

Margins of Safety

Value investors can err by lowering their business-quality standards in order to get a bargain price. That's not a mistake Tim Hartch is likely to make.

Ask Tim Hartch of Brown Brothers Harriman & Co. to describe a favorite stock and the conversation will go on for some time before there's any mention of the share price and valuation. "We're buying a business, not a model," says Hartch.

This business-first approach has paid off handsomely for investors in the \$20 billion (assets) BBH Core Select strategy that Hartch has co-managed since 2005. Over that time, it has earned a net annualized 10.2%, vs. 7.1% for the S&P 500.

Though they're finding bargains relatively hard to come by, Hartch and co-manager Michael Keller do see opportunity today in such areas as oil services, industrial lubricants, wireless technology, pharmaceuticals and seismic data. [See page 2](#)

INVESTOR INSIGHT



Brown Brothers Harriman & Co.
(l to r) Tim Hartch, Regina Lombardi and Michael Keller

Investment Focus: Seek companies with sustainable positions in attractive markets when short-term or low-impact problems are overly discounted in the share price.

Disruptive Behavior

Mario Cibelli's favorite stocks have tended to produce a lot of controversy and volatility – and, in his hands, a long-term record of spectacular returns.

INVESTOR INSIGHT



Mario Cibelli
Cibelli Capital Management

Investment Focus: Seeks companies selling products that disrupt the competitive status quo, allowing strong growth regardless of economic conditions.

As might be expected from someone who trained under investing iconoclasts such as Mario Gabelli and Bob Robotti, Mario Cibelli isn't one to bounce ideas off a network of hedge-fund buddies. "I'm an introvert when it comes to research," he says. "I don't think you can get true insights any other way."

Cibelli's independent streak has resulted in outsized returns for his Marathon Partners L.P. investors. Since its launch in 1997, the fund has earned a net annualized 17.0%, vs. 7.3% for the S&P 500.

Targeting companies whose prospects are frequently under vociferous debate, he's currently finding long-term upside in such areas as self-service kiosks, photo commerce, money transfer, prepaid debit cards and prepaid gift cards. [See page 10](#)

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Fundamental Purpose

Without peer as an expert on industry dynamics and competitive strategy, Harvard Business School's Michael Porter has also been thinking a lot about investors and investing – not all of which is particularly flattering.

INVESTOR INSIGHT



Michael Porter
Harvard Business School

On investors' role: "Directing capital to companies that can use it productively is ultimately the most profound benefit investors can have on society."

*Editor's Note: Harvard Business School Professor Michael Porter needs no introduction to any serious student of business. His seminal work on the competitive dynamics that determine industry profitability and on the strategies companies can employ to positively impact their competitive positions – laid out initially in the books *Competitive Strategy* and *Competitive Advantage* – revolutionized managerial thinking. So articulate was his framework for thinking about strategy and competition that it passed quickly into accepted wisdom. As he recently told *Fortune*, "The highest compliment, I've come to understand, is, 'Oh, that's obvious.' I used to take that as criticism, but now I understand that's the goal – to take a complex problem and make it seem clear and obvious."*

Now 66 and busier than ever writing, teaching and advising, Porter continues to take on a succession of massively complex problems, from reviving inner cities, to making countries more competitive, to transforming the value of healthcare delivery. We caught up with him recently to discuss his latest thinking on competitive dynamics and corporate strategy. To our

surprise, he also had plenty on his mind about investing in general, and value investing in particular.

Your "five forces" framework for analyzing industries – Threat of New Entrants, Bargaining Power of Buyers, Threat of Substitutes, Bargaining Power of Suppliers, Rivalry Among Firms – is an important part of many fundamental investors' research process. Has your thinking on it evolved over the years?

Michael Porter: While the original framework was introduced many years ago, in 2008 I wrote an article in the *Harvard Business Review* that reexamined and reflected on the application of the concept over time. My basic conclusion is that the five forces are still the five forces. There have been various nominations for a sixth force, such as technology or the influence of government, but my view is that those are best understood in terms of how they affect the five fundamental forces that ultimately drive the division of value among industry participants. For example, government policy can raise barriers to entry or lower barriers to entry. New technology can intensify the rivalry among firms or decrease it.

Industry structure is profoundly relevant to investment analysis, but too much of the analysis looks at industries in a simplistic way, say whether the industry is growing or shrinking, or whether it's a down cycle or an up cycle. The fundamental investor that uses the five forces to understand what determines the fundamental economic value creation in an industry and how it is changing gains a huge edge.

Do you think your strategy prescriptions for creating competitive advantage have equally stood the test of time?

MP: My original work looked at the broad positioning choices in an industry – low

costs, differentiation, broad or narrow set of customers. Over time, I deepened the principles for thinking about creating a unique and sustainable position, starting with the value chain. That was partly motivated by the #1 question I had gotten about the generic strategies, which is, "Can't you be both low-cost and differentiated at the same time?" This conundrum led to the distinction between operational effectiveness and strategic positioning. Operational effectiveness is about assimilating best practices. Strategic positioning is about making choices and tradeoffs about what customers a company is going to serve, the particular needs it is trying to meet, and ultimately the value proposition of a company relative to competitors.

I have been focused on the timeless, unvarying fundamentals that underlie competition. There's no question that conditions change and that change is relentless and impacts industries and companies. But I have always tried to understand the principles that never change, and use them to understand the consequences of change and the implications for companies and managers in setting direction. Those principles have stood the test of time.

Broadly speaking, would you say the rate of change in industry structures and competitive positions has increased?

MP: We don't have any real proof, but the general feeling is that things are changing faster. I believe that everyone always thinks that their period of history is one where things are changing faster.

Information technology, however, has clearly been a big disrupter and a speed accelerator. I would also say the aggressiveness with which management is shutting things down and cutting costs has definitely gone up over the last 10 or 20 years. That is partly due to the fact that capital markets are more transparent and investors are more demanding. But on

many other dimensions of competition, I'm not so sure the rate of change is that much faster.

Every year or two over the past 20 years somebody has written an article saying strategy is no longer relevant because the world is changing too quickly and the imperative is to stay one step ahead by changing feverishly. I don't know many CEOs who actually believe this. Just about every company I've ever come in contact with recognizes it needs a strategy. It needs to understand who it is and how it's going to create distinctive value. That's what allows companies and managers to make choices about how to deal with all the trends, versus just imitate the next guy.

Elaborate on your earlier comment that investors' industry analysis can often be simplistic.

MP: Industry trends and today's growth rates are easy to see. What's more subtle is to understand how the five forces are changing, and what that means for where the overall value lies.

For example, a very important trend working its way through many manufacturing industries is that products with embedded sensors are getting "smart" and "connected" to manufacturers and users via the Internet. Smart connected products can have a variety of impacts up and down the value chain. For example, by transforming the nature of after-sale service, where there is a shift toward more preventative and efficient maintenance versus a traditional break-and-fix model. But the trend is neither good nor bad. It all depends on how it's going to impact the five forces in a particular industry. Does it impact barriers to entry? Does it create switching costs for the customer? Does it create new business models focused on selling the use of the product rather than the product itself, rebalancing customer power? Taking the trends and then working them through the five-forces framework is where the insight comes.

Another example is that an industry doesn't have to be growing to be interesting. A year or two ago investor enthusiasm

for the printing industry was non-existent because print is being substituted for by electronic media. But declining industries can be highly profitable if capacity leaves the market and barriers to entry rise. Demand can hold up in less-price-sensitive segments. I'm not making the case for everyone to run out and buy printing companies. But if you look deeply enough, you may have even greater economic opportunities in some declining industries than you do in growth industries where

ON SHARED VALUE:

We're starting to understand that worrisome societal problems represent the greatest business opportunities.

everyone is rushing to get in. Look at the stock price of R.R. Donnelley [RRD] over the past year.

You mentioned that investors have become more demanding. Do you consider that an unalloyed good?

MP: Net-net, I would say capital markets have made it harder for companies to actually have a strategy and make the investments that address the true fundamentals of their industry structure and their competitive position. We've seen a rise in gaming around guidance and delivering quarterly earnings surprises. There's also a tendency for investors to latch on to one company that seems to be doing well and push for everyone else in the industry to imitate it. Analysts tend to evaluate competitors on the same metrics even though different metrics are appropriate for different strategies. All of this encourages convergence, which is the enemy of strategy. The worst mistake in strategy is for a company to compete with rivals on all the same things.

Given all your work with companies and industries, are there any secular trends you'd suggest investors examine?

MP: In the U.S. economy, the single biggest opportunity that will have ripple effects across many industries is the new energy situation. This is certainly not a secret and has already had significant impact on oil and gas producing regions and on the railroads and pipelines that transport all the new production. The next-order effects, which are just beginning, will be on industries where oil and gas are important feedstocks or inputs, such as in chemicals and plastics where U.S. production now has a competitive advantage where it has had a disadvantage. Further down the line, other energy-intensive industries and companies will benefit.

Another area on which I spend a lot of my time today is around the idea of creating shared value. This gets at the relationship between business and important societal issues such as health, education, poverty and the environment. Historically companies have addressed social issues through corporate philanthropy, which is detached from the business and, some would say, spends shareholders' money. More recently, corporate responsibility initiatives have led to much reporting and focus on reducing social harms – again, tangential to the business.

But the real power of a business in society is in being a business – meeting needs at a profit. We're just starting to understand that the worrisome societal problems we face represent the greatest business opportunities.

The pharmaceutical industry is a great example. It was built largely to serve a half billion people living primarily in rich countries with established healthcare systems and relatively high incomes. But another 6.5 billion people are out there whose needs are largely unmet. Companies like Novartis and Novo Nordisk are starting to address those 6.5 billion people profitably with new kinds of products, pricing models and distribution systems. The potential to create shared value is huge and applicable to virtually every industry and sector.

Can you give some other examples of companies creating shared value?

MP: Becton, Dickinson is a medical-device company whose recent growth is being driven by addressing public health needs – like risks from needle-stick infections – working collaboratively with governments and non-governmental organizations to do so. Dow Chemical created a “Breakthroughs to World Challenges” program, tasking each of its business units to find business solutions to a range of global problems. One big hit was the development of Omega-9 canola and sunflower seeds that produce cooking oil with no trans fats and low saturated fats. The seeds yield for farmers twice the oil per hectare than soybeans, and the oils have longer shelf and usage lives for customers. It’s also become one of Dow Chemical’s biggest-selling product lines. This is creating shared value.

It’s crucial for every enterprise to understand its fundamental purpose in society. Lately we’ve been saying that our fundamental purpose is to make money – maximize shareholder value. But this definition of purpose is uninspiring and even risky. Companies also define purpose in terms of the product they produce. But purpose ought to be about the fundamental needs in society a company meets. If Nestle thinks of itself as just a food company, it might think that the goal is to get people to eat more. But if Nestle thinks of itself as a nutrition company, it has aligned its purpose around meeting a fundamental societal need. That opens up optionality and opportunity for Nestle to differentiate itself and innovate in ways that create shared value.

You’re helping to lead a multi-year Harvard initiative on U.S. competitiveness. What would you highlight as key insights from that effort so far?

MP: This starts with the definition of competitiveness. In our definition, the United States is competitive to the degree that companies operating here can compete successfully in global markets while simultaneously maintaining and increasing wages and living standards for the average American. If business succeeds by

cutting jobs and incomes, the U.S. is not truly competitive. We’re finding that the U.S. has serious structural competitiveness problems, which leads us to believe that the country is likely to face slow economic and job growth for years to come.

Everyone seems to understand the macroeconomic problems we face. But our work suggests that we also have a number of serious microeconomic problems that are just as important.

ON ECONOMIC VALUE:

The concern is that it seems the vast majority of energy and effort in investing has become about other things.

While the U.S. retains core strengths in things like entrepreneurship, innovation, science and higher education, we’ve let some of the basics slide. We need to simplify and streamline regulation affecting business to focus on outcomes rather than impose costly reporting, compliance and delays. Our legal system is inflicting high costs on U.S. businesses, as is our health-care system. Roads, bridges and ports are in disrepair, and our communications and energy infrastructure does not match the world’s best.

The corporate tax system is disastrous for U.S. competitiveness, with the highest statutory rates in the OECD and disincentives to repatriate foreign profits back to the U.S. At the same time, the system has so many complex exclusions and deductions that the U.S. ends up collecting lower taxes than many other countries.

Our public-education system, crucial to the ability of workers to compete and to maintain their incomes, continues to fall further behind, especially with respect to middle-level skills involving some technical training. Overall, skill development is broken, leading to unfilled jobs and high unemployment. What troubles us is that the U.S. has not been willing and able to reach consensus, pass legislation, and address any of these problems in decades.

In the same way companies need to define their purpose, you’ve said the same thing about investors. Explain that.

MP: I believe the fundamental purpose of investing is to deploy capital to productive uses in the real economy. It’s the ability of businesses to use capital well to meet needs at a profit and grow that creates all the wealth in society. Government and NGOs don’t create wealth, they utilize taxes and donations to meet societal needs. Directing capital to companies that can use it productively to create economic value, and thus wealth, is ultimately the most profound benefit investors can have on society.

Beyond allocating capital, investors also play a vital role in monitoring what companies are doing, pushing for transparency, and intervening to catalyze change if the capital employed isn’t generating the economic value it should. All of this raises the fundamental wealth that is being created, and this kind of wealth creation does not come at the expense of other investors.

The concern is that it seems like the vast majority of energy and effort in investing has become about other things. It’s about indexing. It’s about momentum. It’s about program trading to capitalize on tiny movements in share prices. It’s about locating your servers closer to the exchange so you can trade in and out a little faster. I’m all for price discovery and liquidity, but improvements here have diminishing returns for fundamental wealth creation. One investor’s gain is often another investor’s loss.

As more investors walk away from fundamental investing, the need and the opportunity grows for value investors who focus on understanding companies, industries and competition. Such investors can do well for themselves, for their own investors, and for society. This is creating shared value. I’d like to see more investors with that sense of purpose, and more rules, regulations and incentives put in place that lead investing in these directions rather than those that create limited societal returns. **vii**

Taking Stock

As readers, we've never gotten a great deal out of investment-oriented publications' "How did we do this year?" types of stories. While we appreciate the effort to be accountable for what's appeared in their pages, there tends to be a lot of back-slapping over great calls, the recitation of which doesn't provide a tremendous amount of value after the fact.

We regularly track how the stocks recommended in *VII* perform, specifically the "focus" ideas in interviews that are accompanied by Investment Snapshots, as well as the one-off ideas in Uncovering Value, Uncovering Risk or A Fresh Look features. The challenge is defining a time frame over which to look. Most of those we interview credibly cite their ability to look beyond the short-term focus of most investors as a competitive advantage, so rating their ideas after a year or less seems unproductive and a bit unfair.

But as the end of the year is a good time to reflect, we're happy to do so – but with a twist, focusing more on what has so far gone wrong than right. Not that a lot didn't go right: Had you invested \$10,000 in each of the 122 ideas mentioned in depth in *VII* over the past 12 months

(\$1,220,000), your portfolio as of December 26 would have \$43,000 more than one that had invested the same amounts in the Russell 3000. That represents an 18.8% gain, vs. 15.3% for the market. (In comparing this to the market's 2013 performance, remember that the ideas tracked only contribute for the time held, which for the ideas in our November issue, for example, amounted to just one month.) No fewer than five stocks – **Quiksilver**, **Manpower**, **Crosstex Energy**, **iGate** and **Leap Wireless** – more than doubled.

Were there commonalities among the handful of unsuccessful ideas so far? Two stand out. Bottom fishing among gold miners, namely **Coeur Mining** and **Allied Nevada Gold**, has decidedly not worked out. Nor, unsurprisingly, have most of the short ideas recommended, most prominently **Herbalife**, German utility **RWE** and **Vera Bradley**. In a horrible year for short-sellers, kudos go to Solas Capital's Tucker Golden for his negative thesis on **Krispy Kreme Doughnuts** in our August issue – its shares have fallen 14% over a period in which the market is up more than 12%.

While many ideas recommended attracted high-profile activist investments

during the year, those cited before the activist went public, such as **Air Products** and **Oil States International**, performed far better than those mentioned after the activist angle became well known, such as **Agrium** and **Ashland**.

Timing has also been an issue with technology companies **Internap Network Services** and **Symantec**. While both have seen their shares fall since being mentioned, the investment cases for each rests on business transformations that haven't yet borne the fruit that their recommenders expect. Each was a "time arbitrage" idea for which insufficient time has passed to accurately judge success or failure.

One idea from our pages for which time has been relatively unkind: British grocery giant **Tesco PLC**. It has been recommended three times in the past two years, most recently in our September issue, and the share price has essentially gone nowhere. Maybe our pointing it out now is a sign that the tide is about to turn.

Here's wishing you all a happy, peaceful and prosperous 2014! **VII**

John Heins

Whitney Tilson

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