*This article by Michael Shearn has been excerpted from a letter of Compound Money Fund, LP. Michael wrote this piece after John Mackey returned to Whole Foods as sole CEO in late 2016. Whole Foods was acquired by Amazon.com in mid 2017.*

We would like to introduce you to a few of the tools we use to forecast the future prospects of a business and to determine whether a leadership team is building a competitive advantage. First, some background. When I started my career in the investment business my skills had been developed by taking courses in Finance and Accounting. I was taught how to calculate financial metrics such as return on invested capital (ROIC) and learned the differences between LIFO and FIFO when accounting for inventory. The tools I was given to value a business were measurement tools similar to rulers and calculators. Later I learned that using *rulers and calculators* to analyze numbers tells you about the past but *investing is in the future*. Therefore I needed additional tools to help me forecast the future value of a business.

### Placing the Odds in Our Favor

I have always been curious as to what makes some forecasters (those in any business of prediction) successful versus others and spent some time researching this area. One key theme emerged. I learned the most successful forecasters always *place the odds in their favor* in some way, especially those in ancient times who would often pay with their life if they were wrong.

So how do we go about putting the odds in our favor when investing?

We start with *choosing business models* that have certain characteristics that help us make predictions about their future cash flows. The best way to explain this is to think about two extremes in business models. At one extreme are those business models that are easiest to predict. Typically these are businesses that have long-term contracted cash flows with stable counterparties. For example, a large percentage of Brookfield Asset Management's cash flows are contracted for long periods of time, such as its long-term office leases in its Class A Manhattan office buildings or the electricity it sells to utility customers generated by its hydroelectric dams.

On the other extreme are those businesses that are most difficult to predict. Examples would be businesses whose revenues are tied to commodity prices (e.g., oil and gas companies) and other cyclical businesses (e.g., construction equipment leasing firms). As some of you know, I operate a privately held oil and gas business (inherited from my late father) and every year I am reminded how difficult it is to do business in this industry. First of all I never know what I will be paid for my product on a year to year basis, yet I am expected to make long-term investment decisions. I basically am always operating in the dark and am restricted in making any realistic forecasts.

## Building a Competitive Advantage

When looking for business models that are easier to predict I used to solely focus on businesses that had a competitive advantage I could easily identify. What I later learned is *most value in a business is created when a competitive advantage is being built* not after it already has one. Think about the big gains in Microsoft's stock. The highest returns went to the early investors who were involved as Microsoft was building its competitive advantage. Since Microsoft has become the monopoly software provider, its returns have been mediocre for more than two decades. The same has held true with many of our past investments in businesses that had competitive advantages I could easily identify, such as Western Union, which has underperformed the S&P 500 since it went public. To remedy this Ann and I set out to identify a series of questions we could use to help us determine whether a business is creating a competitive advantage. The first series of questions we ask are shown below:

- Is the product or service solving a genuine customer need?
- If the business did not exist anymore, would anyone notice or care?

The best businesses are so good at solving problems for their customers that they become indispensable. Think about products or services that you can't live without today, such as Amazon or Google.

We believe our portfolio holding Shopify is building a competitive advantage by solving many of the problems customers face when they set up an online retail business such as designing a website, managing inventory and discounts, or simply accepting payments from a variety of sources such as Visa, Square or Stripe. Shopify's products are so easy to use that most customers can setup an online retail business on their lunch hour. They can then spend most of their time focused on their products and outsource the painful activities. Shopify performs this service for a very low monthly fee which starts at $29 per month and averages $52 per month for most customers. The combination of a low price and easy to use solutions makes the service indispensible to its customers and is what contributes to its 100 percent customer retention rate (this figure does not include customers going out of business). The leadership team is also continually increasing the size of their competitive moat by reinvesting excess free cash flows to solve more customer problems such as making product shipments easier.

Now let's contrast this with software company Oracle which has been highly successful in the past. Oracle basically handles data storage for a company, such as organizing all of the customer information a company collects. Even though they provide solutions to many of the problems businesses face they also make life hard on many of their customers by requiring them to invest a lot of time learning how to use their software. Oracle also makes it difficult for their customers to switch to another provider, and goes to great lengths to ensure any product outside its ecosystem is not compatible with its software. This often creates additional complexity for customers as it does not allow them to use the best solutions. We believe Oracle is losing its competitive advantage as the cloud has made it easier for new entrants to offer competing solutions which are easier to use.

Another question we ask to determine if a business is creating a competitive advantage is:

- Are the products or services good for the customers?

It never ceases to amaze me how many products and services are not good for customers even beyond the usual things that are not good for our health. We believe the reason for this is most leadership teams try to extract as much value as they can from a customer as they attempt to maximize shareholder value. Most are able to get away with this because they have limited competition or have some form of competitive advantage that dissuades others from entering the business. We view these as unsustainable advantages which will eventually erode as technology changes or new competitors enter the market with a better product offering.

We believe pet medical insurance provider Trupanion is offering a good product to its customers in an industry that has historically taken advantage of its customers. Trupanion’s competitors are divisions of traditional insurance companies that make their money by tightly controlling the medical emergencies they will cover for a pet. In other words, they are always placing their own self-interest ahead of the customer.

Trupanion instead has adopted a different business model whereby it aims to charge a certain markup on all of its products and then pass on any cost savings to its customers beyond this amount. This is very similar to Costco Stores which marks up all its products by 15 percent whether it is a diamond engagement ring or a box of cereal and passes on most of the cost savings to its members.

Trupanion also provides a lot of value to veterinarians because instead of following the typical insurance model of delaying payments for more than 60 days in order to extract as much value as they can, they pay for the cost of a visit within 30 days or the day they are invoiced if a veterinarian installs Trupanion’s software.

Because Trupanion provides so many benefits to both its customers and to the veterinarians, vets recommend this product to most of their customers. In fact, vets are the largest referral source of customers for Trupanion even though these vets do not receive any form of compensation. As a result of providing a great product, Trupanion’s revenues are increasing at a high rate and they are building a strong competitive advantage. Thank you again Josh Tarasoff for this wonderful idea!

Another question we ask is:

- Does the product or service create optionality for its customers?

Imagine a software coder that only knows one computer language and suddenly that language becomes obsolete. This software coder will have less value or no value in the job marketplace because he or she is not proficient in new software programming languages. Now let’s imagine another software coder who is familiar with lots of computer programming languages, including the newest ones. This person has lots of options when it comes to coding and as a result has more value in the job marketplace. The same holds true for a business. *The more optionality a business provides its customers, the more value the product or service will have for them.*

Arista Networks, a provider of switches and software that helps companies like Netflix push its movies out of its door to your TV screen, was founded because the leadership team wanted to provide more optionality to customers versus existing offerings. Arista does this by creating software that can be easily integrated with third-party software providers. On the other hand, its chief competitor Cisco prefers to limit its customers to software that it decides to allow within its ecosystem, usually earning a fee for this right. This makes the Arista platform extremely valuable to its customers because they are free to choose the best solutions and as a result Arista is taking market share away from Cisco at a rapid rate, continuing to build its competitive advantage.

Another question we ask to forecast business prospects is:

- What are the common patterns for the longest lasting businesses within an industry?

For example, in the oil and gas industry those producers who are able to generate the lowest cost per barrel of oil are the ones who tend to survive industry downturns and are also able to generate the highest profits when the price of oil rises. If you are looking to invest in an oil and gas firm (don’t worry we will not but I like the example) you would be best served identifying those with the lowest cost per barrel of oil because this would put the odds of discovering the best businesses in your favor and more important help you decrease your downside risk.

Recently, we have been researching the luxury goods industry because it is has been out of favor. As we narrow down which luxury companies we will spend time analyzing we are asking one simple question to select them:

- Which ones don’t discount their products?

At the most basic level, luxury goods manufacturers thrive on exclusivity. Luxury products are often used to signal to others that one has money and belongs in a higher echelon in society. If a luxury company starts discounting it becomes more difficult for their customers to signal to others. Is the consumer the one that bought the item at the discount mall or did they pay full price? You get the drift. Discounting always degrades the exclusivity of a luxury brand. For example, we were able to predict the decline at handbag maker Coach when we watched them first begin to discount their items. We knew they were violating the fundamental principle of a luxury brand – DON’T DISCOUNT! We are currently researching LVMH Moët Hennessy, Richemont (owner of Cartier), Hermès and clothing brand Brunello Cucinelli: all brands which have historically not discounted their products.

### Watch Decisions Being Made Today

One of the keys to successfully forecasting the future value of a business is not allowing *past* results to influence us. Whenever we are looking at the financial results of a company we recognize that these results were due to decisions that were made by the leadership team 1, 5 or even 10 years ago. Instead of focusing on current results, we need to carefully examine the decisions the leadership team is making today and simply ask:

- Will these decisions increase the value of the business or decrease it?

Our goal is to get a general sense of the *direction* of value, whether it is positive or negative instead of trying to quantify the *magnitude*. For example, we began to reduce our position in Whole Foods Market at a time when it was reporting positive same store sales growth and its rising stock price indicated the business was healthy. The reason was we witnessed the leadership team transition from making decisions focused on innovation (e.g., creating animal welfare standards or expanding a new organic product category) to instead making decisions to match the prices of their competitors. As the leadership drifted further away from innovation, we knew their decisions would create less value in the future and as a result reduced our position. Fast forward to today and same store sales are declining compared to prior quarters and co-CEO Walter Robb has stepped down from his position.

Founder John Mackey has returned as sole CEO of Whole Foods Market and we believe innovation will return. This is why we added to our position toward the end of the year. Welcome back fully engaged John!!!

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