INTRINSIC INVESTING
an Ensemble Capital publication

ENSEMBLE CAPITAL'S SUMMER 2019 INVESTMENT AND MARKET UPDATE

1 July 2019 | by Paul Perrino, CFA

Each quarter, Ensemble Capital hosts a conference call with investors to discuss the current market, economic conditions, and a few of our portfolio holdings.

This quarter's call will be held on Tuesday, July 9 at 1:00 pm (PST)

We'd love for you to join us on the call, which you can do by **REGISTERING HERE** or following the dial-in information below:

- Dial: 1-800-895-1549
- Conference ID: Ensemble

If you'd like to listen to our previously-held quarterly calls, an archive can be **FOUND HERE**.

While we do not accept public comments on this blog for compliance reasons, we encourage readers to **CONTACT US** *with their thoughts.*

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WEEKEND READING

29 June 2019 | by Mike Navone

A summary of this week's best articles. Follow us on Twitter (@INTRINSICINV*) for similar ongoing posts and shares.*

HOW THE PURSUIT OF LEISURE DRIVES INTERNET USE (The Economist)

Technology in cellular phones has come a long way in the past twenty years advancing from Nokia's popular snake game in the late 90's to today's phones equipped with live multiplayer capabilities. Internet connectivity and cellular phones have experienced extensive growth, particularly in emerging market countries like India, where subscriptions for mobile broadband services more than doubled between the end of 2016 and the end of 2018 from 218m to 500m.

The availability of internet offers an endless supply of information but many also choose to use their newfound connectivity to be entertained, to express themselves, and to stay connected to each other. This article examines the growth of cellular phones and internet connectivity and its relationship with a potentially increasing culture of leisure.

MASTERCARD ON FACEBOOK'S LIBRA CRYPTO PAYMENTS FUTURE (PYMTS, **@PYMNTS**, PYMTS)

Blockchain technology and cryptocurrencies have attracted speculators, skeptics, investors, and cybercriminals since its introduction into the market and now Facebook is entering the arena with their own payment solution, Libra. Global payments provider Mastercard is one of the founding members of the Libra Project and Jorn Lambert, Executive Vice President of Digital Solutions at Mastercard, was quoted on this topic saying "As you know, we've been looking at blockchain for quite a while, understanding the technology standards, doing pilots with banks and filing a number of patents. We absolutely think stablecoins will play a role in our future, that is [what] we have invested in over the years." This article explores Mastercard's vision of combining cryptocurrenty with a private governing body to create something stable and ubiquitous enough to be used for payments across the globe.

THE TRUTH ABOUT GROWTH AND VALUE STOCKS (Bin Jiang and Timothy Koller, **@KOLLER_TIM**, McKinsey & Company)

When evaluating investments it's rare that they present themselves as black or white. It takes deep analysis and research to truly find out what type of investment you're buying in to. This article discusses the all so commonly used "growth" vs. "value" terminology and how there's much more to consider aside from how the security is labeled. McKinsey conducted an analysis on growth vs. value companies and found that companies labeled as so called "growth stocks" don't actually grow appreciably faster than "value stocks" but that the two categories display widely different returns on invested capital. Ensemble Senior Analyst, Todd Wenning, CFA recently wrote about evaluating companies in his article **LOOKING FOR THE NEXT ROIC MACHINE**.

TWEETS, TRADE AND THE FED NOW HAVE MARKETS MOVING IN PACKS (Avantika Chilkoti, **@ACHILKOTI**, and Pat Minczeski, **@PAT_MINCZESKI**, The Wall Street Journal)

Constant updates about a US and China trade war, uncertainty in the Eurozone, and the Fed contemplating the direction of rates has the market behaving in a "risk-on, risk-off" mentality. This "phenomenon happens when markets essentially split into two broad buckets that move together: risk-off, or haven assets, which rally when investors grow skittish; and risk-on, or growth assets, which rally when risk appetite returns." This articles examines the positive correlation between information distribution and market sentiment within currencies, stocks, and bonds. Ensemble President and Chief Investment Officer, Sean Stannard-Stockton, CFA wrote about investing in this environment in his article **TRADE WARS & RECESSIONS: INVESTING UNDER CONDITIONS OF UNCERTAINTY.**

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ADVISORYHQ 13 BEST FINANCIAL ADVISORS IN SAN FRANCISCO, OAKLAND, & CORTE MADERA

27 June 2019 | by Mike Navone

Ensemble Capital is proud to announce that we have been selected as one of the "**13 BEST FINANCIAL ADVISORS IN SAN FRANCISCO, OAKLAND, & CORTE MADERA (BAY AREA)**" by AdvisoryHQ. The list recognizes the top financial planning and wealth management firms in San Francisco and across the Bay Area. This is the fourth annual AdvisoryHQ recognition list in this category and this is the fourth consecutive year that Ensemble Capital has been selected to receive this award.

The list features an exclusive group of high quality companies who were selected following a rigorous review going beyond just analyzing assets under management, revenue, and the size of the advisory firm. The review and ranking is 100% independently researched and written. AdvisoryHQ is headquartered in California and is a global news media and publishing institution that provides independent reviews of top firms across different industries and sectors.

You can find a link to the Press Release **HERE**.

AdvisoryHQ has ranked Ensemble Capital one of the Top Financial Advisors in San Francisco in 2016 – 2019. AdvisoryHQ uses a multi-step selection methodology for identifying, researching, and generating its list of top ranked firms. More about their ranking methodology can be found **HERE**. *This award does not evaluate client experience and is not indicative of the practice's future performance. Ensemble Capital did not pay a fee to AdvisoryHQ for inclusion in*

their ranking.

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MOAT EROSION STARTS BEHIND THE CASTLE WALLS

17 June 2019 | by Todd Wenning, CFA

> *A great civilization is not conquered from without until it has destroyed itself*

from within. – Ariel Durant

Traditional competitive analysis focuses on external threats.

The most famous framework, Porter’s Five Forces, for example, looks at:

- Competitive rivalry
- Supplier power
- Buyer power
- Threat of substitution
- Threat of new entry

All of these factors analyze what’s going on outside the company and how the company fits in its competitive ecosystem.

Even the concept of an “economic moat” suggests that companies should be fortifying themselves against threats from without.

Expectations

Of course evaluating external threats is critical, but we believe that **MOAT EROSION** typically begins *behind* castle walls.

Only after the company loses customer focus, gets lazy, or gets weighed down by bureaucracy, do competitors have a chance to destroy the incumbent's moat.

In **THE FOUNDER'S MENTALITY**, Bain & Co.'s Chris Zook and James Allen write that corporate stagnation is "An internal problem caused by growth. Ninety-four percent of large-company executives cite internal dysfunction as their key barrier to continued profitable growth…As companies grow in size and complexity, they lose the dexterity and the flexibility they need to sustain growth."

To illustrate, the common perception of Kodak's downfall is that the company was slow to react as competitors launched the digital photography revolution. This is partially true. In fact, **KODAK PATENTED THE FIRST DIGITAL CAMERA** in 1978. Kodak just refused to market it, lest digital sales ate away at their high-margin film sales. Kodak's moat erosion started from within.

To be sure, understanding internal dynamics is challenging for outside investors. (Perhaps that's the reason researchers focus on more observable and measurable external dynamics.) Even boards can fail to recognize internal problems, which is why activist investors have a place in the market.

Yet we think it's essential to get a big picture view of a company's values, mission, and work environment. This matters for both "defensive" and

mission, and work environment. This matters for both "defensive" and "offensive" reasons.

On the defensive side, we want to own companies we believe will maintain (and ideally widen) their **ECONOMIC MOAT** for the next decade and beyond. If we believe the company is **CULTURALLY AGILE**, run by **EXEMPLARY STEWARDS OF CAPITAL**, and cares for all its stakeholders, then we'll be more confident it can keep competition at bay. However, if one of our companies is rotting from the inside, we want to get out as soon as possible.

As for offense, we like passionate companies that are sieging a castle that's crumbling from the inside.

Reality

In 2016, for example, we concluded that Time Warner favored **PROTECTING ITS DIVIDEND** over competing with Netflix on streaming. As such, we exited our position in Time Warner. We had been following Netflix closely, but had not built enough conviction in the strength of their moat to invest in the company. With Time Warner having trouble behind its castle walls, our conviction in Netflix's ability to attack the profit stream of linear TV increased and we established our initial investment in the company.

Shortly afterwards, Time Warner threw in the towel and sold themselves to AT&T. Here's what Sean wrote in an **OCTOBER 2016 POST** after Time Warner agreed to be acquired by AT&T.

While Time Warner has put resources behind HBO NOW and it has had some success in building a direct distribution business, the management team has seemed to believe that it is more important to protect their legacy business and their $1.3 billion annual dividend rather than invest aggressively in preparing their business for the transition to streaming.

By selling to AT&T, Time Warner is waving the white flag and admitting that Netflix has become HBO before the company could become Netflix. Therefore, their best option is to sell to a distributor like AT&T, which itself needs content to compete effectively against Netflix and other streaming platforms.

It's behaviorally difficult for incumbents to innovate when it puts their cash cow at risk. While these companies are protecting their own interests, they are often doing so at the expense of their customers who want or need innovation.

As Professor Thales Teixeira writes in a recent **HARVARD BUSINESS REVIEW** article:

Disruption is a customer-driven phenomenon. New technologies come and go. The ones that stick around are those the consumers choose to adopt. Many of the fast-growing startups such as Uber, Airbnb, Slack, Pinterest, and Lyft don't have access to more or better innovative technologies than the incumbents in their respective industries. What they do have is an ability to build and deliver faster and more accurately exactly what customers want. This is causing the change-of-hands of sizable amounts of market share is relatively short periods of time.

And while Warren Buffett coined the phrase economic moat and painted the picture of companies fortifying themselves in the midst of unbridled competition, he made clear in his **2005 SHAREHOLDER LETTER** that what goes on behind the castle walls is what makes or breaks a moat.

Every day, in countless ways, the competitive position of each of our businesses

grows either weaker or stronger. If we are delighting customers, eliminating unnecessary costs and improving our products and services, we gain strength. But if we treat customers with indifference or tolerate bloat, our businesses will wither. On a daily basis, the effects of our actions are imperceptible; cumulatively, though, their consequences are enormous. When our long-term competitive position improves as a result of these almost unnoticeable actions, we describe the phenomenon as "widening the moat." And doing that is essential if we are to have the kind of business we want a decade or two from now.

It's when companies take THEIR FOCUS OFF THE CUSTOMER, mission, and operational execution that challengers get an opportunity. And in today's hyper-competitive world, it's more important than ever that companies are internally strong and ready for a fight.

The better we can identify internal strengths and weaknesses in the companies we research – and their competitors – the better we believe we can play smarter defense and offense in the portfolio.

As of the date of this blog post, clients invested in Ensemble Capital Management's core equity strategy own shares of Netflix. This company represents only a percentage of the full strategy. As a result of client-specific circumstances, individual clients may hold positions that are not part of Ensemble Capital's core equity strategy. Ensemble is a fully discretionary advisor and may exit a portfolio position at any time without notice, in its own discretion.

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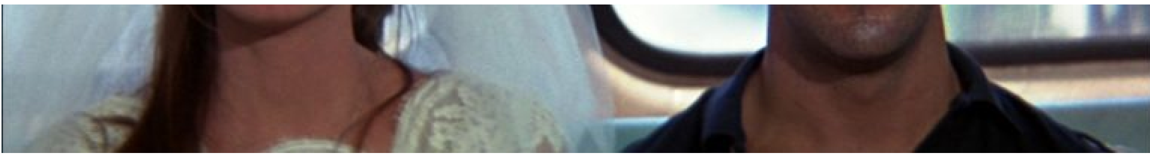
GOING FROM RULE BREAKER TO RULE MAKER

12 June 2019 | by Todd Wenning, CFA

The last scene of the 1967 movie *The Graduate* is one of the most iconic in film history. Benjamin, played by Dustin Hoffman, rushes into the church where his beloved Elaine, played by Katharine Ross, has just been married. He bangs on the glass overlooking the altar, yelling "Elaine!" until she decides to rebel against her family and rush out of the church with Benjamin.



Laughing all the way, Benjamin and Elaine chase down a city bus and take a seat in the back. The movie ends as Benjamin and Elaine's faces slowly turn from joyous to contemplative. The adrenaline rush has faded. The rebellion is over. Reality has set in.

Now what?

Starbucks faced a similarly sobering moment in early 2007.

In his 1997 book, ***POUR YOUR HEART INTO IT***, Starbucks founder Howard Schultz wrote:

"What we proposed to do at Il Giornale (Schultz's company that acquired Starbucks Coffee Company in 1987)…was to reinvent a commodity. We would take something old and tired and common – coffee – and weave a sense of romance and community around it. We would rediscover the mystique and charm that had swirled around coffee throughout the centuries. We would enchant customers with an atmosphere of sophistication and style and knowledge."

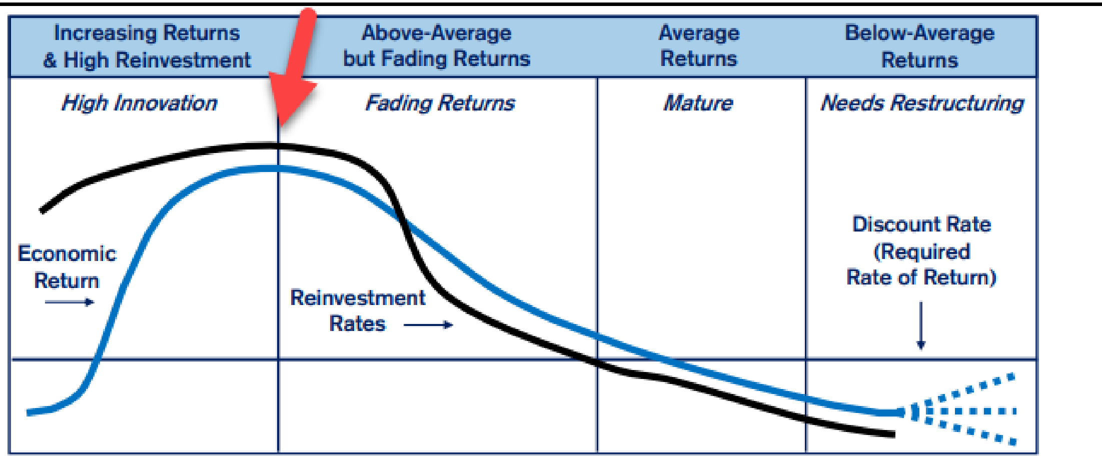
In the 1980s, this mission would have sounded far-fetched and naïve, but Starbucks delivered. From 1997 to 2007, it grew from fewer than 1,000 stores to 13,000 – a pace of about 3.3 new stores per day, on average.

But by February 2007, trouble was brewing at Starbucks. So much so that now-chairman Howard Schultz wrote the following **IN A MEMO** to CEO Jim Donald:

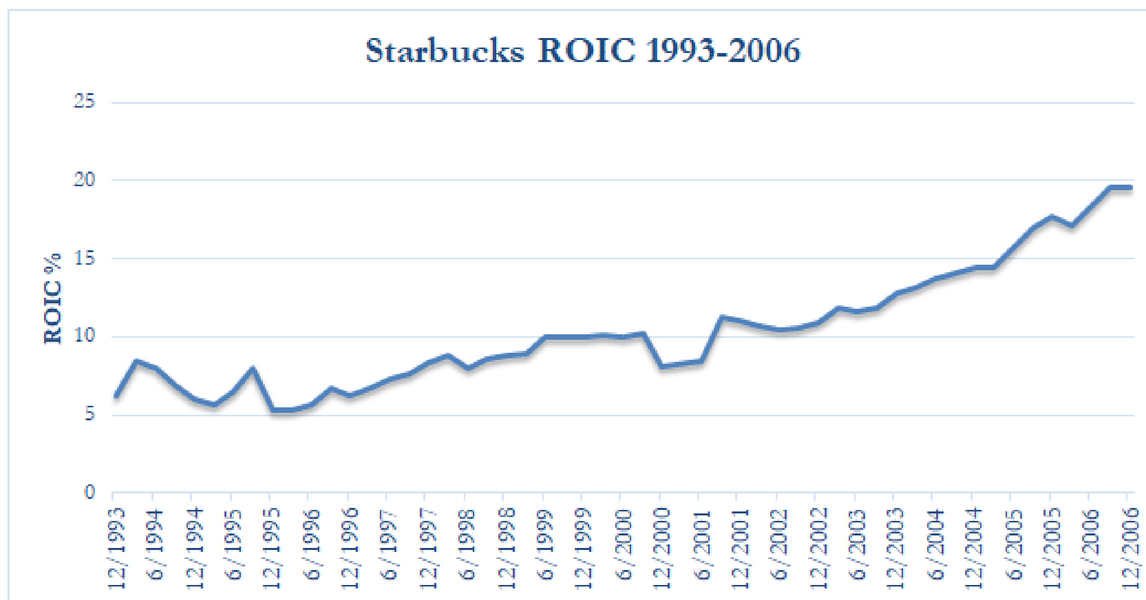
"We have had to make a series of decisions that, in retrospect, have lead (sic) to the watering down of the Starbucks experience, and, what some might call the commoditization of our brand…Some people even call our stores sterile, cookie cutter, no longer reflecting the passion our partners feel about our coffee…Let's be smarter about how we are spending our time, money, and resources. Let's get back to the core. Push for innovation and do the things necessary to once again

differentiate Starbucks from all others."

Starbucks was at a turning point. It was probably right about here in terms of its competitive life cycle.



If something didn't change, Starbucks' returns on invested capital (ROIC) would start to fade toward its cost of capital – and rather quickly.



Source: Bloomberg

As Motley Fool co-founders Tom and David Gardner wrote in their 1999 book, ***RULE BREAKERS, RULE MAKERS***, "Business is as simple as changing the rules at the beginning and then making the rules at the end."

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By any measure, Starbucks in 2007 had changed the rules. It had reinvented a commodity and redefined coffee culture in the U.S.

But then what?

Starbucks was now making the rules. And being a rule maker is a totally different game – culturally, competitively, and operationally – from being a rule breaker. Now you've got upstarts aiming to disrupt your business. Now you've got a castle and moat to protect.

And it's in the rule maker stage where companies can slip into complacency. Margins are fat, cash flow is copious, and everyone at the company is doing well financially. Even a little rest, a moment to smell the roses, can be enough to open the door to new competitors in today's market.

This is what Jeff Bezos was talking about in his 2016 **LETTER TO AMAZON SHAREHOLDERS**

when he emphasized the importance of it remaining “Day 1” at Amazon:

“’Day 2 is stasis. Followed by irrelevance. Followed by excruciating, painful decline. Followed by death. And that is why it is always Day 1.’ To be sure, this kind of decline would happen in extreme slow motion. An established company might harvest Day 2 for decades, but the final result would still come.”

Despite this clear risk, it’s also in the rule maker stage that ROIC MACHINES shine. The market justifiably bets that at most firms, bureaucracy and complexity will creep in and push ROIC toward cost of capital.

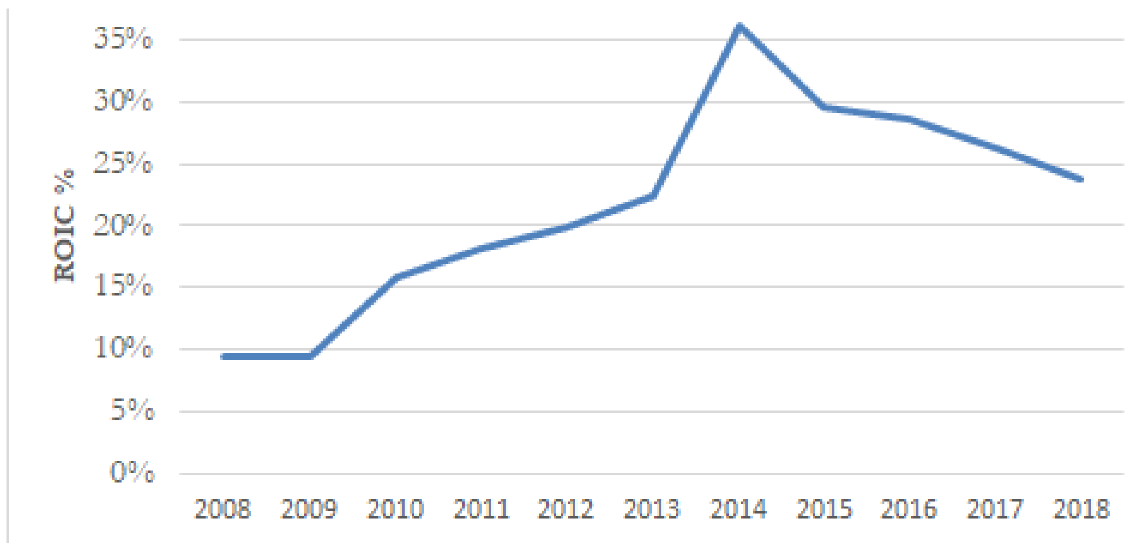
Exceptional companies – the kind we want to own – recognize the long-term threat of bloat and bureaucracy and continue to innovate and disrupt themselves. This helps them maintain (and ideally strengthen) their competitive advantages and fight against ROIC fade.

From an investment standpoint, this transition from rule breaker to rule maker should not be taken lightly. Most companies will struggle with it, so we need to be attentive.

In fact, we think two of our holdings – Google and Netflix – are working through this stage right now. Both are in a “Now what?” phase. Some of Google’s recent and WELL-PUBLICIZED INTERNAL DISCORD is evidence to us that the company is in a soul-seeking moment. And Netflix, long the REBEL IN THE MEDIA INDUSTRY, is now the standard by which all streaming services measure themselves.

We know with the benefit of hindsight that Starbucks turned out to be just fine. Howard Schultz returned as CEO in 2008 and reinvigorated the business. While the outcome was far from assured, Starbucks was culturally agile, innovative, and growth minded. ROICs not just stabilized from 2006 levels, but dramatically improved.

Starbucks Adj. ROIC 2008-2018



Source: Company filings and Ensemble Capital estimates

Like Starbucks, Google and Netflix have strong corporate cultures, have proven to be innovative, and haven't settled for their current market position. We believe the combination of these factors increases the odds that both companies can fight through the rule breaker to rule maker transition and deliver attractive long-term performance.

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