business?

SSS: I think the management team is great and the culture in particular is great. ESG has become very popular and is often focused on whether the company's products and services make the world a better place. If you think about so-called sin stocks like alcohol or gambling, there's the idea that the products and services themselves are somehow negative for society. But that's not what stakeholder value is about. Stakeholder value is businesses whose products and services enrich the lives of their customers, yes, But more importantly, all elements of the stakeholder base.

Home Depot goes a layer further than the traditional thinking of putting customers or shareholders first. They put their employees, who they call "associates" first. The reason they do that is if they put the associates first, the associates will put the customers first and everything else takes care of itself. That's the line that they use. We think that Home Depot truly understands that the way to run their business and to generate as much profit for shareholders as possible, is to really focus on their employees and really treat them well. It doesn't mean just being generous and overpaying people, it means treating them really well, making them delighted to work there.

One thing that we saw during COVID was that this way of thinking extends to the relationship with suppliers. Many people don't think of suppliers as a critical stakeholder, but during COVID, Home Depot went out to one of their paint suppliers and said, "Hey, we can't get enough hand sanitizer.

(Continued on page 44)

Sean Stannard-Stockton, Ensemble Capital

We're worried about our employees dying and we need you to help." And that paint company, who's a critical supplier to Home Depot, shut down one of their paint lines, reformatted it to make hand sanitizer and produced a ton of hand sanitizer for Home Depot. Why was that? It was not because Home Depot had the supplier trapped, it's because they are in a mutually beneficial value-creative relationship with that supplier. And the supplier understood that in a time of need, you stand by your partners.

Everybody understands that in real life. What's so weird is that investment analysts forget that stuff when they get into their spreadsheets. But in real life, there's people in your life who you have value-creative relationships with, and when they come to you at a time of need, you help them. You don't think, is this an optimal use of my time? You say, "No, this is what I do, because they'll be there for me in the future. I don't know when it's going to be. I'm not even going to measure whether I get returned the same value I put into it." When you have value-creative relationships, you invest in those relationships and some big portion of that value accrues back to you.

The book "Built to Last", written by Home Depot's founders, speaks to this issue right from their founding years. You can see that when they talk about their associates "bleeding orange". Those are the sorts of businesses you want to invest in.

"I'm really glad to see that the businesses that we own, generally are paying well above industry averages, because it means that as wage costs get forced higher, there won't be the same degree of forcing mechanism on them. These companies will have to maintain their spread, but they'll have a lot more flexibility to do that strategically."

G&D: How do you think about valuation for Home Depot given where the stock is trading today?

SSS: For every position in our portfolio, we've established an assessment of the intrinsic value based on our expectation of future cash flows and we're evaluating the market price relative to that intrinsic value. But we don't spend much time thinking about current P/E ratios. Yes, revenue at Home Depot was elevated last year, but so were costs. I mentioned they spent $2 billion in extra associate compensation during COVID, and they've already said they're going to make $1 billion of that permanent.

One thing that we're seeing across our portfolio is businesses like Starbucks, First Republic, and Home Depot are proactively raising wages, and doing so in some cases aggressively. We're really pleased to see that, because we think that wage inflation, which is a good thing for the economy, is coming. I'm really glad to see that the businesses that we own, generally are paying well above industry averages, because it means that as wage costs get forced higher, there won't be the same degree of forcing mechanism on them. These companies will have to maintain their spread, but they'll have a lot more flexibility to do that strategically, as opposed to having employees saying, "Hey, I need a raise," or regulations coming in and mandating that. So the $1 billion of that COVID spend being made permanent is great, but in the short term it's still $1 billion of potential earnings that's going to get coughed out of the business, even if at lower revenue levels.

G&D: Switching gears to our closing questions. How do you structure your days and what does a typical day look like for

(Continued on page 45)

Sean Stannard-Stockton, Ensemble Capital

you?

SSS: The first half of my day, the calendar is kept as clear as possible. That half of my day is really devoted to pure equity research. I'm a lead analyst on a lot of these stocks, so I'm focused on researching those stocks, idea generation and all of that. Earlier in my career, I didn't think much about when during the day I did different types of work, but over time I came to appreciate that every person has different times of day when they're better or worse at different types of tasks. I know that when I'm first awake and I've had my coffee, I'm energized and I have the ability to dive into some of the deeper work.

But that's not true of everybody. On our team, for example, we often get emails from Arif at two in the morning because he does his best work from like 10PM – 2AM. And that's fine. It doesn't make a difference. I just try to do what works best for me.

In the second half of my day, I fit in my responsibilities as President and CIO of Ensemble Capital. I continue to do research which is my core responsibility. But I've just found that I can process a bunch of emails at 3PM, in the afternoon, when it's starting to get late, whereas understanding the economics of a company that I'm not all that familiar with is much better in the morning.

Another important element is that our team is remote, in that Arif lives outside of San Diego, Todd lives outside Cincinnati and I'm in Silicon Valley. Our next hire will also almost certainly be somebody in a different geographic area. Our entire staff was already a remote-first team prior to COVID. We had about 20 - 30% time in the office, but we told people to work wherever they want to work to get the best work done. I've come to believe that equity research teams that work in-person, in a single city together, are at a deep disadvantage. Everyone worries the opposite. They say, "Well, if you're remote, you're going to lose the culture and the back and forth and all of that sort of stuff."

That's only true if you have a staff that is not digitally native. Our team is talking all day, every day. We have instant messaging, we have video chat, we have emails. It is a constant discussion here, even though we're all in different areas. Yet having people with different lived experiences, in different parts of the country, is really important. Todd's perspective living outside Cincinnati and in a non-urban area is quite different than my experience living in Silicon Valley. Neither is better than the other, but both are very critical and helpful inputs to the investment process.

G&D: What advice would you give to MBA students interested in pursuing investment management as a career?

SSS: The only reason you should do this because you're super passionate about it. You're going to be competing against people who just love this work so much. I know that's true of the people on our team. We don't need to work weekends here, but on our instant messaging board we're chatting all weekend long because there's always something interesting to talk about. On the weekend, I'm reading lots about investing. Not necessarily poring through research reports in service of some thesis, but just reading stuff I'm generally interested in.

I think that it's really critical that you are truly passionate about it. If you're not passionate about it, just go do something different because you're going to get schooled by people who are passionate in this business. This business is hard work, and even if you're very good at it, you'll have meaningfully long periods of underperformance. So you better be passionate, that's the only thing that's going to get you through those time periods.

Assuming that you are passionate, I think that in the earlier part of your career, you look at

(Continued on page 46)

Sean Stannard-Stockton, Ensemble Capital

people who've been successful and learn about what they did. Read everything Buffett's written, all that sort of stuff. Learning from what other people have found works is a critical first step. From there, you need to begin to develop your own philosophy, because you can't copy your way to success.

You can observe success and use those learnings to inform your own style, but you must develop your own approach. The reason is that it's only your own approach that you will have enough conviction in.

"When something like March of 2020 occurs, you have to have the conviction to stick with your process. If you're just copying somebody else, you're going to start wondering, "Well, what would they do in this circumstance?" So you need to have your own process."

When something like March of 2020 occurs, you have to have the conviction to stick with your process. If you're just copying somebody else, you're going to start wondering, "Well, what would they do in this circumstance?" So you need to have your own process.

As you develop that, I think that the third part is really understanding that investing is about so much more than business and spreadsheets. You need to have your finger on the pulse of everything going on in the world, from cultural trends to politics. Being a curious person and cultivating your curiosity, and giving yourself permission to read widely on lots of different topics, is really, really important to that longer term success. In my own career, early on I read lots of books about picking stocks. Then I moved past that and started reading more detailed, specialized books on things like accounting. But now, a lot of the reading that I do is more around things that are not just about the art of stock-picking.

For example, I spent a lot of the last eight years reading about decision-making research, which is very applicable to what we do. As a portfolio manager, all you're doing is deciding to hold, to buy, or to sell. That's what you do all day, every day, every moment of time. You are constantly being made these different offers from the market, and you need to be making decisions. Even a decision to not react at all is still a decision! We've spent a lot of time drawing on the work of people like Phil Tetlock and Daniel Kahneman who have focused on decision-making to try to extract key lessons.

Those lessons are the ones that I feel have really created differentiated processes for us. When we draw on learnings from other disciplines, to try and understand how those can be important in the investment management process, that helps us generate alpha. We know that many participants in the market are really only just focusing all their time on market information and aren't drawing on those other mental models. And we think that's a really important thing to cultivate.

G&D: Any particular books on that topic that you'd recommend?

SSS: Phil Tetlock's book "Superforecasting" is a must-read, as is "Thinking Fast and Slow" by Daniel Kahneman. The third that comes to mind is Nate Silver's "The Signal and The Noise."

G&D: How do you spend your time outside of work?

SSS: Being an entrepreneur and building a business, as well as running an equity strategy means that there's not a lot of free time! I have my family at home; I've got two teenagers. I spend a lot of time with them. Like a lot of people who have children at home, I don't have some wide variety of other hobbies. Travel is by far my second most

(Continued on page 47)

Sean Stannard-Stockton, Ensemble Capital

favorite thing to do; losing that for the last year has been a real negative. One of the things I love about travel that if you travel with an investor's lens, it gets so even more interesting. I was in Colombia a couple of years ago and I noticed that there was this one beer I'd never heard of that was everywhere. I started asking about it and people said, “that's what everyone here drinks”. And they were telling me about how it doesn't advertise at all because everybody already drinks it. So why would you advertise? This wasn't a business that we were going to invest in, but it made the travel experience more interesting and it made me think about investing, and I think enhanced my investment knowledge.

Then I’m passionate about philanthropy. Early in my career, because Ensemble provides financial advisory service to our private clients, cultivating advice to philanthropic clients became a real focus of mine. Over a quarter of Ensemble's AUM is charitable assets, whether that is non-profit endowments, grant making entities or charitable trusts of individuals. And that's been an area that I've been very interested in, especially in the idea of high impact giving.

In my view, charitable giving is the provision of capital to organizations to create social impact, which is very similar to investing. In social impact, the value is accruing to some third-party beneficiaries rather than to the shareholders, but that's fine. That's the point of it. The stakeholder value lens is still the right one, it is just that as an investor in the end you are judged by the return to shareholders while in philanthropy you are judged by the return to beneficiaries. So I've long been very involved with and interested in discussions on the effective philanthropy movement and how to better measure and maximize impact.

G&D: Thank you very much for your time.

Columbia Business School
AT THE VERY CENTER OF BUSINESS

Get Involved:

To hire a Columbia MBA student for an internship or a full-time position, please contact Dan Gabriel, Director, Employer Relations, in the Office of MBA Career Services at (212) 854-6057 or valueinvesting@gsb.columbia.edu.

Alumni
Alumni should sign up via the Alumni website. Click here to log in.

To be added to our newsletter mailing list, receive updates and news about events, or volunteer for one of the many opportunities to help and advise current students, please fill out the form below and send it via e-mail to valueinvesting@gsb.columbia.edu.

Name: ________________________________

Company: ________________________________

Address: ________________________________

City: ____________ **State:** ________ **Zip:** __________

E-mail Address: ________________________________

Business Phone: ________________________________

Would you like to be added to the newsletter mail list? __ Yes __ No

Would you like to receive e-mail updates from the Heilbrunn Center?

__ Yes __ No

The Heilbrunn Center for Graham & Dodd Investing
Columbia Business School
3022 Broadway
Uris Hall, Suite 2M6
New York, NY 10027
212.854.1933
valueinvesting@gsb.columbia.edu

Visit us on the Web:
The Heilbrunn Center for Graham & Dodd Investing
www.grahamanddodd.com

Columbia Student Investment Management Association (CSIMA)
http://www.csima.info

Contact Us:
RDepaula21@gsb.columbia.edu
MHabig21@gsb.columbia.edu
LTien21@gsb.columbia.edu

Columbia Business School
AT THE VERY CENTER OF BUSINESS
The Heilbrunn Center for Graham & Dodd Investing

CSIMA Columbia Student Investment Management Association

Graham & Doddsville Editors 2020-2021

Rodrigo de Paula '21
Rodrigo is a second-year MBA student, a Meyer Feldberg Fellow and a member of Columbia Business School's Value Investing Program. During the summer, Rodrigo worked as an equity analyst at MFS Investment Management. Prior to Columbia, he worked at Clayton, Dubilier & Rice as a private equity associate. Rodrigo graduated from the University of Pennsylvania with a B.A. in Philosophy, Politics and Economics.
He can be reached at RDepaula21@gsb.columbia.edu.

Matt Habig '21
Matt is a second-year MBA student and a Columbia Fellow. During the summer, he worked in the Restructuring Group at PJT Partners. Prior to Columbia, Matt worked for six years in the Institutional Equity Division at Morgan Stanley, most recently spending three years in their Special Situation Group. Matt graduated from Dartmouth College with majors in Economics and Engineering Sciences.
He can be reached at MHabig21@gsb.columbia.edu.

Alison Tien '21
Alison is a second-year MBA student and a Columbia Fellow. During the summer, Alison worked in the Equity Investment Group at T. Rowe Price. Prior to Columbia, she worked in portfolio analytics at Capital Group in their Los Angeles office. Alison graduated from the University of California, San Diego with a concentration in Economics and a minor in Accounting.
She can be reached at LTien21@gsb.columbia.edu.