

James Aldigé on the Investment Philosophy of Clio Asset Management

We had the pleasure of speaking with James Aldigé, Managing Partner of Clio Asset Management LLC, based in Charlottesville, Virginia.

In the wide-ranging interview, John speaks with James about his background and path in investing, the guiding principles and structure of his firm, the investment philosophy of Clio, and much more. The conversation took place in the spring of 2021.

John Mihaljevic, MOI Global: You invest in a concentrated long-only way in public equities with a portfolio of eight to twelve exceptional businesses. That's an approach many in the MOI Global community will appreciate. Let's start with a little background on yourself and your path in investing.

James Aldigé, Clio Asset Management: I was born in 1981, so I just turned forty earlier this year. I grew up in Alexandria, Virginia, just outside of Washington, DC. My parents both worked in and around the nonprofit sector. My mom founded a nonprofit related to cancer research when I was five, and my dad mostly worked in direct marketing. It was a for-profit business, but many of his clients were in the nonprofit and government sector. I got my introduction to investing at a fairly young age. I talked to my dad about the stock market. I also had classes at school as early as fifth grade where we looked at stocks. My grandmother had given me something like \$500 in a handful of blue-chip stocks around that time, probably age 10 or 11, stocks like Disney, Coca-Cola, and JP Morgan. I remember getting the newspaper every day and following them. At that point in time, I was fascinated by the whole concept of interest, compound interest and dividends, being paid to invest and paid to wait. I was always much more of a saver than a spender. I remember the sheer excitement of getting a bank account. Back then, we had pass books; you'd go and put in \$10, and every month, you'd see the interest start to accumulate.

At sixteen, I had an internship at The Motley Fool, which was headquartered a few blocks from where I grew up in Alexandria. This was probably four or five years after the company had been founded, the summer of 1997. It was a fascinating experience for me. I worked on the message boards and spent much of that summer reading a lot of what they put out. I think the organization has changed significantly in the past twenty years, but for me then, it was the early days of the go-go internet and I learned a ton that summer. I started a TD Waterhouse Roth IRA account at that point and began investing. Every summer, I would plow everything I made to meet my IRA maximum of probably \$4,000 or \$5,000 back then. It was a great way to start investing. I thought I was a genius for the first couple of years. Everything was going straight up in the late 1990s, and then a lot of it came crashing down while I was in college.

I went to the University of Virginia, where I was a history and economics major. I decided not to go into the undergraduate business school there, which counts many successful investors among its alumni. I was a liberal arts major. I've always been fascinated by all different subjects at school, but primarily the humanities and social sciences, and enjoyed learning history, which is where the name Clio comes from – it's a nod to the Greek goddess of history. During college, I invested a bit in my Roth IRA and personal accounts, but I was more focused on my academics. Rather than going to work after school, I spent an additional two years at Oxford, where I studied economic history. In many ways, it is not directly relevant to what I do on a day-to-day basis, but in some ways, it's supremely relevant to how I think about the world long term.

The way we studied it, economic history was the study of economic growth through time at a macro level. Why do some countries become rich and others might not? Why did Western Europe and the UK industrialize whereas it took other countries longer? Then we drilled down to a more micro level, thinking about some of the reasons why that might be the case, whether it's institutions, democracy, culture, geography, or disease. There are lots of theories, and all have a bit of truth to them. For my master's thesis, I studied regulation in an applied setting, and that's become fairly handy as well. The work I did was around a specific case study, but it showed that regulation often has unintended consequences even when it might be well-intentioned. Oftentimes, by raising overall costs, it allows the incumbents, the primary targets of the regulation, to be the beneficiaries of it. That's been an interesting takeaway from my academic studies.

I then moved into investment banking, working for three years in London at Merrill Lynch, where I had a great experience. I think it was quite important to get that formal training in how to be a professional and act in a professional setting. I also learned analytical and modeling skills. I spent a year in equity capital markets doing primarily convertible bonds, which was a great way to learn capital markets. A convertible bond has an equity component, a debt component, and an option component, and being able to understand those three pieces was helpful. However, I realized that it's a pretty niche product, and my learning curve was flattening pretty quickly, so I moved internally to a more traditional M&A group, spending two years doing M&A and corporate finance.

This was in 2007. At that point, London was emerging as a global powerhouse, and people thought it was going to take over from New York. We were doing lots of deals and lots of business. Many of my peers were going into private equity. I was always more interested in the public markets, so I started to interview with hedge funds in New York. In the end, though, I decided to go to business school, applied in the fall of 2007, and ended up getting accepted. I left Merrill in August 2008, right before the crash. It was good to be able to sit out the financial crisis in the cheap seats of an MBA program.

MOI: The Oxford years sound fascinating. You say they may not be as relevant, but some of the best investors have studied subjects like philosophy and history. We are fans of liberal arts and studying broadly. Given the times we live in now, it seems that an understanding of history can be quite useful.

Aldigé: Yes, definitely. I think there's always lots to learn from history – thinking about how things rhyme and echo in the present and trying to use those lessons is an important part in being an investor. In addition, two of the things that have shaped me as an investor are those two crises. I was fortunate not to have a lot of capital or career risk in either of them. During the dot com crisis, I was in college. My PA got blown apart, but it wasn't very big, and it didn't bother me that much. Seeing those stocks go up so much in the late 1990s while I was owning them and then declining so dramatically taught me a lot of humility about the markets.

The financial crisis was tremendously instructive too because in 2007, when I was applying to business school, all my bosses were British. None of them had MBAs, and most of them didn't understand why I would want to leave. They were all making record incomes at that point. Unfortunately, many senior folks in the City of London were living above their means. They were buying bigger and bigger houses, and the cost of living there is high, so they were all spending next year's bonus before it came. Seeing some of those situations play out over the next year and then after I left was highly instructive, not only when you look at companies and think about leverage but also when thinking about your own personal balance sheet. I think it's tremendously important as an investor to live below your means and to be able to have confidence that you're going to be okay through the next 50% drawdown. It has also influenced how I've structured my firm from an operating cost and overhead perspective.

MOI: You started at HBS in the fall of 2008. How was it watching all of it unravel from the sidelines or from an academic institution when you had been in the middle of things for the prior three to five

years?

Aldigé: It was fascinating. I was lucky in that I didn't have to take on the full stress of the event itself from a career or a financial perspective. I was also super lucky in that I had saved money while I was working at Merrill and converted all my pounds to dollars at around 1-to-2, which was a record high exchange rate in my favor. I was also using all my savings to pay for school, so I didn't have any money in the stock market – it was all in cash. It was helpful to be able to use that time to learn, and it was a fascinating time to be a student. At HBS, we had many great speakers come and talk about what was going on in real time. Those were people from various sectors – representatives of operating companies, banking executives, private equity executives, and policymakers. So, there was a real-time supplement to the curriculum where we were delving into the major bankruptcies, bailouts, and all the rest that made the daily headlines. I think it was an awesome time to be in school.

Another interesting thing is that we've had many great businesses come out of my class, startups that have gone on to do amazing things. There's always a lot of entrepreneurs in any MBA class, but given the uncertainty in the economy and the lack of hiring for internships from the traditional banks, consulting firms, and private equity companies in the following summer, many people said, "I'm going to try and do my own thing." That's been awesome to watch as well.

MOI: Post HBS, you got into investment management at Tiger Eye. Tell us about that.

Aldigé: Pretty much from day one, my first year at HBS, I focused my job search on public equity investing positions, so all the big mutual funds that came to campus, Fidelity, T. Rowe, Capital Group, and hedge funds as well. Around January-February, which was the height of internship interviews, I was connected with a friend of a friend who had just been seeded by Julian Robertson at Tiger to launch a fund. He was in the process of hiring full-time analysts and looking for recommendations, which is how my friend pointed him to me. He agreed to take me on as an intern that summer. The fund officially launched on April 1, 2009, and I was an intern that summer from June through August.

During my second year of business school, I worked on some projects for them and then went back full time in June of 2010. That was another hugely impactful and great experience. At Tiger's headquarters at 101 Park, there were probably 30-some funds in the building that all had a relationship to Tiger. It was a very collegial environment, pretty collaborative. Even though each fund was its own separate entity, people were always willing to grab lunch or coffee or talk about their background. It was almost like an MBA in the hedge fund world. For our fund, we started mostly with Julian's capital and grew pretty steadily over the next six years that I was there. Most of that time, it was myself and one other analyst supporting the portfolio manager. It was like drinking from a firehose. I mean, we were covering lots of companies between us and getting on the road a ton, meeting with lots of management teams and learning that traditional Tiger-style long/short equity investing.

MOI: Did you have a focus in terms of industries, market caps, or geographies?

Aldigé: We were a little unique amongst the Tiger universe in that the founder of our firm had done a lot in the oil & gas space and industrials as well. From day one, he tasked the other analyst with covering energy and industrials, and I basically did everything else. We kind of split the economy in half, and what I did tended to drift more towards tech, media, telecom, consumer retail, and business services, so more overlap with what you would see at some of the other Tiger funds in the building. In terms of market cap, we were fairly agnostic. Most of the companies were US companies, but we did invest in Europe and Asia from time to time and used a lot of different strategies. In general, we were trying to own good secular growth businesses, but we would also look at more catalyst-driven and special situations types of investments. It was a great environment to try many different things and see what resonated with me. I always found I was best at trying to identify high-quality businesses that

might look optically expensive and figure out whether they might have a longer runway to continue to grow, reinvest, and remain great businesses for longer into the future than the market was expecting. Those are generally the types of investments I always did best with, and that's the approach I've taken at Clio.

MOI: At some point, you decided to go out on your own. What was your thought process?

Aldigé: There were a few things. I had gotten married. My wife is from Austin, Texas and went to college in Nashville. We didn't see ourselves staying in New York for the long haul. Five or six years ago, it definitely wasn't as easy to work remotely at a fund when the head office is in New York, so that wasn't really an option. So, Austin, Nashville, and Charlottesville, where I went to college at the University of Virginia, those were the three cities we were interested in living in. Also, I struggled at times with the long/short model. I don't think I was a particularly good short seller. I learned many great skills by shorting stocks over those years, but to be a truly excellent short seller, you have to love it and possess a certain personality to do it. What I found was that the first couple of years were the most helpful, where you learn fraud detection and your ears prick up when you see certain red flags, all of which is super helpful for a long investor. Your BS detector gets more finely tuned as a short seller.

Beyond that, however, I felt like being a short seller started to impair my ability to be a good long-term investor because you have to be so much more focused on near-term noise, data points, and risk management. Time is not on your side, so your behavior starts to change, sometimes with your longs as well. You start focusing so much more on the shorter-term data points because you've been doing it on the shorts, and sometimes you have to pair factors against each other. You're trying to make money on both sides of the portfolio at all times. It wasn't what felt I was best at, so that was the second reason. It was a combination of geography, wanting to start a family not in New York City, and wanting to be more of a long-only dedicated investor.

MOI: The point on short selling is a great one because it is indeed a different skill set on the long and the short side, especially if you invest on the long side the way you do in a concentrated long-term fashion. Trying to do that while also short-selling would make your day-to-day environment far from conducive to the kind of long investing you want to do.

Aldigé: Yes, I think that's right.

MOI: You launched the firm with 21 partners putting in about \$21 million. Why did you decide on separate accounts rather than a pooled vehicle and what do you see as the advantages of that structure?

Aldigé: With everything around building a business and designing an organization, a structure, and a strategy, there are trade-offs and pros and cons. For Clio's investment strategy, I think the separate account model has been almost unreservedly a positive. Initially, I was going to launch a fund. That's the world I came from and the only structure I knew, but I had interactions with some folks locally and a couple of others that had pursued the separate account model, which I wasn't overly familiar with. Essentially, you're regulated as if you're a retail wealth adviser or wealth management RIA, but you don't do the financial planning element of it.

I think that this part of the industry has evolved as it's gone from broker dealers to independent RIA fiduciaries. I'd say a lot of firms who use that model aren't necessarily stock pickers. They're still more wealth advisors. They're talking to their clients about retirement planning, risk preferences, and risk tolerances. These days, it seems they are then putting clients in a handful of different ETFs and index funds, maybe some blue-chip stocks that they might have a view on. However, they tend not to be

deep fundamental research, stock-picking firms. That seems to be the norm in the separate account RIA space, but there are some firms out there that use the separate account model to invest like a fund and do a lot of fundamental deep research, diligence, and investing in a reasonably concentrated portfolio. I started talking to a couple of those people, and it seemed like a good fit.

As an emerging startup manager, the biggest benefit is that it gets rid of many tens of thousands of dollars of cost, both ongoing and startup costs. You don't need fund docs, an LPA, and a PPM, so a lot of legal goes away. You don't need a fund audit every year, a third-party administrator, or a prime broker who'll expect you to spend a lot of money with them. The RIA platforms - TD Ameritrade, Schwab, Interactive Brokers, and Fidelity - provide these services essentially for free for the investment advisor. When I started, a few years ago, they were charging \$5 to \$7 commissions on trades, but those have now gone away for the most part. Today, the RIA custodians are primarily making money on some payment for order flow and then the spread on cash balances in client accounts. As an advisor, it's a low-cost way to get into the business. Keeping your expenses down, both your personal and your firm's P&L and balance sheet, is very important not only as a startup manager but as any manager because history suggests there will be multiple 30%, 40%, 50% drawdowns if I'm in business for the next 25 years.

You have to organize yourself and your firm in such a way that you can not only withstand that but thrive during those times. If you've got a high-cost base with a big staff, a lot of overhead, and tons of gold-plated service providers that cost a lot of money, that can prohibit you from achieving this. It also means that as a startup manager, you have to spend a great deal of time raising money because your breakeven AUM is much higher. A lot of folks starting out spend a disproportionate amount of their time on the road trying to raise money, and it's very hard. Many people probably end up taking money from clients that may not be the best fit, which can lead to problems down the road. I wanted to avoid all of those things, and from a cost perspective, the separate account model solved a lot of those issues.

It's also really easy to administer. I have a third-party software firm that helps me do my billing and invoicing. It takes me an hour every quarter. They've got a performance reporting system in there and a client portal. As a one-man firm, I don't spend much time at all on the administrative side of things. It's great from a client perspective, too. Clients retain custody over their assets, and they can fire me at any time. I've got a lot of thoughts on the merits of that model versus an artificial restraint, which is a lockup, but I think clients truly appreciate the model. They retain their tax attributes and get a 1099, and they don't have to wait for a K-1. There are a lot of positives to it.

MOI: This structure seems to be underrated. Clients may feel comfortable because they retain custody, and it seems a lot more transparent.

Aldigé: Yes, it's super transparent. You can log in any day, see exactly what you own, and what your assets are. You're not waiting for a quarterly report which may not even disclose what you own in your account, how it's being invested, and what was done during the quarter. I think that helps to build trust with clients.

MOI: You have an interesting fee schedule where you reward client loyalty.

Aldigé: That's right. I initially had a fee schedule where the management fee declined as AUM grew, which is starting to be a more common feature of funds, especially funds that charge a performance fee, trying to disincentivize asset gathering and also reduce the management expense burden as the fund grows and giving some of that back to clients. When I first proposed this to my state regulator, they didn't get it. I ended up deciding to replace it with what I call a loyalty discount, which essentially tries to solve for similar things. I expected the firm would grow over time and, hopefully, assets would

grow, and I wanted to give some of that back to clients, but instead based on individual client tenure as opposed to firmwide AUM. Starting in year four, the management fee goes down five basis points annually over the next five years, so 25 basis points cumulatively, from 1.25% to 1.00%. Hopefully, clients appreciate it. I don't know if it will be the deciding factor in whether someone wants to stay if they're on the fence in year five, need the money, or aren't happy with me, but it's a bit of a bonus.

MOI: There's no performance fee, and clients can withdraw their investment on short notice, right?

Aldigé: Yes, no performance fee historically and 10 days' notice. I think managers love lockups and believe them to be highly valuable. I'm not necessarily convinced this is the case. I've talked to many people that have run separate accounts and funds side-by-side, that have done lockups and no lockups. A lockup is an artificial mechanism to protect the fund but also to protect other clients in a fund structure so you don't have people redeeming and having to potentially liquidate investments at fire sale prices, which can impair everyone who remains in the fund. With a separate account model, that problem goes away. If a client wants to redeem, I can simply give them back their capital, sell their stocks, and give them cash, or they can remove me from the account and keep the stocks they have and decide what they want to do with them. It doesn't have any bearing on anybody else's accounts.

The second thing is that it's their money. They've all worked hard for it, and if they decide they need it, they should have access to it. My hope is that all the other things I'm doing – be it letters, communications, the performance, or the fee structure – will make them want to stay. Hopefully, they feel like they're getting a lot of value for the price they're paying, so they'll want to stay and not feel like they're bound by some artificial lockup when they might need the money.

MOI: Let's shift gears a bit and talk about your investment philosophy. How do you go about identifying the great businesses you want to have in the portfolio? What are your core investment criteria?

Aldigé: I was always more successful at investing in what I deem to be very high-quality businesses and trying to own them for as long as possible. It's not a particularly unique strategy. What manager out there would say, "I want to own a crummy business with low returns on capital, sketchy management teams, and huge amounts of debt." While the strategy is not unique, it can be hard to execute. You need a structure and a client base that is conducive to this type of investment strategy. You also need to have that punch card mentality of only making a handful of decisions each year, trying to be thoughtful and having a high bar for capital deployment. The things I prioritize are high returns on capital, sustainable growth opportunities, the culture, and the management team.

I suppose where I tend to be most different is that Return on Future Invested Capital is a big part of my analytical process. What I probably spend the most time on is trying to think through what that looks like from a unit economic and a capital deployment basis relative to what a company's done over its history, whether that's inflecting higher or coming down relative to its cost of capital, and then trying to think through how many years into the future the company can continue to deploy capital at those rates. When I make an investment, it's probably the area I generally find to be the most different from what the market is expecting.

MOI: How do you judge whether a company can reinvest at a high rate?

Aldigé: Backing up a bit, I think the most influential learning I've had has come in the last few years, and it's from reading the work of Michael Mauboussin. His book *Expectations Investing* was a huge mental unlock for me. A few things stick out from that book, which I think everyone would benefit from reading. First, it's the idea that for a stock to deliver a return greater than the market return, it has to fundamentally perform greater than what's expected by the market. This is something most

investors know, or should know. The second piece is the concept of disaggregating a business into its steady state component, which is more of a bond-like cash flow stream, and its future growth component. To me, that was an especially helpful framing, and I think Michael does the best job of anyone of marrying the academic theory of investing with its practical application. When you are able to disaggregate those two pieces, you can spend a lot more time reverse-engineering. Just like when people do reverse DCFs, you can also reverse-engineer those pieces of the analysis to understand better what the market is thinking for the future runway of reinvestment if you anchor your assumptions at certain levels. That's been an immensely helpful framing for me. I then adapted that analytical framework to my own thinking and my own style.

What I want to find is companies growing their intrinsic value each and every year. I know there's a lot of debate about growth and value investing and buying 50-cent dollars versus buying growing businesses. I certainly fall in the latter camp, but most of the businesses I tend to look at are those growing their intrinsic value on the order of 15% to 20% each year. One proxy people use for intrinsic value accretion is free cash flow yield plus free cash flow growth. I think Glenn Greenberg was one of the proponents of that proxy. I try and take this a step further, using some of the insights from Michael Mauboussin's book to say, "Okay, you've got a free cash flow yield. What's the *steady-state free cash flow growth*? What would this business grow its free cash flows each year if it stopped reinvesting for growth?" So, no growth capex, only maintenance capex, and no growth P&L investments, only maintenance P&L investments. You're getting rid of all growth R&D and all growth sales and marketing. You're basically investing to maintain steady state, and for a subscription-type business, you have to replace the churn. For any business, you have to replace any outgoing customers, but you're just investing to keep the lights on, doing basic maintenance. Some businesses can still keep growing pretty nicely based solely on the industries they're in if they have enough secular tailwinds and a strong position within the industry. Some businesses will grow only at GDP at steady state, and some will grow below GDP. Many of the businesses I tend to look for will probably grow higher than GDP in a steady state context, at least for the next several years. At some point, though, if a company stops re-investing in its business, it will eventually come back to a GDP-type growth rate, or worse, at least in nominal terms.

These are two pieces, free cash flow yield plus steady state free cash flow growth. The third one is at what rate of return and for how many years into the future can a company reinvest all the excess capital it generates above the maintenance investment. That's the piece I spend the most time thinking about. O'Reilly Auto, which I own, has one of the most impressive historical track records of return on invested capital but also a pretty good future growth runway at higher rates of return, certainly relative to what the market is expecting. It's digging into the unit economics of each store and each distribution center and trying to figure out whether what's been happening for that business historically is a good proxy for the future, whether those returns are coming down meaningfully or going up, and then trying to compare it to what you think the market is expecting.

MOI: What are some of the biggest challenges in implementing this approach? We would imagine many companies don't give you all the data you might need to get a good handle on some of these items.

Aldigé: I think it's the opportunity, to be honest. I mean, in the industrial or the energy space, where investments are in physical assets and capex, businesses have been talking about what their maintenance capex and growth capex is for years. However, for the huge number of companies that invest in intangible assets, or more through the P&L than through the cash flow statement, that language is simply not there yet. Companies don't talk about their maintenance level of sales and marketing, R&D, and G&A. They probably will need to in the future because it's such an important piece of the analysis, but it is difficult to disaggregate. For subscription businesses, it can be a little easier if they give you churn figures, and you have enough to triangulate around gross and net churn

and net dollar retention, diving into the unit economics of a business.

The analysis is different for a software business than it is for, say, a retailer. It's trying to use the reported financials and make adjustments to the accounting to have them make sense for that type of analysis, talking to the companies and trying to sense check your assumptions, and putting the question to them. "You spent \$100 million in SG&A last year. How much of that would you consider to be growth SG&A versus maintenance?" You can also do a lot of ratio analysis. Year-on-year comparisons can be tough and lumpy, but if you look back over the last five to 10 years or even longer, you can see how much a company has grown its sales and each of those investment items — fixed capital, which is capex and acquisitions, P&L investments, which is SG&A, R&D primarily, and then working capital. You can see what percentage those have changed each year as a percentage of the sales growth, and that's a good proxy for how much reinvestment capital is needed to grow sales above a baseline steady state amount.

MOI: When you take the case study of O'Reilly as a retailer of auto parts, how do you think about the ways in which the industry landscape might be changing and the role of online sales going forward when you're trying to figure out the future reinvestment rate?

Aldigé: There are many things going on with O'Reilly, just like there are for any company. In my view, the beauty of the O'Reilly model is that each retail store serves two different customer bases, and the physical assets in both the store and the inventory can be leveraged to serve both of those. You've got your B2C retail customers, but you've also got your B2B repair shop customers, and you can flow all that inventory and serve from your distribution centers all those customers from the same store. In some respects, it's what you see in other retail categories — with the rise of e-commerce stores, retailers are trying hard to leverage their stores as distribution hubs. Again, it's still only a B2C model for them, but it's trying to make more use and sweat the assets at a higher rate in an omnichannel context.

In terms of what you were asking about, the total market for auto parts is roughly \$225 billion. Labor is something like \$70 billion of that, and then tire sales are about \$25 billion. Most of the retailers — O'Reilly, AutoZone, Advance — don't sell tires. What you're left with is about \$130 billion of addressable market. Of that, the DIY piece is roughly \$45 billion. AutoZone has about a 20% share there, and O'Reilly more like 13%. The do-it-for-me segment, which is the professional B2B repair shop piece, is about \$85 billion. I think Genuine Parts might have about a 10% share there. Advance is 7%, and O'Reilly is a bit below that. The online piece is about \$15 billion or \$16 billion at this point. Last year, it grew 30%, so up from about \$12 billion in 2019. Overall, you're already looking at close to 12% of the industry having gone online to e-commerce.

A lot of these online companies have been around for a long time. RockAuto was founded in 1999. You've got CarParts.com, Parts Geek, and DiscountAutoParts.com. Then you have the big player in the space, which is Amazon. I think a lot of that opportunity for online is mostly well penetrated. It's a fairly mature category. What gets sold through online channels are things like wiper blades and seat covers. It's not things that are mission-critical to the operation of the car, which you need now. It might be a heavy part, which isn't conducive to shipping via UPS. You might need tools to help you install it, which O'Reilly can loan you at the store. You might need someone to show you how to install it, which an O'Reilly employee can do on the spot. If it's not the right part, you want to be able to take it back right there and get the right one. These are all things a store like O'Reilly is the best at, so I'm not too worried that e-commerce is going to start to take material share from someone like an O'Reilly.

The other piece people are worried about from a long-term secular trend is the electric vehicle piece. Again, a long time will pass before EVs become a meaningful portion of the car parc. You're talking

20-30-plus years before it could significantly dent the sales. It's not even clear to me that it's going to be a massive negative if the fleet were to change to be EV-dominated. Given how gradual it will be, you'll have lots of time for the parts retailers to get their ducks in a row, to offer parts that can service an EV vehicle in addition to traditional internal-combustion engine vehicles.

MOI: How do you think about the valuation here? What's an appropriate way to value a company like O'Reilly?

Aldigé: One of the things I've learned from reading Michael Mauboussin is that multiples should be an output of the analysis, not an input. The way most people are trained to value businesses is to forecast two or three years of earnings and then put an earnings multiple on it, which might be derived from some historical multiple or relative to its growth or maybe to competitors. I feel like a lot of that is pretty arbitrary, but at the same time, that's how the majority, certainly of sell-side analysts and still a lot of buy-side analysts, tend to value companies. Then they make a price target and back-solve their IRR over a two- to three-year period or whatever their holding period is. They might also try to identify a catalyst they think might lead to multiple expansion.

I tend not to approach valuation that way. I like to go back to the idea of how much intrinsic equity value the company is growing each year, which is the sum of those three components I mentioned earlier, and then try to come up with a fair value, which can come from a DCF type of analysis or a multiple type of analysis. I'm contradicting myself in a way, but the multiple analysis is just another shorthand way of doing the DCF. What I'm trying to figure out is based on the share price today and what I think the revenue growth, margin profile of the business, and the return on future invested capital are and how long into the future the market is discounting that this company can continue to reinvest. You've got the steady state bond-like component, which is the maintenance level of free cash flow today and capitalized at the company's cost of capital, you've got the steady-state free cash flow growth, and then you've got the reinvestment piece. You can back-solve it in a way that you can come up with a number.

I try not to be too precise about it, but when I invested in O'Reilly, I thought the market was saying that this company has maybe three or four years of runway left to reinvest at high rates of return above its cost of capital - for this company, returns on incremental capital are north of 30%, which it has done historically, and I think it can continue to achieve ROIICs in that ballpark. This company has been around for decades. It's been growing its store base at call it 200 units a year recently, and it's been getting very good returns on incremental invested capital on those new stores. The market is saying it can only do that for another three years, but I don't agree. This is still a highly fragmented sector, so it doesn't seem that plausible to me that the competitive advantage period of the company, i.e., the reinvestment runway at above-average rates of return, is only three or four years. It might be closer to 10 years, or even longer. If you run at least a 10-year number through the model, you get a much higher valuation on that future growth piece that you can then add to the steady state piece and think about the business being materially undervalued. It's an added bonus for a company like this that is never going to get the multiple credit it deserves based on its returns on invested capital, because it buys back a ton of stock. As that valuation stays low, if you've got a long-term time horizon and are willing to own it for the next 5 or 10 years, the company is going to shrink its share count at discounted prices which, at the end of the day, is going to benefit anyone who remains a shareholder in the out years.

MOI: Do you have any rules of thumb for how much of the steady state value you want to be in the current market quotation versus how much of the future value is part of the overall value?

Aldigé: No, but that's a great question. I don't have any rules of thumb. It depends on the company and the sector. For a software name, oftentimes the steady state piece is roughly the current customer

base, adjusted for net and gross retention. That's another way to go about this analysis, especially for businesses where you have a lot of data on customers. This customer-based valuation is applicable to any business, but it's easier to apply to a subscription recurring revenue business. When you have disclosure around the cohorts, the number of customers, the churn, and customer acquisition costs, you can calculate your lifetime value and all those things. You can then solve for how much of today's valuation in the share price is that steady state component from the current customer base, and how much is from new customers which might come in the future. Some businesses will have to invest more to acquire those customers, some less, but there's a reinvestment component to both of those.

You can disaggregate a bunch of software companies and look at them against each other. Many will have a current steady state piece that's, say, 20% of their valuation in the share price, and the remaining 80% by implication has to come from new customers. Sometimes, you'll come across a company where the metrics are so good, the churn so low, the net dollar retention so high, and the customer acquisition costs so low that you may find a scenario where the share price is saying that 70% is the steady state value and only 30% needs to come from new customers. You can think about that relative to the total addressable market and its peers. Every once in a while, you find a company where the market is saying that it will sign up very few new customers, and you'd be shocked because you have a differentiated view on how good the customer growth runway is. I don't know if that makes any sense. There's no rule of thumb, but it's certainly always something interesting to think about.

MOI: When it comes to subscription-based businesses or recurring revenue businesses, what are some of the key variables you want to look at to understand those unit economics and be able to value the customer relationships, either the existing or future customers?

Aldigé: You'll want to think about your average revenue per customer across cohorts and your gross margin, as well as what operating expense you need to attach to that, so take away the sales and marketing for new clients and think about what amount of flow through there is for an existing customer – the contribution margin. Then you want to think about the gross churn rate, which is the inverse of your customer retention rate. You also want to think about your ability to upsell an existing customer; either you're expanding seats or usage within the customer without much associated sales and marketing, or you're taking up price, or you're adding already-existing modules for which you can charge more. Then you get to a net dollar retention rate. If you have most of those variables, you can get a good sense of how much the existing customer base is worth.

MOI: Have you found that those types of businesses do a good job with disclosure? Is that something where you run into hurdles? How much of your analysis can you typically base on the company data versus having to dig it up yourself?

Aldigé: It can take a lot of legwork. In the software space, companies know that their investors want to see these metrics, so they're starting to provide a lot more. They're providing cohort analysis, churn, and net dollar retention. Obviously, they're going to paint those numbers in the best possible light. To assume that those retention figures remain as high as they are for a long time in the future is pretty unrealistic, so you have to assume a decent amount of fade in those metrics. On the gross retention metric, a best-in-class company like ServiceNow retains 98% of its customers annually. That's 2% churn, which implies it retains a customer for 50 years. If that goes up to 99%, it's 100 years. If it goes down to 97%, that's 33 years. It's probably unrealistic to think that 98% figure stays steady and that all of these customers will be around for the next 50 years. You do need to incorporate some degree of fade in those metrics, and we'll see how the market plays out.

The same goes for the net retention piece. Many times, these companies are very early in their adoption curves. If they're landing and expanding at early customers and getting 150% net dollar retention, that's probably not going to last either. It's as much art as it is science, and you're trying to

think through where these companies are in their lifecycle, how competitive and mission-critical the product is, what pricing power a company has, and how much it is willing to flex it. You get to those different pieces of the mosaic by talking to the companies, their customers, competitors, employees, and former employees. You do all those things everyone does but trying to be thoughtful about it and come up with a valuation that makes sense to you. Then you act only in those times when you feel like there's a pretty big divergence in what you found and what the market believes.

MOI: How do you build the confidence that you have an understanding the market doesn't have — does it happen through conversations with customers and competitors?

Aldigé: It depends a lot on the sector and my familiarity with it. You want to have a relatively simple thesis that you understand and believe to be right, but also one where you feel you'll have the ability to maintain conviction even when things inevitably go wrong. It's all those things. As you follow companies and industries for a longer period of time, it becomes easier. I wouldn't point to anything in particular that is different about my diligence process, but it's a combination of all those techniques. I believe the valuation piece I use is slightly different, and it helps me to build a framework around expectations and only swing the bat when I think there's a big divergence in that long-term reinvestment runway versus what the market is expecting. Most people estimate earnings three years out, and if they are forecasting \$2 when the sell-side consensus is \$1.50, they consider that a good setup. I'm not playing that game. At the end of the day, it's all trying to solve for the same thing (i.e. fundamentals vs. expectations), but it's going about it with slightly different types of analysis.

MOI: Are there other criteria you look for that you like to see in your investments, for example, when it comes to management quality or incentives, on the capital allocation side, or with regard to the balance sheet?

Aldigé: Most of those are pretty standard for people who invest in high-quality businesses. I love to find companies that I believe to have a strong culture, that try to take care of all stakeholders — not from an ESG perspective but because they've realized over the years that when they treat their employees and the communities where they operate well, it leads to better outcomes, less staff turnover, more loyal employees, and lower costs. How do you figure that out? You can look at culture scores online, but I think many companies have figured out how to game sites like Comparably and Glassdoor.

Sherwin-Williams was one of the first companies where the quality of the culture made a huge impression on me the first time I visited it. Most of the senior executives have been there for 30-plus years. They've all grown up there, starting in the company's management trainee program right out of college. They work in a store, then they run an operating group or a group of stores, and then they run a division. They move around. Companies like that tend to do better than those that just poach executives from other companies to run their business. It's not a hard-and-fast thing, but it's something that stands out.

From a compensation perspective, it's clearly better when the CEOs are heavily invested in the stock relative to the amount of their cash compensation and are more aligned with shareholders from that perspective. One of the things I struggle with — which has probably led me to miss out on some good investments — is that I generally don't like to invest in dual share class stocks. In many respects, a lot of the companies I look for are growth type companies. Many businesses that have come to market in the last decade have the types of structures where you have a big divergence, a wedge between how much the CEO and founders own versus how much voting power they have. I find it problematic. That might be an odd thing to say, since, in general, you're investing in a company because you believe in the management team. You're saying, "I don't care if they've got 10% economic ownership but 75% voting control. Why should it matter? I'm trusting them by investing in the stock." However, I think

that all works until it doesn't. If you're going into an investment with a 10-year time horizon, which I try to do, that's just one of the things that could potentially go wrong. If the management team, the founders, and the CEO don't have the same alignment of interests as the common shareholders, it can lead to issues over time.

MOI: You have a fairly concentrated portfolio, typically eight to twelve positions. How did you arrive at that level of concentration?

Aldigé: There wasn't a huge amount of science behind it. It's simply what I felt comfortable with. If you do the math, that's roughly an 8% to 12% average position size, or if you're holding a little cash, maybe a bit lower than that, which felt about right to me. I typically draw my investments from a wider list of 50 exceptional businesses that I've been collecting and studying for the past 15 years. The average holding period can vary from two to seven years, which means that, in general, you'll be turning over two to three names a year in a 10-stock portfolio. That 20% to 30% turnover feels right to me when I think about how productive I am, how many good ideas I have in any given year, and how many from that list of 50 and maybe some adjacent companies I can build a conviction in. All those inputs went into both the 8 to 12 and the target turnover. You can make arguments about diversification and talk about diversifying risks and all those things, and I guess they are helpful, but that wasn't the primary reason behind the 8 to 12.

MOI: How do you think about how much cash to hold?

Aldigé: Fundamentally, it's a bottoms-up decision based on the quality of the ideas I have at any given time. Sometimes, I might have sold something, and there's a mismatch in the timing. Just because I sell something on January 1 doesn't necessarily mean I have something immediately ready to replace it. It might take me three, four, or six months to redeploy that cash. In general, I tell my clients that I want to be 'mostly invested most of the time', which means anywhere from 2% up to 10% cash is what I would call 'mostly invested most of the time'. At certain times, it could be higher than that, but my hope is that it will never be above 20%, and that's the highest it's been since inception. It's just a function of the bottoms-up ideas. When markets are more richly valued, like they are today versus last March or April 2020, it sometimes becomes harder to find good ideas. It is reflective of the overall market macro environment, but I always tell my clients I never want to use that as an excuse. I mean, no matter what the market is doing or where it is valuation-wise, there will always be many businesses out there today that will generate tremendous shareholder value over the next decade. As a fundamental stock picker, it's my job to find them. The bar is probably higher when markets and valuations are higher and overall yields and IRRs are lower, but it's not an excuse.

MOI: What does a typical day look like for you?

Aldigé: A lot of reading. I wake up. I read news, email, and the Wall Street Journal cover to cover, sometimes another newspaper as well, whether it's the FT or more popular news, USA Today-type news. Then I usually try to dedicate a portion of each day to a specific company or an industry. In a given week, I'll usually be spending time either on a new idea or learning more about an existing investment. That would involve reading a handful of transcripts each day, along with blog posts, sellside research, industry journals, and Twitter. Sometimes it's a 10-K. Sometimes it's a call with a company or with someone in my network who might know something about the company. I try and spend at least a couple hours each week reading a book, be it a book on investing, a biography, something on market history, or history in general. I'll also carve out a couple of hours every day for more analytical work. There's no pre-set structure to it. Some days feel much more process-driven, and some are very freeform, where I let the day go where it wants to go, and I have nothing on my calendar and my to-do list. On other days, I might have 5-10 things on my to-do list related to specific companies or sectors.

MOI: It sounds like a good environment for some deep thinking.

Aldigé: Yes, that's the goal.

I've got two desks in my office, and I try to work at the one that doesn't have a computer on it. I work in a property on the Boar's Head resort in Charlottesville, with big fields and lakes right outside my door. It's good for walking. There are tables outside. It's a very different environment from Madison Avenue and New York City.

MOI: James, anything we haven't touched on that you'd like to mention?

Aldigé: I guess the one thing I didn't mention is Clio's two guiding principles, which are Simplicity and Alignment. Those two words are embedded in my process and help guide every decision I make, whether on organizational design, client engagement, new client development, terms, or the investment side of things. Whenever I'm faced with making a decision on any of those fronts, as a business owner or an investor, I come back to those. What's the simpler path? Is this a simple approach? Is this a simple investment thesis or setup? Or is this going to make life more complicated, and if so, is it worth that trade-off? Then, does this decision promote alignment? Am I aligned with the companies I'm investing in? Am I aligned with the clients I'm bringing on board? Am I aligned with the service providers?

Those are the two north stars I've tried to live by, and I think they have been really helpful. An anonymous account said on Twitter yesterday that the path to success becomes clearer when one realizes the investment industry gets paid to manage the same unnecessary complexity it creates, which I thought was generally pretty true in this industry, albeit a somewhat cynical take. There's a lot of needless complexity in the investment industry, with a lot of middlemen taking cuts and fees along the way. I'm certainly part of that. I'm a middleman, just like everybody is, but it's helpful to try and limit the number of middlemen along the chain and to operate in as simple a manner as possible.

MOI: We like those two north stars and are reminded of the Leonardo da Vinci quote that simplicity is the ultimate sophistication. A lot of folks in this business forget that (or are incentivized to forget it). Thank you so much, James.

James Aldigé is the Managing Partner of Clio Asset Management LLC ("Clio"), where he serves as the Portfolio Manager for the firm's investment strategies.

Prior to founding Clio, James was a co-founder of Ivy Road Partners. Ivy Road was a full-service investment office, providing endowment-style management for families and affiliated foundations. As one of three Managing Partners, James served as the Head of Public Investments. In this role, he designed and led all aspects of the firm's public investment program, which included both third-party managers and a concentrated direct equity portfolio. He also assumed COO responsibilities which included building out extensive firm and fund infrastructure, regulatory compliance, and service provider oversight.

Prior to co-founding Ivy Road, James spent seven years at Tiger Eye Capital, a fundamental long/short equity hedge fund based in New York with strategic backing from Julian Robertson and Tiger Management. At Tiger Eye, James was a Partner and Managing Director and held primary responsibility for the fund's investments in the tech/media/telecom, consumer/retail, and business services sectors. Previously, James was an investment banking associate in the London office of Merrill Lynch & Co.

James holds an MBA from Harvard Business School, as well as an MPhil with distinction in Economic History from Oxford University. He holds a BA with high distinction in Economics and History from the University of Virginia, where he was an Echols Scholar and a junior-year inductee into Phi Beta Kappa.

James serves on several UVA-related boards and initiatives, including the Board of Managers of the UVA Alumni Association, the Advisory Board of the UVA Licensing & Venture Group Seed Fund, the National Selection Committee of the Jefferson Scholars Foundation, and as Vice Chair of the Jefferson Trust.

James lives in Charlottesville, Virginia with his wife and two daughters.