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Active Managers Can't Jump (so Invest with the Seven-Footers)

In streetball parlance, active managers have thrown up enough bricks to host a masons' convention. Marking the worst relative quarter since 1998, less than one-in-five large cap managers, and only 6% of large cap growth managers, outperformed the S&P 500® Index in the first quarter of 2016. We don't put much weight on just three months of performance data but, despite what Mark Twain writes, statistics don't lie: fewer than one-quarter of managers outperform their benchmarks over the long-term. With such disappointing outcomes, the economic value of our profession will remain in question and cheap beta will look relatively attractive.

While it is a fact that the average investment manager doesn't outperform (just as the average person can't dunk), does there exist an identifiable subset of skilled investors (or basketball players) that can beat the averages? In basketball, the answer is easy. A group of seven-footers will obviously enjoy a higher propensity to dunk than the general population.

But where are the equivalent of seven-footers in active management? Martijn Cremers and Ankur Pareek answered that question in their study "Patient Capital Outperformance: The Investment Skill of Active Managers Who Trade Infrequently."[1] According to their research, the necessary conditions for outperformance require both high-conviction, as measured by holdings that differ substantially from the benchmark, and patience, as defined by portfolio turnover. The professors found that institutional managers holding both characteristics outperformed in general by more than 2% annually, before fees.

Managers possessing either trait, let alone both simultaneously, are rare. Over the last three decades, average active share, the percentage of holdings that differ from the benchmark, has shrunk to 60% from 75% in 1980. In other words, we have become a profession of largely "benchmark huggers." Turnover, an inverse measure of patience, has increased even more dramatically with the average holding period dropping from five years in the 1970's to under twelve months today. Such short time horizons lie more in the realm of *speculation* than *investing*.

But merely sitting for years on a portfolio of low-quality, overvalued stocks that aren't in the benchmark won't lead to good outcomes. We would dovetail Cremers and Pareek's study with other research suggesting preservation of capital-focused, value-based, and owner-oriented investment strategies as other key attributes of durable value-creating managers. One may recognize the shared values with Warren Buffett's mythical intellectual village, Graham-and-Doddsville. He had it nailed thirty years ago.

By design and disposition, Mar Vista's strategies align with these characteristics and, over a full investment cycle, the outcomes. We manage a decidedly high-conviction and patient strategy with 85%+ active share and an average turnover of ~35-40%, while our holding period for a business averages five years. In the face of continued challenges for active managers, Mar Vista has built, we believe, resilient analytical and behavioral advantages common amongst *active managers that can jump*…just don't expect us to dunk a basketball.

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[1] Cremers, Martijn and Ankur Pareek. "Patient Capital Outperformance: The Investment Skill of Active Managers Who Trade Infrequently." September 2014.

A Dream Team of Capital Allocators

"After ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business."

-- *Warren Buffett, 1987 Shareholder Letter*

As Buffett's quote implies, the higher a business' returns on capital and the longer one's investment horizon, the more management's capital deployment strategies will influence *per share intrinsic value growth*. Accordingly, Mar Vista's investment team spends an inordinate amount of time assessing and debating the capital allocation skills of, and opportunities for, our companies' management. Protecting, widening and extending the duration of competitive advantages via skillful capital allocation, and possessing the "capacity to suffer" to the benefit of long-term returns, are simply among the most important skills we look for in management. As we have discussed in prior letters on *Outsider*-type[2] management teams, our CEOs adroitly steer at the helm of advantaged business models.

For example, *Mettler-Toledo*'s deeply ingrained shareholder-focused culture and competitive advantages (economies of scale, intellectual property, switching costs) manifest themselves in clearly superior financial results. While earnings per share have grown more than five-fold since 2004, only 44% more capital is invested in the business. As a result, returns on capital have expanded from 13% to 32% during that time period. Using Buffett's framework, under CEO Olivier Filliol's leadership since 2008, Mettler has generated $1.9 billion in excess capital or 65% of the total capital invested. Nearly all the capital was redeployed towards repurchasing undervalued stock (shares outstanding are down by more than 20%) driving sustainable mid-teens per share intrinsic value growth.

While in a completely different industry, *Intuit*'s financial model is similar to Mettler's. Software platforms in tax (TurboTax) and small business accounting (QuickBooks) require minimal capital creating a powerful engine that has provided $7.5b of cash since 2008. CEO Brad Smith has returned 85% of the excess capital to shareholders via repurchases and dividends helping to drive mid-teens per share intrinsic value growth.

TransDigm's capital deployment strategy is decidedly different from Mettler and Intuit's, but even more effective. An aggressive series of moat-expanding and value-creating tuck-in acquisitions has built TransDigm into an aerospace giant. During CEO Nicholas Howley's ten-year tenure, the capital base has increased four-fold as operating profits have expanded seven-fold lifting returns on capital from 7% to over 13%. TransDigm's formula for success: rapidly expanding excess capital generation + high incremental returns on reinvested capital = high-teens compounding of intrinsic value.

Following Berkshire Hathaway's well-designed blueprint, *Markel* has built a unique compounding machine that combines intelligent underwriting of risk with disciplined investing. This tax-efficient, levered investment vehicle benefits from the power of permanent and negative-cost capital (i.e., insurance float) and the talents of a capable and honest management team that reinvests all the excess capital back into investment portfolio. Tom Gayner, Co-CEO, and Steve Markel, Vice Chairman, have developed a long track record of prudent underwriting and tremendous investment returns. The public equity portion of Markel's investment portfolio has outperformed the S&P 500® Index by 2% per year for the last twenty years. As a result, book value has compounded at a 20% rate since 1986. Despite a more challenging insurance and interest rate environment, we think Markel can grow per share intrinsic value at 10-15% annualized rates over the next decade.

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[2] Thorndike, William. *The Outsiders: Eight Unconventional CEOs and Their Radical Blueprint for Success*. Boston, Harvard Business Review Press, 2012

Mar Vista's Commitment to Our Investors

Though there are never guarantees in investing results, the Mar Vista team remains committed to the foundations of our success:

- Focus on the process, not the outcomes
- Emphasize capital protection as much as upside potential
- Think like rational business analysts first, not traders of individual stocks
- Identify good capital allocators that think and act like *Outsiders*
- Exploit the manic-depressive nature of Wall Street
- Take concentrated positions when the expected returns relative to the risks are favorable
- Expand our circle of competence and latticework of mental models
- Align our economic incentives with our investors

As always, we appreciate the trust you have instilled in us as stewards of your capital. Our role as fiduciary is paramount to everything we do and open communication about how we are managing your capital is an important part of that responsibility.

Please let us know of any questions, comments or concerns you have. We look forward to the opportunity to discuss our investment philosophy and thoughts with you through these updates, conference calls and personal meetings. You can reach us by phone at 310.917.2800, via email at info@marvistainvestments.com or visit our website at www.marvistainvestments.com.

All the best,
The Mar Vista Investment Team