MOI GLOBAL

This article is excerpted from a letter by MOI Global instructor Sean Stannard-Stockton, president and chief investment officer of Ensemble Capital Management, based in Burlingame, California. Visit Intrinsic Investing for additional insights.

One of the more important drivers of equity returns recently has been something that did not happen. The US did not go into a recession. Back in the 4th quarter of 2018, many investors began to fear that a recession was near at hand after strong levels of economic optimism had characterized the first nine months of 2018. But as we pass the one-year anniversary of these fears exploding into the public consciousness, the unemployment rate has remained at low levels, solid rates of economic growth continues, even as the US laps quite strong levels of growth last year, and corporate revenue and earnings continue to grow.

Notably, the decline in home sales that began last summer and was a key sign of potential economic weakness, has now reversed and returned to growth. As we discussed in a blog post in November of last year examining the housing weakness, even indicators like declining home sales that have a decent historical record of predicting recessions, are not by themselves actually strong evidence that a recession is coming.

While the overall US economy has not gone into a recession, the manufacturing and industrial segments of the economy have slowed to a crawl and are running at near recessionary levels. This is actually the third such slowdown over the last ten years. During both of the past slowdowns, as well as so far this time, consumer spending, which makes up 70% of the US economy, has remained resilient.

In the fund, we have Mastercard (6.2% weight in portfolio) trading near all-time highs as the company directly benefits from consumer spending with management saying they see continued growth. On the other hand, we have Landstar Systems (4.7% weight in portfolio), which facilitates transportation of goods shipped via big rig trucks. The company’s flatbed segment specializes in moving heavy equipment used in manufacturing and industrial industries and the slowdown in these end markets is evident in the company’s financial results.

But as is normal, the drivers of the Fund performance this past quarter were primarily company specific items, rather than macro trends. Notable areas of strength in the Fund during the third quarter included TransDigm (3.3% weight in portfolio) up 14%, Google (7.2% weight in portfolio) which rallied by 13% and First American Financial (4.7% weight in portfolio) which gained 11%. TransDigm’s gains were driven by positive updates from the company on the integration of a large acquisition they completed recently. The strength in Google came from a strong earnings report, which calmed market concerns related to the previous quarter in which the company missed earnings expectations. And First American’s stock benefit from the rebound in housing sales.

The primary source of weakness in the Fund was Netflix (6.0% weight in portfolio), which fell 27%. We also saw modest declines of 5% and 3% respectively in Ferrari (6.6% weight in

portfolio) and Oracle (4.5% weight in portfolio). The decline in Netflix' stock was caused by weaker than expected new subscriber additions in the most recent quarter and investor concerns about competition from Disney Plus, launching in November. We've written extensively about Netflix, but in short, we believe that the weaker than expected subscriber results was within the range of normal volatility seen when the company raises prices and we believe that Disney Plus will do well, but a slate of blockbuster movies and kids TV shows will be an addition to, not a replacement for, a Netflix subscription. The declines in Ferrari and Oracle were relatively modest, with Ferrari's decline more a consolidation of gains earlier in the year (the stock is still up over 50% this year) while Oracle declined some on renewed concerns about their shift to a software-as-a-service business model, and yet the stock remains up over 20% so far this year.

Later in the letter, we will be discussing two of the holdings in the Fund in more depth. However, in addition to investors being interested in the positions in the Fund, we are often asked why we don't own certain companies. Given the Fund is a focused portfolio of 15-30 stocks, we spend a significant amount of time researching any company before it enters the Fund and then we continue to engage in rigorous research as long as we are shareholders. So, sometimes the answer to why we don't own a certain stock is as simple as the stock in question has never made it to the top of our priority list. But we also research and ultimately pass on many potential investments that are perfectly good companies.

Back in the beginning of 2018, we published an in-depth discussion of why we chose not to invest in a company called Ecolab, despite concluding that it was a perfectly solid company. In this letter, we're going to describe in more general terms entire classes of stocks that come close to meeting our requirements for investment, but which we ultimate decline to purchase. In a focused fund, what you don't own can have a significant impact on performance and so we wanted to lay out the process by which we choose to avoid stocks that at first glance may appear to be great companies.

We recently created a diagram that distills our investment philosophy into a few core principles. In a recent blog post introducing the diagram, we noted that three factors must always be in place before we would consider investing in a company: a competitive moat protecting the company from competition, strong management, and forecastability. When one of those factors is missing, we call those investment ideas "traps."

We thought we'd elaborate on our trap concept here. We've identified three traps we want to avoid. First, the commoditization trap. This is when there's strong management in place and an easy-to-understand business, but either a non-existent or narrowing moat. Much of a company's intrinsic value is driven by its so-called "terminal value" – the value the business will create over the very, very long term. As such, if we're not confident that a company can maintain or widen its economic moat beyond 5 or 10 years, estimating terminal value becomes increasingly difficult. In this circumstance, long-term returns on invested capital and growth – the two pillars of our valuation model – can decline faster than might otherwise be expected. Some investors are comfortable making a bet on a company's decline being slower than market expectations – and that's another way to make money – but we think that's a dangerous game and one we intentionally avoid.

The second trap is a stewardship trap. This is when there's evidence of a durable moat and an easy-to-understand business, but we lack confidence in management. We live in a hyper-competitive economy where cheap and abundant capital and new advertising platforms have made it easier than ever for challengers – whether that's a startup or Amazon – to take on lazy incumbents and chip away at their business. Because of this, we require our companies to be managed by what we consider to be good business stewards. Our management teams need to understand how to create sustainable value and thoughtfully allocate capital.

The final trap is the complexity trap. This is when we like management and think there's a durable moat, but we just can't get comfortable understanding the business. Sometimes the reason is that we lack requisite domain knowledge in a specialized field. Other times, the financials are opaque, or the business operates in multiple competitive arenas and we struggle to grasp unit economics. Before investing in any company, we want to appreciate the known risks and the so-called "known unknowns" about the business, and a lack of understanding prevents us from achieving this.

To be sure, there are a lot of good companies that fall into one of these traps. They might even make good investments at the right price. But our aim is to own great businesses – and then, of course, pay a reasonable price for them. Because we manage a concentrated fund of between 15-30 companies, we must be selective and stay true to our strategy. Hopefully this discussion provides a glimpse into the rigor of our investment process.

We know that there are a lot of good companies that we don't own. Our goal isn't to have an informed opinion on every stock in the market, but only to find 15 to 30 stocks that possess all of the characteristics that we look for and also trade at a discount to what we believe they are worth. The truth is, stock picking is hard. While there are lots of stocks that we think might be a good investment, we are looking for a very select group of stocks where we think the odds are stacked heavily in our favor. Sticking to the discipline we just described is critical to our process.

Company Focus

Mastercard Inc. Class-A (MA)

Mastercard Inc (6.2% weight in portfolio): We've owned Mastercard in the Fund since inception and we believe it ranks near the top of fund in terms of meeting and exceeding our requirements in each of the core areas of our assessment process.

Mastercard is a company that pretty much everyone has heard of. In fact, if you are reading this letter, no matter where you live in the world, as long as it's not China, there is a very good chance you have a Mastercard in your wallet or purse. If you don't, then you have a Visa card. You probably have both. These two companies hold an effective duopoly on the processing of credit and debit card payments.

Importantly, these companies do not lend any money. If you look at your credit or debit card, you'll find that it is issued by a bank. If it has the name of a non-bank company on it, such as American Airlines or Apple, these companies have just partnered with a bank to

issue the card. In American Airlines' case, it's Citibank and the new Apple credit card is issued by Goldman Sachs. The issuing bank is the one whose checking account a debit card is tied to and they are the ones lending the money to fund credit card payments.

On the other side of the transaction, is the merchant and its bank. No matter whether you swipe your card, or wave your Apple Watch with Apple Pay, or use PayPal to process a payment via your credit or debit card, or use Google Pay or Amazon Pay to facilitate an online transaction, in each case your bank and the merchants' bank need to exchange information across a communication network. And that network is almost always provided by Visa or Mastercard. While you might hear about how merchants pay 2% or more in credit card fees, Visa and Mastercard are only collecting about 1/20th of that fee, with the banks, the ones taking the credit risk, earning the bulk of the fee.

Americans are so used to using debit and credit cards that it is easy to lose sight of how amazing the Visa and Mastercard networks are. The fact is that when you walk into a store anywhere in the United States, you take it for granted that the merchant will allow you to swipe a little piece of plastic with either the Mastercard or Visa logo on it and they will then let you walk out with your purchase. The reason you carry a Visa or Mastercard is because you know they are accepted everywhere. And the reason they are accepted everywhere is because everyone carries one. This is a classic example of a "chicken and egg problem." Before everyone accepted these cards, it was difficult to convince consumers to carry one. And before everyone carried one, it was difficult to get merchants to accept them.

Having solved this problem, Mastercard and Visa now have a competitive moat around their businesses, which makes it very difficult for any new company to compete with them. Recently we visited a Target store in the middle of Silicon Valley. At the checkout stand we noticed a sticker advertising that they accepted Alipay, the payment network founded by the Chinese company Alibaba. When we asked the cashier how often people used Alipay, she actually didn't know what we were talking about. Despite having noticed the sticker, no manager had ever thought to explain it to her, and no customer had ever asked to use it. Why wasn't she trained on how to process Alipay transactions? Because her manager knows that few people carry this form of payment. Why don't customers carry this form of payment? Because few stores accept it. Building a globally accepted payment network was hard in the past. But today it is even harder because not only must a new company in the payment industry solve the chicken and egg problem themselves, but now that it has already been solved, a new competitor must solve the problem in a way that is much better than the existing solution.

So, let's finish looking at Mastercard through the lens that we just introduced; moat, management and forecastability.

First of all, we think Mastercard has a very strong moat for the reasons just explained. We also think this moat will remain valuable because we think it is highly likely that a decade and more from now, the service Mastercard provides will remain critical to facilitating commerce and valuable to both merchants and consumers.

We also believe Mastercard's management team is top notch. Not content to sit still and

milk cash earnings from their network, Mastercard's management team is forging ahead into business to business transactions. While a large portion of consumer transactions occur via cards, business to business transactions, the payment of invoice to vendors and other payments between business, is still a slow, manual process. So Mastercard has been investing earnings from their credit and debit card network into solving the B2B payments problem. They've also been aggressively forging ahead in emerging markets, where they have been a leader in using new technologies and adopting their systems to local markets.

While Americans are used to their cards being accepted everywhere, in India, the birthplace of Mastercard's CEO and a country with a population four times larger than the US, only 5% of merchants accept credit cards. With the chicken and egg problem not yet solved in this country as well as some other emerging markets, the competition is fierce, but the opportunity for Mastercard is very large. Despite reinvesting in their business, Mastercard produces far more excess cash than they need to grow the business. So, we are also glad that they have shown themselves to be smart allocators of capital, buying back significant levels of their own stock at very attractive prices, paying a dividend, and increasing the amount of debt in their capital structure in a prudent manner.

Finally, we believe that the company's long-term economics and thus the value of the business, is reasonably forecastable. This is partially because of the domain expertise our team has built over the years and our confidence that we have a strong understanding of the payments industry in which Mastercard operates. But just as importantly, it is because we believe Mastercard's business to demonstrate high levels of intrinsic forecastability.

While some companies are subject to highly unpredictable changes in macro factors, such as an oil company being dependent on the price of oil, Mastercard's business is driven by far more stable trends. The key metric for those global consumer spending trends, which even during recessions do not decline by more than a couple percentage points and which we are confident will grow at a modest, but steady rate over the very long term. On top of that growth driver, the company benefits from the relentless shift of consumer spending from cash and checks to credit and debit. While it might seem that much of this shift has already played out in developed markets, we can look at a near cashless country like Sweden to see that even US consumers are likely to see continued declines in the use of cash and checks. Our CIO had a little example in his own life recently when his utility company emailed to say that rather than directly billing his checking account for his monthly bill, they were now offering the option to have his bill linked to his credit card. And in the San Francisco Bay Area, we see more and more new stores opening which simply do not accept cash payment.

Of course, while we have very high levels of conviction in Mastercard, it doesn't come close to being a risk free investment. All investments in equities involve accepting relatively high levels of uncertainty. It is the requirement of accepting uncertainty that explains why stocks offer higher rates of returns than bonds. But in seeking investments for the Fund, we require every company to exhibit relatively low levels of uncertainty compared to the average public company on the core issues of the longevity and relevance of the their competitive positioning, the management teams capabilities in creating economic value and

allocating excess cash flow, and both the intrinsic forecastability of the business as well as our own team's capabilities and circle of competence.

Tiffany & Co (TIF)

Tiffany & Co (4.4% weight in portfolio): When we think about luxury goods, two things tend to come to mind. First, we tend to think of European brands like Louis Vuitton, Chanel, and Cartier. In fact, according to the consulting firm Deloitte, French, Italian, and Swiss companies together accounted for just under half of global luxury good sales in 2017. Second, we tend to recognize a luxury brand when we see one. A Ferrari, for example, is unmistakable, as are Louis Vuitton handbags with their ubiquitous LV insignias. That's largely the point in purchasing a luxury item, of course – to communicate status to others.

Curiously, Tiffany does not fall into either of those buckets. It's one of just a few global American luxury brands and the casual observer cannot tell a Tiffany diamond engagement ring from one purchased elsewhere. There's no room on a diamond for logo placement, after all.

So how does Tiffany do it? Like its European luxury counterparts, Tiffany is draped in a wonderful narrative and history. You might be as surprised as I was to learn, for instance, that Tiffany has been around since 1837 and has been in the diamond business since 1848, when Charles Lewis Tiffany opportunistically purchased diamonds from fleeing French aristocrats in the French Revolution of 1848. His timing couldn't have been better, as new American millionaires clamored for royal jewelry to show off their recently achieved status. That's what got the ball rolling.

As a company, Tiffany is older than Cartier (founded in 1847), Louis Vuitton (founded in 1854), and Burberry (founded in 1856). This durability matters in luxury because it communicates a brand's ability to endure all kinds of major socioeconomic changes and remain relevant over successive generations. It also communicates a certain timelessness of core products that remain in fashion despite intermittent fads and trends.

Tiffany is one of the few brands in the world that can be identified by a color alone. Its trademarked robin egg blue provides instant recognition, from near or far. And that color communicates elegance, exclusivity, and sophistication. To be sure, more than one would-be suitor has tried his hand at putting a non-Tiffany item in a Tiffany Blue Box to achieve the desired effect. It's a risky move, of course, for if the ring doesn't fit, you have some explaining to do when the recipient needs it to be resized. But that speaks to the power of the Tiffany brand – that the color of the box can multiply the value of what's inside it. Assuming the item was properly acquired, a Tiffany ring in a Tiffany Blue Box communicates to the recipient that you're worth the extra money.

Tiffany's narrative has been carried forward into the modern era by popular media, such as the classic movie Breakfast at Tiffany's starring Audrey Hepburn, and more recent movies like Sweet Home Alabama and The Great Gatsby. The most recent advertising campaigns feature millennial celebrities like Zoe Kravitz, Lady Gaga, and Elle Fanning.

To be sure, the Tiffany brand has been mismanaged at various points in its history. However, we think current CEO Alessandro Bogliolo, who joined the company at the end of 2017, has been a fantastic brand steward and is executing well in the areas the company can control. Notably, we are encouraged by his focus on "informal" luxury to better resonate with the Millennial generation. Last year, for instance, Tiffany opened a "style studio" in London's Covent Garden, about a mile away from its ritzy high-end storefront on Old Bond Street. The "style studio" format is more informal than the main store, with barstool seating, fragrance dispensers, and opportunities to interact with and customize Tiffany-branded jewelry. We think this is a healthy way for Tiffany to reach out to new consumers without diluting the core brand value.

Like other luxury brands, Tiffany is seeing growth in emerging Asian economies, some of which are adopting Western-style engagement ring culture. In August, Tiffany announced a partnership with India-based luxury retailer Reliance Brands Limited to open new stores in Delhi and Mumbai. As the CEO of Reliance Brands put it in the press release announcing the deal, "Tiffany needs no introduction in India – it is iconic and timeless."

That quote brings up an important point about Tiffany's brand-driven moat. As we mentioned earlier, it's extremely challenging to attach a brand (and command a related price markup) to a piece of jewelry that from a distance cannot be differentiated from a similar item. Given its rich heritage and place in popular culture, Tiffany, as the Reliance Brands CEO put it, "needs no introduction." This is a huge advantage for Tiffany against any would-be upstart competitors.

In many other areas of the luxury goods market, we've seen direct-to-consumer brand startups leverage social media to take on incumbents. But it's far more difficult to start and scale high-end jewelry, as the product doesn't outwardly advertise the brand. It takes decades, if not generations, to be considered "iconic and timeless." And this says nothing about the expensive input costs – gold, platinum, diamonds, skilled artisan wages – that would go into a high-end jewelry operation.

In summary, we're confident in Tiffany's moat and have growing confidence in Tiffany's management. We think the company is set up well for continued relevance in future generations.

Definitions

Price-to-Earnings (P/E) Ratio is the standardized valuation metric. The higher the number, the more expensive the stock is for each dollar of earnings per share.

Operating Profit is the profit of a company after it pays expenses attributed to its sales but before interest, taxes, restructuring and other onetime charges.

Operating Margin is Operating Profits divided by sales (or revenue). It allows you to compare profitability across companies and industries by standardizing across sales levels.

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