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THE CONTRARIAN PATH

The Capulets and Montagues, Hatfields and McCoys, and Growth versus Value? The financial media would have us choose sides in a never-ending epic struggle for superior investment returns. Upon closer inspection however, we see a growing number of star-crossed lovers and kissing cousins that blur the traditional lines between growth and value. To be sure, lines still exist. From the value camp, a margin of safety, a sound balance sheet, long-term earnings and cash flows bought at an attractive price strike us as timeless elements. Rather, we see lines blurring due to fundamental shifts in the economy and the manner in which the companies themselves are crossing enemy lines by adopting each other's strategies. These fundamental shifts at the company level have produced (at first glance) some odd couples along the way.

First, consider that traditional value investor Warren Buffett's Berkshire Hathaway now owns large stakes in both Apple and Amazon (traditional growth names), and second, consider that traditional value names Walmart and Disney are now attracting growth investors as they aggressively muscle into the domains of Amazon and Netflix, respectively. We place ourselves in the value camp, but we have never hesitated to purchase growing firms (assuming they meet certain conditions we discuss later). However, our frequent approach is to wait patiently until they go on sale, whereby we seek to purchase significant value through a discounted share price. Although Buffett and Munger recently bemoaned "missing" Google as an investment, we discuss later the principles of "value investing," but more importantly contrarian behavior, that led to our purchase nearly five years ago. Regardless of one's disposition towards growth or value, we believe the overriding factor to investment success lies in contrarian behavior (particularly if one's goal is to obtain a bargain).

If the growth and value debate sounds a little confusing, do not worry, the expert index creators that track so-called growth and value stocks also appear plenty confused. To their credit, when we scan the constituents of the S&P 500 Value Index, we see several of our holdings (identity crisis averted!). For example, sitting prominently on the S&P 500 Value Index is our holding in the Walt Disney Company. Naturally, curiosity drove us to review the S&P 500 Growth Index, where surely only the most intrepid growth investors would dare tread (pause for laughter). What did we find third on the list? The Walt Disney Company. While S&P may be inconvenienced by this duplicity, we are not.

In order to explain today's confusing state however, it helps to see that its seeds were actually sown some 85 years ago.

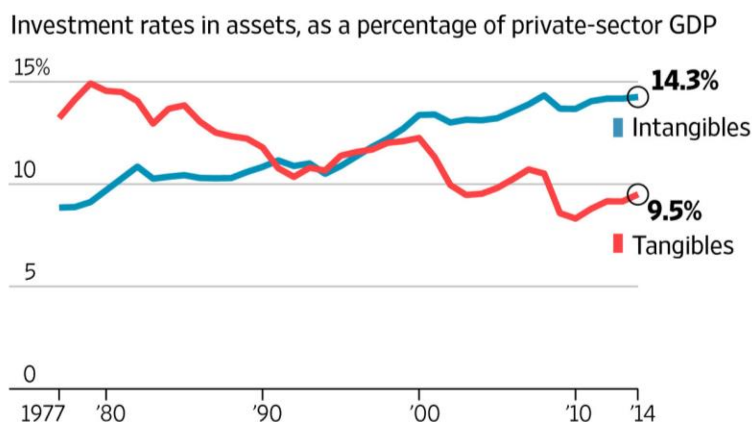
Value Beyond Measure: Counting the Unseen

In 1934 the major economies of the world were mired in the Great Depression, and in response economists were feverishly working to explain the current environment, its causes and prescriptions for its recovery. It was at this time that an economist named Simon Kuznet developed and prepared a thorough accounting of national income that has since evolved into what we know today as Gross Domestic Product, or GDP. In that same year, Benjamin Graham, the investor, professor at Columbia University, and "father of value investing" wrote Security Analysis, his first of two seminal books that

shaped generations of investors that followed (including John Templeton, Warren Buffett and countless others).

A year later in 1935 a cartoonist at the Walt Disney Company modified Mr. Disney's already popular Mickey Mouse character by shortening his nose and adding white gloves, thereby solidifying the iconic image that we still know today. Despite Mickey's overwhelming popularity at the time—dating back to his creation in 1928—both Mr. Kuznet and Mr. Graham would have likely seen his value too difficult to capture either in GDP statistics or on the balance sheet that Graham would have assessed in his calculation of intrinsic value. This is no fault of theirs as the economic world they inhabited was dominated by industrial "tangible" assets that could be touched, seen, measured, and valued. Mickey Mouse was a financial outlier. He was a creative idea, an animated sketch, the rare "intangible" asset that subsequently generated billions of dollars of wealth for shareholders and somehow, quite remarkably, still creates wealth today.

In 2019, however, the advent of the internet, collection of data, and rapid computation of that data has led to compositional changes in the economy and the manner in which value is created for shareholders. Today, the marginal assets propelling the "knowledge" economy are increasingly represented by creating new ideas built from combining readily available data collected in real time, from around the globe. In other words, the assets driving economic gains today are more closely related to Mickey Mouse in nature, than they are to the tangible assets that statistical measures, accounting methods, and valuation methods were designed around in the last century. This reality has created significant challenges for today's economists and accountants, who still struggle to account for intangible assets that defy being touched, seen, measured, valued, and in some cases even fully understood. Rather than tackle the anomalous values of Mickey Mouse, or the formula for Coke, economists and accountants today are tasked with collecting, interpreting and recording data representing a widely expanded realm of intangible assets including: in-house proprietary software, customer databases, customer network effects, business processes, and organizational structures. So, while the assets listed above are very real to shareholders, and tend to be more durable than not, the business activities used to create them flow through the income statement as expenses, rather than get recorded on the balance sheet as an investment. In sum, the financial parties that collect and report data to the markets are failing to capture an increasing amount of economic activity tied to today's growth in intangible assets.



Sources: Carol Corrado, Charles Hulten, WSJ

Despite any shortcomings in economic or accounting data, the investment community has been far more discerning and adaptive. Ben Graham's assessment that an intangible asset should not be included in the calculation of intrinsic value was based on the observation that intangible assets were frequently rendered worthless, and therefore dangerous, when a better idea entered the market. In his time, intangible assets carried much shorter lifespans, and by contrast, many intangible assets in today's economy have proven surprisingly durable.

To illustrate a durable intangible asset, consider the November 1990 release of Microsoft Office that almost 29 years later continues to dominate workplace software applications with reportedly over 1 billion users. Another example could be found in the September 1997 launch of Google which today is estimated to control 92.6% of the search engine market with 5.4 billion daily searches run on its site. Both of these examples provide insight that the most powerful, and durable intangible assets create a "network effect" that can stay in place for decades, when successful (Visa and Mastercard are examples in the financial world). The other aspect worth mentioning here is the winner take all nature of a successful network effect; Microsoft Word devoured WordPerfect and Google supplanted Yahoo. Another powerful network effect can be seen in Facebook (and its dismantling of predecessor MySpace). Interestingly, you can still use WordPerfect, Yahoo, or MySpace (yes, they actually all still exist), but given their small networks the incentive to do so is also small. So, yes of course, there is still a risk to owning an intangible based business such as Yahoo that gets capsized by Google, but we also suspect that proclaimed value investors found little comfort in the tangible assets of Sears.

Irreconcilable Differences: Margin of Safety and the Balance Sheet

In light of the above, we have coincidentally teased out one of the traditional dividing lines between growth and value investors. Value investors, to their credit, possess a strong bias towards capital preservation and this bias is supported by a calculation of intrinsic value, and the resulting margin of safety (i.e., the share price discount relative to intrinsic value). The estimate of intrinsic value can be achieved through many approaches, based from measures of earnings, cash flows, dividends, returns on invested capital, and in the most conservative approach an NAV derived from the balance sheet. This bias creates a practice among value investors of all stripes to connect earnings, cash flows, and the assets that produce them (and their durability to do so). With that said, value investors instinctively focus on assets that can produce over long-periods of time, and through changing economic environments (i.e., oftentimes, value investors purchase during periods of duress). Irrespective of the analytical method, value investors tend to hold in common an obsession over understanding the potential downside in any investment holding.

To see this, consider one of Benjamin Graham's most famous investment strategies. In his "net-net" investment screen, Ben Graham (and countless followers since) made purchases in firms that traded for less than the balance sheet value of their cash and net working capital (with adjustments made for doubtful receivables, and the estimated liquidation value of the inventory). In this case, a purchase would only be made in the circumstance that the balance sheet itself assured a return to the investor in the case of liquidation (a highly conservative condition). If attempted in today's market, this approach would likely stumble for any number of potential reasons. First, obvious and identifiable discrepancies between a share price and liquidation value would be arbitraged very quickly thanks to the large number of investors searching for these relationships. Second, liquidation values have become increasingly difficult to measure because many of the critical assets are intangible, and not recorded on the balance sheet. This last point is owed to the growth of intangible assets resulting in a natural progression of the economic fundamentals away from Ben Graham's specific strategies (that

were built around tangible assets). Most importantly though, the changing fundamental aspects do not threaten his overall philosophy, which continues to thrive today.

One final note here is that we believe in order for a Ben Graham style asset-based valuation approach to be successful today—such as the widely used price to book ratio—the analysis would need to make an estimate regarding the value of intangible assets (not fully reported in financials) in order to calculate a reasonably accurate ratio. Since many intangible assets are not counted in traditional book value, the price to book value without any adjustment appears inflated (and expensive). Similarly, a low price to book ratio without any adjustments implies to us the possible need for asset write-downs or a firm's reliance on underperforming tangible assets. Since low price to book ratios are a key focus for the "value" indices, we believe these measures have a bias towards selecting firms with less productive assets. To the extent this is true, this collection of assets are very likely to underperform the overall market, much less the growth stocks where earnings estimates are growing even faster (but may not be sustainable). In sum, we believe low price to book ratios naturally steer money towards underperforming assets. This was not necessarily a bad thing—in the past—when underperformance could recover and generate attractive returns through mean reverting economic forces such as overcapacity, recession, etc. However, in today's market we believe there is a stronger probability that low price to book ratios identify uncompetitive assets that may never recover (i.e., value traps that are suffering at the hands of competitors), and therefore more careful analysis is needed for these low price to book scenarios.

Contrarians Capture Growth and Value

Regardless of the evolving landscape, the good news is that flexible and open-minded value investors need not find themselves in extreme scenarios such as Yahoo or Sears in their search for a bargain. Instead, we see a fertile middle ground in this environment as capital intensive businesses invest more heavily into intangible assets (creating new growth), and capital light businesses migrate towards the tangible economy (creating more safety). As we conclude our discussion, we will return to Disney and Google to illustrate these concepts from a value investor's perspective.

Earlier we referenced Warren Buffett and Charlie Munger's lament for "missing" Google as an investment. While searching our valuation screens (rankings) in late 2014 we perused the data for Enterprise Value / EBITDA ratios, where we found ranked in the (lowly) bottom quartile of the market the iconic tech growth firm, Google (now Alphabet). To say the least, it was an odd sight, perhaps on par with a celebrity sighting at your local Walmart. After independently verifying the data, two things became clear: one, Google shares looked like a bargain, and two, the market had become pessimistic over the firm.

Investor frustration with Google at the time was owed to recent compression in its operating margin, and a fear that the margin compression was owed to slowing growth and/or growing competition (Facebook was a concern). Our view was somewhat different. We understood that the firm was making substantial investments that were being expensed through its income statement, and therefore negatively impacting its margins. Coincidentally, we knew this because the firm's push into tangible assets (i.e., Nest home security, and Waymo self-driving autos) had piqued our interest since these businesses were both more tangible and looked well positioned versus incumbent competition. In any event, during early 2015 the shares had never traded at such a large discount to the S&P 500, not even during the depths of 2008-2009. The valuation reflected concern over the core search business, but in our view assigned no value to the firm's investments in Nest, Waymo, etc., or even YouTube for

that matter. This was easier for us to comprehend since Google's new investments had a tangible, measurable nature.

In hindsight, the tools and methods we used to identify Google for purchase were relatively conventional, and we believe the critical factor in the early 2015 purchase (March) was our contrarian behavior. It might be easy to dismiss the contrarian factor in hindsight but bear in mind that Google's traditional growth investors had turned against it, and many value investors were indoctrinated to avoid technology (following Warren Buffett's views at the time). However, we believe the widespread pessimism from both corners of the market is precisely why it was trading at such a low valuation. Fortunately, several months later in August of 2015 Google reorganized itself into Alphabet, which thereby separated the financials of Google and the other businesses, revealing the continued prowess of the core Google business and the relative performance of the new business lines. The stock market liked what it saw, and we continue to hold the shares today. The timing of the reorganization was luck of course, but we have always believed that you make your own luck.

Timeless Value Principles: It's a Small World

While Google provides us with an illustration of a largely intangible business migrating into more tangible business lines, and thereby entering the realm of value investors, we will now visit the more conventional paradigm (we believe) for today's market, which involves capital intensive businesses investing further into intangible assets to pursue new growth opportunities. While the Google example was interesting, we believe there are far more potential investments fitting into this second scenario. Moreover, we find the potential investment returns from this second scenario a more dynamic opportunity. Our reasoning is that intangible assets tend to carry higher margins and growth rates when compared to capital intensive models, and when these assets either integrate with or replace tangible assets the opportunity for higher valuations (and shareholder returns) is greater. Namely, in this discussion we are targeting traditional value names (that already possess a certain level of safety) that are now adopting growth-oriented strategies.

There is some chance that you are among Netflix's 151 million global subscribers. Statistically speaking (at least) there is also some chance that you were among Disney's 152 million annual park visitors in 2018. The open question then is how many of Disney's 152 million park visitors (during 2018) will subscribe to its upcoming Disney + streaming service to be released in November at $6.99 per month. The second question could very well be how many Disney fans that did not attend a park last year are looking forward to the release of its streaming service and might even replace their $12.99 per month Netflix basic subscription with Disney plus (particularly Netflix subscribers with children). It is admittedly somewhat difficult to handicap how the streaming wars will unfold in terms of market share, but we believe from an investment standpoint, the choices seem more obvious.

To be sure, Netflix is a remarkable company that single-handedly revolutionized the cost and delivery of household entertainment. Prior to Netflix, cable television dominated. Cable is expensive, delivered mostly at home and much of its content seems stagnant. Netflix is cheap, can be viewed anywhere, anytime, and its content is constantly updating with a wide variety of popular selections.
Those arguments were compelling for Netflix investors, but these arguments increasingly extend to a host of Netflix competitors. We note that Netflix is a business model built entirely on intangible assets.

We believe Netflix possessed the classic "first mover" advantage. Whereas the firm saw an opportunity and capitalized on it in magnificent fashion, the limited barriers to entry in the streaming business

suggests to us the streaming game is quickly saturating with competition. This also implies to us that going forward Netflix will have to compete far more on the quality of its content. If content is king, then we favor arguably the most valuable content provider on earth (in our opinion), Disney. Moreover, we believe this argument is strengthened by Disney streaming its content at a little more than half the price ($6.99 / month) of Netflix's basic subscription and less than half of Netflix's premium subscription ($15.99).

To the extent that Netflix sees its business supplanted by competitors, it would be following a reliable historical pattern in the marketplace for intangible assets. The Wright Brothers did well, but the commercial manufacturers that followed flew much higher. Laszlo Biro made a small fortune ($2M) on his invention of the ball-point pen, but Bic made an exponentially larger one (multi-billions). In the case of Disney's opportunity, we believe the company would be moving from strength to strength through its transition into streaming technologies.

The firm's opportunity lies within continuing its proven expertise in scaling up intangible assets (recall, over 800 characters) through movies, television, merchandise, cruise ships, and theme parks. We believe streaming shifts its distribution capabilities into an even higher gear. Take for example the legacy distribution model of a Disney Star Wars character that is currently leveraged across the network of assets mentioned above. While Disney possesses an already envious distribution model, there is currently a physical limitation given that much of its distribution occurs through relatively large tangible assets (i.e., theaters, parks, cruise ships, and merchandise). The tangible assets therefore impose natural limits to consumption. However, as these assets become distributed through streaming technologies, the only remaining physical limitation is the viewing device itself and an internet connection (television, smartphone, tablet, laptop, PC). To gain a sense of the opportunity, there are approximately 39,000 worldwide movie theaters (a narrow example), but there are an estimated 3.3 billion smartphones in use worldwide. Returning to the investment context, Disney's expertise in creating intangible assets (entertainment content) was historically limited by its tangible distribution channels but going forward its distribution channels will be exponentially larger through digital mediums.

The opportunity to expand Disney's reach through Disney plus is somewhat straightforward, but the more critical element for shareholders is the opportunity for Disney's profit margins to expand in kind. Because the assets in question are largely intangible, the majority of their associated costs were expensed in earlier periods and their profitability flows rapidly to the bottom line with each sale. In sum, the economics surrounding intangible assets carry higher profit margins given the relative absence of overhead, and in this case Disney has an opportunity to accelerate its shareholder returns through both accelerated growth and an increase in profit margins should Disney plus begin to make a material contribution over time.

Although we find Disney's growth strategy compelling in and of itself, we believe there is one remaining element that brings the discussion full circle. The element in question is the role of risk in the investment equation.

Earlier in our discussion we mentioned the role of tangible assets, and their ability to reduce risk to investors. The reduced risk is owed to tangible asset values being more readily observable, which is critical in the case that the company needs to liquidate an asset and pay down debt if it met difficult circumstances.

Disney is somewhat unique in that many of its key assets are intangible, but the cash flows created through its trademarks and copyrights surrounding Mickey Mouse, Star Wars, Marvel, Disney Princesses, etc. are also discernible, and we believe would be marketable to a third party (as would its real estate and tangible assets). Irrespective, the firm carries only a modest amount of debt at 35% of its total equity, and we believe this represents a conservative balance sheet. For comparison, let us return to Netflix. Because of the changing competitive dynamics thanks to Disney and many others entering the streaming business, we see considerably more risk in the case of Netflix. The principal argument goes directly back to Ben Graham's view on the matter. Should Netflix's ability to compete on content falter or become overtaken by competitors, we believe its balance sheet could facilitate a precipitous decline in the share price. In our opinion, we see an unacceptable level of risk to Netflix's balance sheet where its debt to equity is 198% (compared to Disney's 35%). If Netflix saw its subscribers materially decline, we believe it could prove difficult to service its large debt balance, and with no real tangible assets at its disposal it would be difficult to raise funds through asset sales or new debt issuance. Priced with a P/E of 84.1x 2019 earnings, we also believe investors would show little patience in that scenario. Conversely, if the streaming business does not materialize as well as anticipated for Disney, it has little debt to cause concern, and the firm would simply fall back on its core business, which is both stable and attractive (in our view). That scenario too may lead to share price declines, but we believe declines would have a natural limit given the quality of the legacy assets (that help create the margin of safety).

To summarize, and with specific emphasis on how we believe value investing still shapes our view, we see limited downside in the case of Disney, but conceivably dangerous scenarios for Netflix. From the value perspective, Disney's balance sheet is a source of strength and potential safety, while Netflix's balance sheet is a cause for concern. That is not to say that we believe Netflix is doomed (it could continue to thrive), only that we believe its business model carries an unacceptable level of risk (accentuated by its debt), and we would likely never own it based on its risk of loss (our value orientation).

As we close, our comments were meant to outline a paradigm that we see in the market today proliferating across a wide range of firms. Taken in that light, we believe there are many opportunities surrounding this phenomenon as incumbent capital-intensive firms seek growth. We believe we hold many other instances of this paradigm in our portfolio that we may discuss in future commentaries. As we also mentioned before, we believe there are some limited cases where intangible asset firms are pursuing higher levels of capital intensity. In either case though, we believe the investment decision requires a certain amount of both critical and contrarian thinking, rather than following the blind prescriptions for growth and value.

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