

## Tom Russo on Investing in Businesses With a Capacity to Suffer

Thomas A. Russo, Managing Member of Gardner Russo & Quinn, joined the MOI Global community at Latticework 2022, held at the Yale Club of New York City on December 13.

In this keynote presentation, Tom discusses:

*Why these businesses have a capacity to suffer:*

- Nestlé
- Alphabet
- Mastercard
- Heineken
- Philip Morris
- Ashtead
- Berkshire Hathaway

*Why he looks for companies these attributes:*

- Consumer belief in product indispensability
- Price inelastic demand
- Long-term goal of reinvestment of operating free cash flow to drive intrinsic value appreciation on a per-share basis
- Capacity to reinvest
- Managerial capacity to suffer — valued board-level support from founder-led and family-controlled board with an eye towards any indication of agency costs which should be avoided at all costs
- Redeployment of western market free cash flow into underwriting reinvestments to drive increasingly international returns

Examples of companies that do *not* have a capacity to suffer: General Mills, Cadbury, SAB Miller

Sources of a portfolio manager's capacity to suffer: long-term taxable investor base, limit percentage of investors' wealth, low expectations, low investment advisory fees, and tax efficiency

*This conversation is available as an episode of Invest Intelligently, a member podcast of MOI Global. (Learn [how to access](#) member podcasts.)*

*The following transcript has been edited for space and clarity.*

**Tom Russo:** My topic is investing in companies with the capacity to suffer. More precisely, the company management must have the capacity to suffer. It doesn't require you to suffer other than the fact that successful long-term investing does involve periods like the one we've just gone through – that's certainly a suffering kind of environment.

I would encourage you to ask questions, and when we're done, I hope you will have come to understand why it is that the funds we oversee end up largely dispersed in international companies (about 50% of our assets). It's been a long-standing love affair with non-U.S. companies. We have companies where there's the possibility of low agency costs. That often has to do with family-

controlled boards where we feel like we have alignment of interests with the management and the owners representing their own interests; we get the benefit of those low agency costs.

Our companies have the capacity to reinvest as well as the capacity to suffer. It's that reinvestment that draws our capital to where there's a very large TAM. Another key point is that we tend to favor family-controlled companies.

Our investment philosophy was forged as a result of a meeting with Warren Buffett. He came to my business school class in the early 1980s and made two points. The first one was that you should maintain an international perspective given that 95% of the global population lives outside of the US. Today, it's probably 97%. The philosophy was shaped by the desire to find businesses you could reinvest in. The reinvestment opportunities globally are what we look forward to.

The reason why reinvestment is so important is the second point Warren Buffett made to our class, which was that you only had one benefit as a public market investor: the non-taxation of unrealized gains. If you're going to compound your funds to take advantage of the reinvestment, you're probably going to want to look broadly.

With global consumer brands at the core of our portfolio, it makes sense for us to look abroad. This is driven by the insight that if you can redeploy the capital internally, you are better off growing your intrinsic value without having to pay taxes, avoiding attacks on gains, and then taking advantage of the extraordinary opportunities in the international markets. You have population growth and GDP growth.

The benefit that accrues naturally from a long-term buy-and-hold approach is the deferral of taxes. Our average turnover in the past 10 years has been 5.5%, which is considerably below averages. First and foremost, we look for businesses to invest in. We want to redeploy the free cash flow from the business to generate the compound.

The first thing we look for are indispensable products. These are products whose users believe they can't do without. Take Martin Marietta Materials. It's a domestic company, but it has the supreme element of indispensable product because if you don't have crushed stone in a community, you're not going to build much. Martin Marietta has a collection of terrific quarries around the U.S., and that product is indispensable, just as indispensable as See's chocolate is. If somebody is a fan of See's chocolate, they won't accept something else.

At the very start, we are looking for indispensable products. The goal is to have price-inelastic demand for the product. We've been in pursuit of price-inelastic demand for products ever since Semper Vic was formed in 1983. It came about because of the hyperinflation of the late 1970s. One of the benefits of having indispensable products is that when you raise prices, you don't lose volume. We find the ability to raise prices most forcefully in consumer brands, which is where we spend much of our time. We probably have 70% of the funds in consumer-oriented companies.

Not all businesses have the capacity to reinvest. The knowledge of which ones don't have it is as important as of those that do. See's, for example, couldn't reinvest money. Berkshire has a host of advantages - starting with Warren's stock-picking prowess - but the structure it has in place where it sends the cash to Omaha is extremely important in the kind of investment returns it's been able to sustain because the head of See's chocolate isn't burdened with trying to redeploy every year the abundant capital that See's spins off. It sent \$2 billion to Omaha over the years and that has been ably deployed but not by the head of See's because the company doesn't need to absorb any more capital than what it has. The ideal capital structure is to clear it out and send it away. The same thing is true with Clayton Homes and a host of other businesses within Berkshire - send the cash to Omaha.

The capacity to suffer relates to the fact that when managements spend the right amount of money to develop long-term competitive advantage in desiring to build their intrinsic value on a per-share basis, they are going to end up in period where that investment weighs negatively or lumpily on the reported profits. Lumpy investment expense is something most of Wall Street does not relish. It likes smooth and predictable. Our companies are unfettered by a requirement to have those conditions necessarily apply because they so often have families still running the businesses through public company managements, but with the goal of increasing the family's wealth.

When you have 5.5% turnover, you have some very long-standing holdings. We initially established Nestle, which is 10% position, in 1986. With Berkshire Hathaway, it was 1981, when the partnership was formed. MasterCard was started maybe 12 years ago. We've had Philip Morris for probably 35 years and Heineken for maybe 40 years.

We do deploy capital for a very, very long time. The reason those businesses are as they are in the portfolio is that we believe they have the capacity to redeploy their free cash flow in an unprecedented manner because doing so drives the value of their shares. Nestle and the management are aligned with us. Most often, the families that own the company have interests aligned with ours.

When it comes to indispensable product, Nestle is a leader. It's globally dominant in coffee and pet food. It's developing a dominant business in supplements, health, and nutrition. The markets are huge. Coffee is half a trillion dollars. Health and wellness is a smaller market, but it's growing fast.

This company has suffered and is suffering today as it expands into health, supplements, and other businesses. It's investing through its income statement and acquisitions. It has been equally aggressive in investing in the businesses directly. A noteworthy recent investment was the one in Starbucks, the deal giving Nestle perpetual rights to market Starbucks consumer packaged goods and foodservice products globally, outside of Starbucks coffee shops.

The development of Nespresso – the fabled single-serve system that only goes to market through boutiques and the internet – took 15 years of investment spending. That's the sort of standard. Nespresso took 11 years to break even. There was a turbulent development period because the CEO and the chairman of the company both believed Nescafe, the traditional powdered coffee, was the highest form. They felt the development of Nespresso was cannibalizing it. In some ways, this is a perfect Clayton Christensen innovator's dilemma situation. They had the opportunity to develop this product. Had they not taken it, it would have probably cost them the core franchise. This was a block and tackle at the same time as it was opportunistic.

The one thing I would want to remember is that when Buffett came to our class in 1983, it was just about the time he was migrating away from cigar butt investing into franchise investing, which was underway in part because of the early returns they were getting off of their ability to raise prices without loss of items at See's. They began to understand the value of goodwill, which shows up in pricing power.

**Participant:** You spoke about the capacity to reinvest for your companies. Sometimes, companies can reinvest even more than their earnings in a given year. They are often doing equity financing. How should one think about that? When should or shouldn't a company do it?

**Russo:** If by what you say is that they have the capacity to reinvest, it's extremely limited. Many, if not most, companies don't have it. If you've got it, you should take advantage of it and spend up to the point where you've run out of the opportunity, but you are also encouraged to spend it because it's competitive. If you don't act, your competitor will.

If you have the trademarks, the factories, and all the assets required to be a leader in your field, incrementally invest beyond that. Think of Brazil for Heineken. We're involved with it. Heineken sold a million cases when it entered Brazil through a series of redeployments of the free cash flow that came from the Heineken business growing in Brazil. It's now up to 17 million. That's an extraordinary return on investment. The company did it because it knew it would secure the income streams but also because it would foreclose the competition from others. That's the goal – to foreclose and also to grow.

**Participant:** The companies you own are very prominent, big companies, and you have a very low turnover ratio, which effectively means you own for a very long time. What you are doing can possibly be done by your investors. When you talk to your investors, what sort of value add do they see by you managing the portfolio versus them buying those same companies and possibly doing it themselves?

**Russo:** There is that eureka moment when we may learn of something they don't know. That can be either on the upside or the downside. We could learn that there's another route of substantial reinvestment available that will disrupt or transform, and we're more likely to know that than they are.

Then the question is, "What do you do with the money next? And then what?" Charlie Munger's questions. Then, we will hopefully find for them the next Nestle or the next Heineken, which are probably Heineken and Nestle. In our case, we'll probably stay the course with those because we were so enamored with their reinvestment opportunity, but if they weren't that good, there would be moments where we'd probably be moving capital around.

**Participant:** A question on capacity to suffer for reinvestment. We're long-term holders. We've held Alphabet for 11 years. One of the questions we've been asking ourselves is whether some discipline on spending tends to go by the wayside late into the cycle. You see somebody like Musk taking over Twitter, cutting a bunch of the staff there. It doesn't so far seem to have impacted the product. With Alphabet, the numbers are absolutely staggering – \$85 billion in R&D, \$71 billion in capex. How do you get comfort that some of these science experiments and things going on within Google align with the long-term vision we all have as investors in some of these companies? I suppose you're not involved in the day-to-day management of Google, and neither are we. You don't have the transparency as to where those \$71 billion or \$85 billion went. How do you get comfortable?

**Russo:** Google paid a billion dollars for YouTube. I think it's going to do over \$30 billion in revenues with a fairly full margin now. For a very long time, however, it was doing nothing but generating expenses. It was the same thing with Google Cloud. The growth rate for both of those is now quite substantial.

There are other areas as well. There's one area under development right now which is fascinating. It allows someone to search locally and see offers by stores within walking distance of their residences. You can google and end up knowing that something's at the store across the street from you, which you would not otherwise know. Now, that knowledge is available through Google for free to anyone who searches in their local community. I think the number is something like 24 billion entries in Google. The company can scale something like that up, and it could change the way the retail landscape advances.

We know about it because it's big now and starting to surface, just as we know about the economics of cloud now because it's big enough to be pulled out and is now being developed independently of other businesses.

The capacity for suffering in Google's case is fascinating because when the company went public, it had a rider on its public offering documentation that said, "By the way, if you have any thought about

ever voting for anything at this company, you should probably go somewhere else because this is only going to be controlled by three families, and they alone will have the voting rights.” They explained it as follows, “We want to be able to invest for the long term. We really want to be insulated from Wall Street’s standard treatment where you’re required to meet numbers and also show some management of costs.” They want to be as we want them to be – full-throttled in taking on costs to develop new, competition-precluding investments. That’s our goal, and that’s their goal.

Interestingly, over time, that goal at Google began to be compromised since it’s been increasingly difficult to get the three founders together in a room. That’s because as they became rich, they realized there are very large boats, very large houses, and very large art collections to buy. Suddenly, the interest split their attention and decisions weren’t being made. Still, too much of a good thing is too much of a good thing. Having the success they had meant that they needed to have some way to effectively make decisions so that they could move on with big and complicated projects. They brought in Sundar to serve in lieu of the three, so they no longer have to agree upon activities that involve spending, losses, and all the rest.

Beyond that, it hasn’t been a performance rocket ship. When you back out the cash and give them returns they’re getting from the businesses that are now showing margin expansion, it’s not a terribly expensive company. With something like that 24 billion SKU enterprise in local search, you realize it’s still looking for big disruptive opportunities.

By the way, the notion of investing for the long term versus the near term, within the fallout of the Apple move earlier this year relating to mobile data access, Google paid along the way in a fashion different from what Facebook demanded. Google took a more expensive approach because it paid for contact along the way but now has a better competitive position having suffered through investing in a way that was more costly upfront than what Facebook had.

**Participant:** How do you characterize your decision to veer from your key influence Buffett in including tobacco investments, which, as we know, have wonderful price-inelastic demand and the Lindy aspect to them? I’m not a moralist, by the way.

**Russo:** Clearly, there are a couple of issues. The first one is excise tax. What you’ve just described is the playground for excise taxes, and governments are going to need a lot of revenue. Up against the idea that the taxes on beer and cigarettes are regressive, there’s also the hunt for cash to meet government obligations. This suggests that for excise tax reasons, you’ll probably see prices go up consistently, which will slow down growth. Even though it’s inelastic, it’s not entirely so, and you can see some trading down. Neither of those would be particularly useful. In the meantime, valuations are attractive, and they are able to deploy capital. We only own the shares of Philip Morris in this case.

To return to Google, YouTube has now broken even, but that took 13 years. The cloud business had \$18 billion in cumulative losses within the last three years. We’re checking on that, but the order of magnitude for cloud spending is larger than this number would suggest given how long Google has been adding and the appetite with which it spends when it’s at something. It also has this whole portfolio full of businesses that are still loss-making. It had a resolution in some ways to get the decisions down to the division so it could spend more, which was done once Sundar became the sole CEO and the company amped up its spending again.

With MasterCard, the interesting area of loss-making and investment burden here is that over the 10 or 12 years we’ve owned the shares, the company has had an explosion of volume across its rails. It’s an immensely high-margin business. Given the magnitude of it, that volume over the rails should have forced the operating margin the company reports to go way up because MasterCard was receiving so much extra volume on the rails without incremental costs required. Its operating margin – stuck in the

mid-50s – did not go up even though there was this extraordinary tailwind that would justify it. It's our way of coming up with a measure of what it is, in a sense, suffering from.

The real problem with this capacity to suffer is the issue of avoided investments. Knowing that the company has that kind of built-in positive effect of operating leverage, it could have spent a lot less and still delivered some margin expansions quite considerably, but it would not have built as strong a franchise.

The payback for that comes around exactly now where the prospects for MasterCard have brightened dramatically because of the collapse of venture capital and private equity in fin tech. Fin tech is on the side rail for the time being, and MasterCard has a chance to push hard on the pedal to grow its business. I'm sure the tap-and-go has been transformative: 54% of on-premise transactions are now contactless. It's transforming the business and the benefit it enjoys as a result of the reduced competition from easy-money startups.

I first invested in Heineken in 1986. When I went over there, the CFO at the time said, "Why are you here?" I said we were interested in investing in the company, to which he replied that it was a family company. However, they had stock in the marketplace. Not only did they have a holding and shares in the marketplace, but there were special shares the family uses to control the business. Those shares today are trading at a roughly 20% discount to the non-voting shares – we own the voting shares in the holding company at a 20% discount for essentially the exact same instrument. That discount has widened and narrowed. Right now, it's quite wide, so we've been adding to the holdings.

We showed up in 1986. It was funny. I asked the CFO whether they had seen any change in the way people were consuming beer. Back then, beer was sold with such high velocity in the Netherlands that they didn't refrigerate it. They just bought it and brought it. As the CFO said, he and his wife would buy it at the grocery store and bring it to the basement; basements were cold, so they didn't have to refrigerate it.

However, he said things were changing. When I asked him what he meant, he said young people had a different habit of consuming and treating Heineken. He explained they had these things called American parties where you invite someone to your house, but they have to bring the stuff. I said, "Ironically, we call that a Dutch party in the U.S." In any case, Heineken shipped a lot more over the years. Close to 60% of its business is in emerging markets. It recently acquired a controlling stake in India's largest brewery, which owns Kingfisher – a well-known but narrowly distributed brand. It's a massively expandable opportunity.

I was extraordinarily excited about this until I met with the head of the United Breweries. He began to suggest how hard it is in India to certify your business and make product in each market. It's a complicated market to develop. It's going to be extremely important. There is only 1.5 liters of consumption per capita. In China, it's over 30 now. It was massively below that when China westernized its taste, so we expect that to be extremely popular.

The family controls it. With that, they've been able to show extraordinary discipline. In this case, Heineken first had the ability to say no, which public companies would not have. About five years ago, Heineken was offered to purchase a local brand called Schincariol. It was on the market for five billion dollars. Heineken's family-controlled company took a look and said they thought it was probably worth about 700 million. Wall Street clamored for them to buy it because it was such a logical extension and such a big market. They refused to listen to Wall Street. The shares were pummeled for this lack of daring. The brand went to Kirin, which paid five billion dollars.

Five years later, Kirin came back to Brazil with its tail between its legs and said it would welcome

another offer for the business because it couldn't quite handle it. It had lost hundreds of millions of dollars. Heineken bought it for 700 million. It very likely would have been pushed into buying this business if it weren't for the family because the fit was compelling, but the price was incorrect. Now, Heineken owns it for 700 million dollars, and it has the capacity to redeploy into rolling it out. Brazil is already Heineken's largest market, and it continues to grow at a rapid pace.

As a result of that transaction, it brought in a portfolio full of local beers to supplement the Heineken beers. They went to market in the same truck. The following summer was extremely friendly for beer. There was the World Cup and enormous heat. For a host of reasons, Heineken had pledged to Wall Street that it would show margin improvement, and that margin improvement would go out to the next three or four years and be 0.2-0.25 percentage points each year.

Due to this extraordinary weather and extraordinary consumption, the local beer grew massively higher than expected. Since it was a lower-margin business, it took the operating margin down across the board. The entire Heineken company was influenced by that extraordinarily successful summer in Brazil. When it went to Wall Street to report the results for that period, it said, "Sorry. We didn't make the migration from 17 to 17.25. We only went from 17 to 17.1." I guess it was a 20-basis-point shortfall. The shares reacted to that by dropping 22%.

Heineken could have protected against that, but it thought it'd be a good thing to grow the beer at full prices, with a marketing campaign and all the rest. It thought it was probably a good thing to keep cultivating that marketplace even if it meant failing to hit something it had the capacity to suffer through that stock chart. Anyhow, it has continued to grow. Volume in Brazil has increased 40% over those five years.

Any questions?

**Participant:** This one is on Netflix, which is in your top 10. Congratulations on buying it the last couple of quarters. It's a nice entry point. I was curious how you think about project-level financing decisions at Netflix. How does that company perform NPV and ROI analysis on individual film or TV projects?

**Russo:** The film business is obviously one of the reasons why the market mistreated the shares so badly. It was also the churn – it was a modest increase in churn but directionally signaling something that had been absent for a long time. The extrapolation on the churn was extremely costly.

In my view, it was probably more of a negative by the market than the cost of private financing. Our position on the question you asked is that the reason we were interested in the company in the first place is because it had the concept we look for, which is that the consumer couldn't believe they could do without it because they have the full day parts of programming – unlike others who have sporadic offerings and offerings that come off when people churn at a much higher rate.

I think no other competitor has as low a churn rate as Netflix. Even with the slight churn you saw, its engagement went way up during the same period. The actual economics of it – other than the churn – are such a high headline-grabbing number. The investment in full-time programming Netflix has to do is what gives it the competitive advantage because it fills up the day parts.

When we made the investment, it was an interesting time because all the major studios announced at about the same time that they were going to create a whole line of programming for the streaming video marketplace. Nearly all that made the pledge had ravaged balance sheets. What you've seen over the past 12 months is the collapse of the efforts by the major studios to go directly into streaming; they're going back to the old-fashioned practice of selling off the rights to certain items

after they play in the networks to Netflix.

Netflix faces a substantially reduced funding for streaming-only product. That will only get worse. On an incremental basis, the competitors are showing ever more pain in their own production world. That's been a big turn.

Back in 1999, an amusing observation was that the large-cap growth stocks collapsed so much that if a client directed that they pull up a large-cap growth stock portfolio from an investee to move it into small-cap value, they wouldn't have to move or sell any shares because, over time, by the magic of the markets, the large-cap growth stocks became small-cap value. That was a massive amount in 1999. It's been a massive factor even in 2022. The valuation of Netflix has certainly come way down.

The final thing is there's also an emotional aspect to investing. I don't think I've ever had as many calls saying, "What do you think you're doing buying those shares?" People were majorly pissed off because everybody had lost a huge amount. You could tell everyone had been singed by watching this thing become a slow trainwreck.

There was a suggestion we may have stylecrept to go into those shares, but we have made big investments over our lifetimes in cable and broadcasting all through EW Scripps and The Washington Post. We have a fairly meaningful background. We just didn't have an investment in Netflix neither as it soared nor as it came down, but we did have the opportunity to purchase shares at quite attractive multiples with the big questions suitably addressed. We'll see how that works out, but the partnership with Microsoft impressed us immensely by virtue of the fact that Netflix did not try to take the cheapest deal on the block. It went to the best, and I think it will benefit from it.

**Participant:** You've got Heineken. You've got Nestle. You've got these companies with an ability to reinvest in their core businesses and expand that way. Having high conviction in their ability to do that, engaging with management, there's logic to it that makes a lot of sense to me. Now you've rolled in something like Google. To be perfectly frank, Google's ability to reinvest in its core search business is somewhat limited. Google Mind, AI, and things of that nature are dramatically different businesses. How do you think through generating conviction and edge in its ability to reinvest in what will end up being a lot of divergent directions? To parrot Howard Marks, these are a lot of large-cap companies and their ability to reinvest is well-known. What is it that you see in the names outside of Google that others don't, allowing you to have conviction in them?

**Russo:** In large measure, it's time horizon. We can suffer through disruptions along the way because the management teams that implement and execute on those long-term measures realize that if they hit an air pocket - as in Brazil, where the ironic thing was that Heineken sold too much beer. The business was too successful, and the average mix effect meant the company didn't meet a target Wall Street cared a lot about, but the family and the company really didn't.

We like the traditional advertising disruptive role that Alphabet has played and continues to play as it grows its share of advertising. We get comfort from our managements - in Nestle, in Heineken, and in Philip Morris - all of whom say in meetings with us and other investors, "This year, we've just circled another two billion dollars of expense reductions." If you ask them afterwards, "Where does it come from? Because you've done this for the past six years." Right now, it's all coming from advertising effectiveness. They said they haven't even scratched the surface, but the effectiveness of targeted advertising is something we highly esteem.

We're quite impressed with this unusual startup within Google, the across-the-street phenomenon where it's trying to increase its data on consumers by offering them that feature and handling and capturing data on what that consumers bought, when, where, and for how much.

As an aside, if you think of all the devices Google has had, I'd say it hasn't really shown great skill in that area. That's one of the things we scratch our head about. Why is it so successful elsewhere? I think the answer to that is probably Apple.

**Participant:** Building on that question, what do you make of Wall Street labeling Netflix and Google as long-duration equities even though they have all these strong cash flows and reinvesting? That's what I keep hearing now as to why they're down 30 and 40.

**Russo:** I think it means that the valuation of those businesses was predicated on what they've been able to establish as their share out a long time. There are a couple of risks. One is whether they can deliver on that goal that far out. The second thing is that it's all discounted back with an interest rate that's up three times what it was 18 months ago. There's a risk given it's a compounder. In theory, it has pent-up demand that'll keep going, but then the discount back ends up with it possibly being worth less than what it was when maybe the growth rate was more subdued but the discount rate was as low as it had been for so long. I think that might touch upon it.

**Participant:** We're large shareholders in both Google and Netflix. I wanted to get your take on how you feel about the durability of those moats versus some more mature businesses, like a Heineken or a Nestle, which have been through the wringer for 50 to 100 years. These businesses have been around for 20.

**Russo:** Todd Combs recently made the same point while speaking at a function, saying that franchises seem to have a more perishable time on this planet. Let me hazard a projection: There's a chance that four years out, TikTok will feel like Snap or something, but you wouldn't think it now. If you were to think it now, every sign or signal that this will be a platform of extraordinary development potential but not being able to know it in advance and with able competitors coming at it. That able competitor thing is firmly tied to the flow of venture funding and some creep-over funding from private equity. We bump up against this in MasterCard, with those very industry-specific assaults that have been massively well-funded.

**Participant:** Your entire strategy seems to be predicated upon judging people well and then giving them a long leash over many years. How do you judge people?

**Russo:** Yes, it's all about people. It's about those willing to deploy capital and take a risk with the benefit of knowing that they won't be dislodged from their task midstream if it burdens reported profits to such an extent that good things for management no longer happen. That's where the real corrosion takes place - when there is enough spending burden that the management you would otherwise trust to favor the company's interests starts to worry about its own. This is where the capacity to suffer is so valuable.

We had this with Philip Morris over the past decade. It spent five billion dollars from 2005 to 2011 on its reduced risk products. It had far more as it continued to spend. Over this period, it went from one million to 21 million users of that product. This is a highly interesting development because the reduced risk products don't pay excise tax since governments around the world have typically felt they were instrumental in pushing people away from traditional cigarettes to a healthier alternative.

The company's management is driving this extremely hard. The expenses are all passing through to reported profits. It is showing less money earned. On top of that, the U.S. dollar was soaring. All of Philip Morris' profits are in local currency, not in dollars; it's losing 12% or 15% on currency. At that moment, management has every right - if it were a more standard kind of management team - to take a host of steps that would soften the impact of all those forces in the present tense and push them out to another person's watch. That's where we find we are most at risk in companies.

We don't worry so much about making an acquisition of something where there might be some shenanigans in how it's being handled or who's selling what to whom. What's more important for us is the notion that the management team is fully aligned with the families and with us as free riders in some ways.

**Participant:** As a business gets passed down from generation to generation, sometimes the second, third, fourth, or fifth generation doesn't have the same motivation as the previous one. What would it take for you to acknowledge that something has changed in the motivation of the newer generation to the point where you say, "I don't trust this management team anymore," and you need to sell?

**Russo:** We exit positions. That 5.5% in turnover is what it is, but we do exit positions when we feel like there's a breakdown in that alignment or that vigorous pursuit of redeployment of capital for the long term for fear that it disrupts the near term, which in turn is the basis for compensation. We will exit positions when it feels that such a shift is taking place. The harder one is "What did he do in the family? Who's been involved successfully?" It goes through a generational thing with the idiot nephew or the spendthrift uncle. We don't have that happen very often, but that's a time when we have to be particularly mindful of the characters.

For example, Alexandre Ricard took the helm of Pernod Ricard after Patrick died suddenly. We could not have been better served by Alexandre, who is in his early to mid-50's. He's been in the business for 20 years. He went to Wharton Business School. He's perfect. We've been lucky on a couple of those. We've avoided the harder question.

Richemont - which is a fairly large holding for us - has a family deeply involved with it, the Rupert family. The patriarch is incredibly hands-on. He's a big, bold guy. They ended up plowing into Net-a-Porter, which was an early-stage e-commerce fashion business that ended up costing some three to five billion dollars. It was a big reversal. He had the power to do that transaction.

We have to make sure we end up with businesses that have solid support from the board. I think that's one of the things we can count on. Then we have to make sure that the family is thoughtful and deliberate.

Sure, we would have sold if Alex Ricard hadn't been appointed; it was his spendthrift cousin who has done nothing. You can imagine the fall any moment. We're perfectly prepared, and we will probably spend more time than most getting to know them. That time spent is something we value. It was often time spent with Alex Ricard 10 years ago, when he was finance head of the China business or the equivalent.

We pay attention, keep in touch with those companies, and continue to monitor them. I think we are aware of changes before they may have adverse effects. If they truly mess up, we're prepared to sell, which is nice to the extent that these companies could be fully private, but it's our belief - and I think that families think so as well - that there's something better about being partly public. There's a benefit that comes from the fact that mistakes are exposed and addressed. They're embarrassing, but the firm has to learn from them.

With a partially public company, we believe the risk of error goes down because of the scrutiny that decision-makers know they will face in terms of how well those decisions have been made.

*About the keynote speaker:*

Thomas A. Russo joined Gardner Investments as a partner in 1989. In 2014, Mr. Russo became the

Managing Member of the firm. Mr. Russo serves as Managing Member of Gardner Russo & Quinn LLC and of Semper Vic Partners GP, LP, which oversees two “global value,” long-only, equity investment partnerships, the first of which Mr. Russo founded in 1983. Mr. Russo oversees more than \$8 billion distributed between Semper Vic partnerships and separate accounts managed in parallel fashion.

In his role as a global value investor, Mr. Russo attempts to commit clients’ capital to globally leading companies whose brands permit them the capacity to develop market shares in those parts of the world that are undergoing economic growth and increasing political stability. Such economic growth, coupled with increased consumer disposable income, creates a large total addressable market (TAM) for our businesses to address. He prefers companies with sufficient cash flows from existing operations to allow them to underwrite long-term-oriented investments required to build market share and develop enduring franchises.

In selecting investments, Mr. Russo looks for companies that possess two valued “capacities,” i.e., the “Capacity to Reinvest” and the “Capacity to Suffer.” It is rare to find a company that possesses the above-mentioned “Capacity to Reinvest.” It is even more rare to find management teams that have the “Capacity to Suffer.” Our company managements have the “Capacity to Suffer” when investments, required to ensure strong growth in intrinsic value on a per share basis, inevitably burden current, reported profits. He has found over the years that family-controlled public companies are often best positioned to withstand criticism which comes from Wall Street when the burden of such long-term investments weighs negatively upon reported short-term profits. Hence, he has relied over time on public company investments where founding families still retain control and significant investment exposure. Typically over 50 percent of Mr. Russo’s portfolio companies remain family controlled. Founding families of our public companies, like Mr. Russo and his investors, prefer the ability of investments, intended for long-term gains, to allow one to hold positions tax efficiently for as long as franchises, built by such long-term investments, continue to deliver growth in intrinsic value on a per share basis.

Thomas Russo is a graduate of Dartmouth College (BA 1977), and Stanford Business and Law Schools (JD/MBA 1984). Memberships include Dean’s Advisory Council for Stanford Law School, Dartmouth College’s President’s Leadership Council, and California Bar Association. Mr. Russo is a charter member of the Advisory Board for the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School. He serves on the boards of the Winston Churchill Foundation of the U.S., Facing History and Ourselves, and Storm King Art Center. In May 2017, he was awarded The Graham & Dodd, Murray, Greenwald Prize for Value Investing.