Some things and ideas: February 2018

Some internet links and ideas I've liked or found interesting in the past month

- **Bill Nygren (Oakmark) Interview transcript**
  - I loved this interview.
  - The line that really stuck out to me (and which modest proposal highlighted) is how twenty years ago you could simply buy low P/E stocks, but today the cheap stocks generally deserve to be cheap and the really interesting ideas today are ideas where P/E ratio misses the story.
  - The idea here is a more elegant way of framing the idea I mentioned in my annual letter- finding value in things that computers / quant models can't pick up.
  - When I think about this line, I can't help but think of "value investors" who've been short Netflix and Amazon for years. Most people who've shorted them have done so on the "they are great but they look expensive" thesis. I think that's a failure to evolve mental models over time. Sure, both have always looked expensive, but if you were shorting them because they were a bit expensive you were really missing the forest for the trees. Kudos to Nygren for overcoming that bias.
  - Along these lines: I (and I would guess most of my readers) belong to the cult of Malone, but I think it's constantly underrated just how good of an investor Malone is / how early he was to recognize and adapt to new investing ideas. Remember, Malone got his start as a cable operator. But he expanded his fortune by going into cable channels and then continuing to expand into satellite radio, live

event companies, sports leagues, and even online category killers (Lending Tree and TripAdvisor, though the later has been a… disappointment recently). At the core of all of these investments was Malone identifying businesses that scaled up well; if he had limited himself to just cable monopolies he would not be an investing cult hero (note: this discussion could apply well to Barry Diller as well).

- **Market Valuation**
  - Thanks for all of the insightful replies to my annual letter excerpt on market valuations.
  - A few people pointed to the "fight the fed model" paper as a rebuttal. I simply disagree with that paper. If the risk free rate is 1% and companies can borrow almost infinite amounts of money at 3% pre-tax, there is no way equities can trade at an after-tax earnings yield of 6.67% (a P/E of 15x). Activists and Private Equity firms would have a field day with that arbitrage / financial engineering.
- **Fairholme / Sears**
  - Fairholme's 2017 annual letter came out, and it's a bit crazy to me that Fairholme shareholders get a one paragraph explanation after a decade long windmill tilt of realizing Sears' value. As recently as 2015 Fairholme was arguing Sears was worth ~$150/share!
  - It's really interesting to reread some old Sears' old annual letters (Here's their 2009 letter which is particularly on my mind, but all are interesting)and financials (here's their 2010 10-k and 2009 earnings release).
  - Today it's easy to mock people who invested in Sears, but in hindsight I'm surprised more people / value investors weren't heavily invested in it. You have two (at the time?) great investors in

Berko / Lampert with huge positions in it, you have significant asset protection on the downside from the real estate, the core business is profitable / spitting off cash / poised for a cyclical upswing as you recover from the recession, and one of the decades greatest investors is in charge of capital allocation (leading some to say it's the next Berkshire Hathaway). If you presented me with the combo of those facts today I'd probably be drooling.

- Of course I say "I'm surprised more people weren't heavily invested in" Sears, but Ackman's investment in JCP and Starboard in Macy's (among others) all had heavy echos to Lampert / Sears, so maybe investors were burnt by the same investment thesis but just chose to do it through different companies / structures. If you're looking to build a reputation, it's probably better to drive the change yourself (i.e. Ackman choosing JCP's CEO and driving that change) versus just piggybacking Lampert / Sears… of course, from a reputation point it would have been best to completely avoid all of those retailers in hindsight!
- Rereading the letters, in a lot of ways it seems like Lampert saw the future of retail pretty clearly. His first letter talks about learning from customers / taking advantage of information to shape offerings (big data?) and creating a flatter organization (Amazon's 2 pizza teams?). Another 2005 letter talks about being a customer focused company (Amazon is customer centric and loved for it). In 2009 the company is focused on express checkout, launching private label brands, mobile apps, and launching an online marketplace. This all seems obvious in hindsight, but I believe it was well ahead of its time; I just reread Walmart's fiscal 2009 and fiscal 2010 annual

reports and while they're starting to talk about online as a growth engine, they are much less focused on it / not laying out the clear vision of it that Lampert does.

- Again, with hindsight it's almost surprising that Sears didn't work out. They had a huge asset base, a great capital allocator, and someone who had a decently clear vision of where the world was going. The big issue to me was management. I think this NYT article hits the nail on the head on what went wrong- Lampert chose to manage Sears / KMart, and getting involved instead of hiring good managers who could execute his vision killed the company. Was it ego ("he seemed to think he was smarter than anyone in the retail business") after years of success? The need for a new challenge? Who knows, but with the benefit of hindsight I think more than anything what ruined Sears was a controlling shareholder who got too involved and couldn't be removed when it was clear someone else needed to take the reins.
- I see a lot of similarities to Valeant in the Sears story. For example, both openly mock competitors spending and capital allocation decisions.
    - Lampert is obsessed with cutting costs and chides the industry for "wasteful" capex spend to open new stores instead of repurchasing shares.
    - Valeant for years mocked the pharma industry for being too fat and investing in unprofitable R&D.
- Speaking of the benefit of hindsight, it's funny to reread Lampert's 2005 annual letter, which highlights Jack Welch's transformation of GE and how Jeff Immelt is continuing the same tradition. In 2005 those three (Lampert, Welch, Immelt) were

worshipped; today, not so much.

  - Last thing on Sears: It is legitimately crazy how many of these blow ups Buffett / Munger have called. Buffett predicted Sears wouldn't work. Both Buffett and Munger predicted Valeant. The two are next level; people who mock them for their calls on Bitcoin should take note.
  - Turning back to Fairholme's letter (which is how this very long section started), it's tough for the 23% position in Fannie / Freddie Prefs not to catch your eye. I haven't followed the situation very closely, but my general understanding is they're suing the government and will make multiples of their money if they win but take a zero if they lose. That is a HUGE position for such a binary outcome where one of the outcomes is a zero. The future will be interesting: if they win the lawsuit, the fund will be almost certainly be the best performing fund this year and we'll see "he's back!" articles on Berko, while if they lose the fund is effectively over. I wonder if having such a big position in such a binary outcome is a sign of actual conviction or someone making one last desperate bet with skewed personal risk / reward for the manager ("if this pays off I'm back in the game, and if it doesn't I was done for anyway").
    - Given that position sizing, I'm betting the Fairholme directors were breathing a sigh of relief when they saw the Sequoia / Valeant suit was dismissed, though I wouldn't be surprised if there were still lawsuits for everyone involved if the Fannie suit fails.
    - **Update (I wrote the above in early Feb)**- Yikes. Not looking good for that bet.
- **Netflix Q4 earnings**:
  - Speaking of Netflix / turning back to the Oakmark

transcript: NFLXreported blowout Q4 earnings and the stock's been a rocket ship.

- I love Nygren's way of looking at Netflix (the company looks cheap because they only charge $10/month and have huge pricing power). I mentioned this before, but Netflix currently costs less than $15/month. Time spent streaming per Netflix sub is up ~10% YoY; people are basically putting all of their free time into streaming Netflix. People used to pay $70-$100/month for cable TV that included advertisements and they spent less time watching that $100 package than they do Netflix today for <$15/month. The untapped pricing power of Netflix is unbelievable.
- Netflix earnings / stock performance got me thinking- if you just followed the strategy of buying something when the company's core offering becomes a verb (i.e. when someone will tell you to Google something when they mean to look it up, or to come over and "Netflix and Chill" when they mean they want to….), how would you have performed? My gut tells me pretty well- buying something that becomes a verb generally means you've invested in a "category killer" with huge market share. This is just off the top of my head, but the only four recent examples of companies becoming verbs are Google, TiVo, Tinder, and Netflix. If you had invested in them (you'd need to invest in Tinder through Match, which (disclosure) I'm long through IAC) you went three for four, and the three were mammoth homeruns. Maybe that's just recency bias (though historical examples like Xerox or Fedex would have done well) or I'm just forgetting a ton of recent examples, but it's certainly interesting mental model for the future (when something has become a verb, it's hitting critical scale / consider buying). This

really isn't a super original thought but tough not to think about it / refine it given how much easier it's becoming to scale something.

    - The other companies that pop in mind here are Mace and Taser, which are actually brands but the only things that pop to mind when people talk about pepper spray / electroshock weapons. Both are public (taser is part of AAXN; Mace is part of MACE)- I haven't really looked at either but Taser appears to have done alright while MACE has done poorly. I don't think these (or maybe even TiVo) fit my definition though- I'm looking for something that becomes a verb for when you do something (i.e. when I search for something online I Google it); not a name that replaces the noun as shorthand (i.e. when I say Mace I simply mean pepper spray).

- **Microcap activism**
  - A strange trend I've seen a little of recently- small caps / microcaps going activist on other microcaps in unrelated fields. I get why it's happening (activists get on a board and then push for that company to get involved in other activist investments so they can leverage their capital), but it's pretty weird and a questionable use of corporate resources.
  - For example, Digirad (DRAD), a healthcare imaging company, is part of a group going activist on Aviragen (AVIR), a pretty speculative pharma company. I think their activist case makes sense, but Digirad's business isn't exactly firing on all cylinders. Just strange that they'd take the distraction of an activist case on, even if their participation / investment is small. Activism is hard and time consuming; if a company is going to

get involved in activism (even at a small scale or through a small investment), are they really looking to maximize value for all shareholders or simply to curry favor with a key / large investor?

- **Update**- I wrote the above in late January / early Feb. It looks like the DRAD group won and got Aviragen to recut their merger deal with a more favorable stock ratio. Good for them, but I still wonder if this type of activism is really a good use of the company's time / resources.

- **Sears' Same Store Sales (SSS)**
  - Forgot to mention this in last month's blog (and somewhat related to the big Sears discussion up top), but Sears' (SHLD) financial update was a beauty. A SSS of down 16-17% is incredible on its own, but I think even more incredible is an adjusted SSS number of down 14-15%. Companies generally aren't shy about making crazy add backs and adjustments to make awful SSS look less awful on an adjusted basis (A few years ago I got obsessed with Cosi giving SSS adjusted for the Pope's visit), so the fact that Sears couldn't figure out an adjustment that would get them to better than negative ~15% speaks volumes to their business.
- **Sports betting**
  - One of the core tenants of this site is simple: I can't let a month go by without talking about how bullish I am on the publicly traded sports teams / sports franchises in general.
  - One of the things that makes me most bullish is the potential for sports betting to get legalized.
  - It's not just that sports betting will bring in massive new revenues (I'll discuss that in a second); it's that sports betting dramatically increases fan engagement. Consider how you feel

watching a game where your star fantasy football running back plays to a game when you have nothing on the line.
  - That said, the revenue potential here is huge. Advertising revenues would explode as casinos / sports books look to reach fans. Plus, sports leagues would likely get a cut of every bet- the NBA testified in New York and a few other markets that they want 1% of every bet made on their games. The "cut" leagues get will probably vary (one plan a few years ago called for 0.25% to go to the leagues), and there will be some added expenses to ensure game "integrity" (i.e. no fixing), but the potential is massive (I've seen estimates that $400B/year is bet on sports; obviously that's across all sports (including boxing, horses, etc.) but I would guess that number increases dramatically if sports betting is legalized. A 1% take on a number that big would drive huge revenues into all of the sports leagues.
  - PS- NBA viewership seems to be doing pretty well so far this year…
- **Some other stuff**
  - NYT on New York Subway Construction Costs (Sad!)
  - Inside Amazon's Artificial Intelligence Flywheel
  - Airbnb is adding hotels and a loyalty program
    - **Related:** How Airbnb plans to win over hotels