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Investment Strategy

"When Smart People Talk, We Listen"

We don't know how long ago we met Frederick "Shad" Rowe, but we are glad we did, because our conversations with him have been net worth changing. Recall that Shad is the founder, and portfolio manager, of the Dallas-based Greenbrier Partners Capital Management and one of the smartest guys on Wall Street. We first heard of him while reading Forbes Magazine in the 1970s where he was a regular contributor. We still have many of the articles from back then and have often used quotes from those articles in these missives. Last week, we read his monthly letter, which we think is consistently brilliant; indeed, when smart people talk (write) we listen. In this month's letter Shad wrote:

> It strikes me that the once passionate investment debate of content versus distribution has now become irrelevant. The creation of content has exploded (and shows no sign of slowing), the number of distribution channels continues to grow, and the costs to create and distribute content have decreased dramatically. As a result, the balance of power has completely flipped. The new king is the consumer – long live the king. Previously consumers had little choice; now options are unlimited as their expectations continue to rise. Thanks to technology, people can consume whatever content they want, whenever they want, wherever they want, and however they want. In addition, the very definition of content has changed – consumers themselves are now the world's most prolific content creators thanks to YouTube, Facebook, Instagram, Twitter, Snapchat, etc.
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> As a result, the lines between content creators and distributors continue to blur. A number of today's most successful companies have the ability to create, purchase, and distribute content themselves. Moreover, these companies have built platforms that billions of consumers love and use every day – this is what matters and is why we believe in the concept of "digital real estate", a key tenet of Greenbrier's investment philosophy. As a reminder, here is the theory: The applications on the home screen of your smartphone have become the most valuable real estate in the world. The value of these platforms is based on unprecedented scale, customer loyalty, and profitability. [Note: eight out of the top ten most popular iPhone applications are properties of Greenbrier companies, which does not include Apple's own preinstalled applications.]
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> These developments have clearly democratized the creation and distribution of content for billions of people, which is positive (for the most part). But, the unlimited choice is overwhelming for most people – there are not enough eyeballs or hours in the day to discover even a fraction of what is currently available. Consumers may look for new things, but typically spend most of their time on the few dominant platforms, which is why it will be so difficult to displace them. As a result, we expect these platforms will continue to capture the majority of user time and attention, which makes this 'real estate' so desirable.

Shortly after reading Shad's letter, we received an email from one of our financial advisors (FAs), which more or less said that, arguably the smartest guy on the Street of Dreams, Oakmark's Bill Nygren, is saying exactly what we have been saying for years. The FA's email to us read:

> I wanted to follow up and let you know that Bill Nygren, the Portfolio Manager for Oakmark Fund and Oakmark Select presented at our sales conference last week and had some great points about how to value companies in the world we live in today, and why the Morningstar style box can be misleading. Since we do get questions about how he might own a stock like Netflix or Alphabet in a value portfolio, I thought this might help.
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> In 1975, 83% of assets on the balance sheet for the average S&P500 company were tangible, today only 13% of the assets are tangible.
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> In the days of Benjamin Graham, defining value was much more straightforward and easy to categorize. Low price to book value was an accurate picture of value, because most companies were "asset heavy".
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> Example: a company buys a machine to manufacture a good, this expense is amortized over the expected life of the machine, and therefore the entire expense does not impact the balance sheet all at once, immediately. Future value creation is accounted for. Today, when a company spends money on something like R&D to develop new products,

> that expense hits the balance sheet immediately, all at once, even though the return on that investment may carry on for 10 years. This affects ratios like P/E and P/B immediately with a large up front expense, making "asset light" companies look more expensive using existing GAAP accounting methods.
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> Example: If a company like Netflix spends on advertising—that expense is added to the balance sheet immediately, even if the average expected subscriber is a customer for 10 years. Oakmark would adjust that advertising cost over of the expected life of the customer, which would lead to a lower P/E or price to book.
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> With existing GAAP accounting, cost of acquiring a customer is expensed up front, immediately, even if the customer lasts a lifetime. In 1975 there was a 71% correlation between the stock price and tangible book value for S&P500 companies, today there is only a 14% correlation, though low price to book is still used to define value stocks in indexes like Russell and by Morningstar, etc. Overall, value investing is the same today as it was over 80 years ago. Investors follow fads, get emotional and over-react; this creates a gap between price intrinsic value, creating a margin of safety and the opportunity to make money.

We have discussed "intangible capital" for over a decade, suggesting companies that are accruing intangible capital at a faster rate than other companies would likely be good investments. The two best organizations that we know that invest this way are GaveKal (Louis Gave) and Knowledge Leaders Capital, whose mutual funds are managed by my friend Steve Vannelli.

As for us, the S&P 500 (SPX/2840.35) is back within "spitting distance" of new all-time highs, a view we have embraced since our "bottom call" at the February 9, 2018 "undercut low." Since then, the SPX has gained 12.2% and, in the process, left the "market crash" predictors and the "range bound" crowd in the rearview mirror with many individual stocks gaining 20%+ over that timeframe! As for our models, they are recharged with a full load of "internal energy", suggesting the potential for an attempt at new all-time highs this week. If past is prelude, however, such action usually fails on the first attempt to make new highs. Nevertheless, that is our "call."

The call for this week: In recent missives, we have written about the rotation that has been occurring in the equity markets over the past few weeks. In their weekend strategy letter, the astute Lowry's Research organization writes:

> Information Technology and Consumer Cyclicals were the two most consistent market leaders during the first half of 2018. Over the past month, however, apparent profit-taking has caused both Sectors to underperform the S&P 500. Rather than moving to cash, though, investors appear to have reinvested their profits into other Sectors such as Consumer Non-cyclicals, Industrials and Financials. Sector rotation such as this is typically associated with a healthy bull market. A similar rotation appears to be occurring away from the Small Cap market segment into what had been a laggard Large Cap segment. The overall result of this rotation among market Sectors and Segments was another new all-time high in Lowry's Operating Companies Only (OCO) Unweighted NY Price Index on July 26th 2018.

Manifestly, we agree with the good folks at Lowry's, leaving our call for new all-time highs this week intact.

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