



THE  
MANUAL  
OF  
IDEAS

TM

## Value-oriented Equity Investment Ideas for Sophisticated Investors

A Monthly Publication of BeyondProxy LLC \* Subscribe at [manualofideas.com](http://manualofideas.com)

*"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."*

### Investing In The Tradition of Graham, Buffett, Klarman

Year IX, Volume V  
May 2016

When asked how he became so successful, Buffett answered:  
"We read hundreds and hundreds of annual reports every year."

#### Top Ideas In This Report

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#### Highlighted Events — Join Us!

##### Asian Investing Summit 2016

April 5-6, 2016, fully online [REPLAY valueconferences.com](http://REPLAY.valueconferences.com)

##### The Zurich Project Workshop 2016

June 8-9, 2016, Zurich [SOLD OUT zurichworkshop.com](http://SOLDOUT.zurichworkshop.com)

##### Wide-Moat Investing Summit 2016

June 28-29, 2016, fully online [valueconferences.com](http://valueconferences.com)

##### Latticework 2016

September 14, 2016, New York [latticework.com](http://latticework.com)

##### VALUEx Munich 2016

September 20, 2016, Munich [valuex.org](http://valuex.org) *BY INVITATION ONLY*



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# THE BERKSHIRE HATHAWAY ISSUE

- ▶ Selected BRK Holdings Profiled by The Manual of Ideas Team
- ▶ Proprietary Selection of Top Three Candidates for Investment
  - ▶ Insights into Berkshire Hathaway by Larry Cunningham, John Huber, Jeremy Miller, Ravi Nagarajan, and Whitney Tilson
  - ▶ Exclusive Interview with Sean Stannard-Stockton
    - ▶ 10 Essential Screens for Value Investors

*Berkshire Hathaway holdings analyzed in this issue include Axalta Coating (AXTA), Deere & Company (DE), General Motors (GM), Graham Holdings (GHC), IBM (IBM), Kinder Morgan Inc. (KMI), Lee Enterprises (LEE), Media General (MEG), Moody's (MCO), NOW (DNOW), Phillips 66 (PSX), Procter & Gamble (PG), Suncor Energy (SU), U.S. Bancorp (USB), USG (USG), Verisign (VRSN), Verizon (VZ), Visa (V), and Wal-Mart (WMT).*

## New Exclusive Content in the MOI Members Area

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or email [support@manualofideas.com](mailto:support@manualofideas.com))

- ▶ Jeremy Miller on Warren Buffett's "Ground Rules"
- ▶ Dan Sheehan on Avoiding Bad Investments
- ▶ Three Idea Presentations from Asian Investing Summit 2016
- ▶ *PREMIUM:* Business Development for Investment Managers

REPLAY Asian Investing Summit 2016, the fully online conference hosted by ValueConferences and The Manual of Ideas.

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## Sean Stannard-Stockton on Buffett-Style Investing in a Mutual Fund and Separate Account Context

*Shai Dardashti, Managing Director of The Manual of Ideas, recently conducted an exclusive interview with Sean Stannard-Stockton, president and chief investment officer of Ensemble Capital, based in Burlingame, California. The firm, which dates back to 1997, manages the Ensemble Fund (ENSBX) as well as separate accounts.*

**The Manual of Ideas:** Please tell us about the investment mandate of Ensemble Capital Management.

**Sean Stannard-Stockton:** Ensemble Capital is a wealth management firm managing approximately \$425 million on behalf of a little over 100 families and charitable institutions as well as a publically traded mutual fund. Our investment mandate varies across clients, but always involves a focus on long-term capital appreciation and protection. For our mutual fund, as well as for many of our clients, we manage a focused portfolio of 15-25 high quality companies, which we believe are competitively advantaged and trade at a discount to our estimate of their intrinsic value.

**MOI:** Please tell us about your background and how you became interested in value investing. What events or people shaped your investment philosophy the most?

**Stannard-Stockton:** I was first exposed to investing when I read a book about stock picking during a road trip my family took when I was thirteen years old. I was immediately hooked. That book put an end to my childhood dream of being a major league baseball player and put me on the career path I've taken ever since.

Most of the reading I did on investing when I was young was rooted in a value approach. David Dreman, Warren Buffett, Mike Burry (via the blog he wrote in the late 1990s) and Ben Graham were the investors whose writing I focused on. When I joined Ensemble Capital, our founder Curt Brown was more of a growth investor, although always with an eye to not overpaying. As we worked together (it was just me and Curt for a number of years) our approaches fused first into a "growth at a reasonable price" approach and was then refined into the approach we utilize today of investing only in competitively advantaged

companies, with what we believe are sustainable moats that trade at a discount to our estimate of their intrinsic value.

**MOI:** How would you describe your investment approach?

**Stannard-Stockton:** Our process starts with seeking out unique companies with differentiated offerings that we believe can resist the brutal competition that tends to eat up any excess profit that is generated by less competitively insulated firms. It is only these advantaged firms for which we believe we are well positioned to estimate intrinsic value. Companies with little to no competitive advantage end up in our "too hard pile" no matter how cheap they might appear.

One key moment in the evolution of our investment strategy was when I read the book *Valuation: Measuring and Managing the Value of Companies*, by McKinsey & Co. The book offers compelling, long-term evidence that high rates of revenue growth decay quickly so that within

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five years of any given starting point, on average, even the fastest growing firms have seen their growth slow to around 5% a year. Investors saw this first hand in the wake of the dot-com bust when high growth companies such as Cisco Systems and Microsoft ended up producing around 5% growth in the subsequent decade. On the other hand, while growth decays quickly, the book offers a similar study of return on capital levels and shows that while high return on capital businesses do

see a decay in returns, high returns are far more persistent than high rates of growth. The average high-return business sees its return premium decline, but then stabilize at rates approximately twice as high as the market overall.

What this means is that investors should be careful in paying up for growth, given how fleeting high growth rates can be. High returns on invested capital, which result in more distributable cash per dollar of reported earnings, are far more persistent and so therefore investors are justified in paying up for these types of businesses. While we love to see strong growth, so long as it is done in a way that also generates strong returns on capital, our portfolio is characterized more by its collective high return on capital business models than by its growth characteristics.

While high returns on capital businesses as a group tend to produce persistently strong returns on capital, our analysis focuses on understanding the qualitative reasons why a company generates high returns. It is the persistence of these qualitative competitive advantages that will most influence the rates of return on capital that a company will produce over the long-term.

**MOI:** What are your key stock selection criteria, and what types of businesses have you favored historically?

**Stannard-Stockton:** We only invest in companies that we think benefit from sustainable competitive advantages that we are in a position to understand. Within that limited universe of investable companies, we only purchase shares of stock that trade at a material discount to our estimate of the intrinsic value of the company they represent.

Historically, we've found these types of business across a range of industries. Because we focus our portfolio in 15-25 of our best ideas, we take great care to ensure that the companies in our portfolio serve different end markets and have limited cross-correlation of risk. Some of the areas we've historically found attractive are:

Business service companies such as **Broadridge Financial** (BR) or **Paychex** (PAYX) where the service is mission critical to their customers, but where the cost makes up a very small part of their customers cost structure creating significant switching costs due to the time, energy and business disruption risk of changing providers with very little in the way of absolute cost savings.

Companies such as **Google** (GOOGL) or **Landstar Systems** (LSTR) that benefit from strong network effects where more customers using their offering makes their offering even more valuable. In Google's case, that has to do with the wide range of data they collect from their users across their product set enhancing the data (such as search results) that they provide to those same users. In the case of the trucking logistics company Landstar Systems, the more shippers they serve, the more loads they can provide to truckers and the more truckers on their platform the more loads they can move for shippers. In many ways, Landstar is almost like a market exchange company where the network effect is caused by more people on each side of a given trade increasing liquidity and causing the exchange to attract more customers.

Companies with truly dominate brands within their industry, such as **Scotts Miracle Gro** (SMG), with over 50% market share in Lawn and Garden or **Pepsi's** (PEP) savory snack food portfolio, where they are many times larger than any other competitor.

While we recognize that low-cost providers can offer a defensible set of competitive advantages, we believe (and the historical evidence offers supports this view) that moats

based on differentiation are far more sustainable than moats based on being the low cost provider. That's why we've owned **First Republic** (FRC) for its extremely high touch customer service-based moat rather than Wells Fargo with its low-cost advantages, or why we've owned **Costco** (COST) with its ability to charge a membership fee due to its differentiated offering rather than Wal-Mart with its low cost based business model.

**MOI:** How do you generate investment ideas?

**Stannard-Stockton:** Our idea generation process is highly qualitative and based almost entirely around reading a very diverse set of information sources. We believe that while access to information might have once been a competitive advantage for investment firms, today the key expertise is your ability to appropriately filter the fire hose of information that is at everyone's finger tips.

Most of our ideas come from reading business articles that address what makes a given company unique. We also find a lot of value in reading periodicals such as the Manual of Ideas that highlight other managers with a similar approach

to us and which companies they are interested in. We find that the qualitative "screen" of another moat focused investor buying a stock is a far better source of ideas than a quantitative screen run on a Bloomberg terminal.

For instance, we never would have invested in First Republic if we hadn't read an interview with Shawn Kravetz of Esplanade Capital in which he argued that the company was best understood not as a bank but rather as a customer service retail franchise. This comment totally transformed the frame through which we viewed the company and made us realize that with a net promoter score higher than Apple's, First Republic's ability to grow and protect their profits had little to do

with traditional banking industry issues and was in fact a function of their ability to continue to replicate their high touch customer service across more markets.

**MOI:** How has market volatility over the past several years affected your investment process, and have you tweaked your approach in any way as a result?

**Stannard-Stockton:** We're aware that many investment firms that have historically been focused on company analysis have begun to say that given the financial crisis they are now more macro focused. We think this is the wrong lesson to learn from the crisis. While we've always

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sought to understand the economic context in which our portfolio companies operate with a specific focus on trying to understand if current results are super or sub-normal due to economic conditions, we do not think that macro-economic conditions are predictable enough to be a key driver of investment decision making.

The financial crisis highlighted the degree to which economic conditions can overwhelm company specific analysis, but we do not see any evidence that the financial crisis revealed an approach to make economic conditions more forecastable. It is critical that investors differentiate between important drivers of returns vs forecastable drivers of returns. While macro-economic conditions can be an important driver of returns, they are not forecastable over the short to medium term and so we have not changed our attitude towards these indications since the financial crisis.

All that being said, investors are required to have a longer term outlook on many macro-economic variables whether they recognize it or not. For instance, an investment in **Charles Schwab & Co (SCHW)** must take into account the fact that the company will earn very different levels of earnings under various interest rate environments. An investor who assumes that current interest rates will remain unchanged in the future is just as much making a forecast as an investor who thinks that interest rates will rise.

When faced with these sorts of decisions, we generally default to an assumption based on mean reversion rather than a specific forecast. So we expect interest rates to rise over time (say over the next five year), because historically there has been a robust connection between nominal GDP and longer term interest rates. We expect nominal GDP to mean revert towards its historical average and the nominal GDP/interest rate relationship to reestablish itself. We make similar assumptions when needed around macro-economic variables such as the number of home sales that will occur each year, the number of cars that will be sold, the rate of unemployment or the relationship between global trade and global GDP growth.

**MOI:** How do you protect your portfolio from permanent loss of capital, and what is your take on holding cash?

**Stannard-Stockton:** Our primary protection against permanent loss of capital is ensuring that we invest our

capital in companies with relatively predictable futures due to their strong economic moats and then being sure that we do not pay an excessively high valuation for their future prospects.

Just as important as limiting our holdings to these sorts of companies is appropriately weighting these holdings within our portfolio. It surprises us that for all the many, many books and resources devoted to which stocks to buy, there is so little advanced discussions on position sizing.

There are two drivers of our weighting decisions, 1) our confidence in the accuracy of our assessment of a company's intrinsic value and 2) the potential upside available from the current market quote to this estimate of intrinsic value. We give more weight to item one when sizing our positions. We'd rather own an asset at a small discount to an intrinsic value we are very confident about than own an asset at a large discount to an intrinsic value which we have less confidence in.

This approach has theoretical support from research on optimal bet sizes for gamblers. If someone offered you 2:1

odds that the sun would come up tomorrow, you should make a much larger bet than if someone offers you 1,000:1 odds that it will rain tomorrow. This is because the odds of ruin are so much less on the first bet. Both bets may have a positive expected return, but the bet that is more likely to be a winning bet is a better candidate for a larger size bet.

Certainly, other investors can offer more complex answers, but we think that these simple approaches are the best way to control risk within a long only equity portfolio.

The cash in our portfolios are a residual of our investment decisions. We never target a certain level of cash, as doing so implicitly is a bet that the market will fall in the short term and we think short term market moves are unforecastable. But if we do not have enough investment candidates to get fully invested we will happily hold cash until we come across a new idea.

**MOI:** What is your take on portfolio concentration, and how does it reflect your philosophy on risk?

**Stannard-Stockton:** When the position sizing approach we outline above is implemented across our portfolio, we end

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up with holdings of between 2% and 10% in each company and 15-25 companies across our portfolio.

Research shows that once a portfolio owns 25 companies that have unique risk profiles (i.e., they are not all energy companies for example), there is very little diversification benefit from adding additional holdings. Efficient market proponents argue that there is no cost to adding additional holdings and so investors should add every available company to their portfolio. As fundamentally-driven investors seeking to outperform the market, we see the cost of adding additional holdings as being forced to add our 50<sup>th</sup> or 100<sup>th</sup> best idea. Simply put, we don't have that many good ideas! We think that the sort of companies we invest in are relatively rare and opportunities to buy them at a material discount to their intrinsic value is even rarer. Therefore, we seek to manage our portfolio using an approach that captures the vast majority of the benefits of diversification while allowing us to keep our clients' capital in our best ideas.

**MOI:** Can you recommend one or two recent books that have given you new insights into the art of investing?

**Stannard-Stockton:** *The Prize: The Epic Quest for Oil, Money & Power*, by Daniel Yergin isn't new, but it is well worth a read today given all the volatility in energy markets. The book won the Pulitzer prize by telling the story of the entire history of oil using an extremely compelling narrative structure. In many ways the history of oil is the history of the world for the past 175 years or so. It has played a key role in so many historical developments. The most important lesson from the book is understanding that the oil industry has always been characterized by booms and busts. The recent bust isn't actually very remarkable when viewed on a long enough time frame.

The new book *Superforecasting: The Art and Science of Prediction*, by Philip Tetlock and Dan Gardner is an instant classic that anyone involved in financial markets should read. Tetlock's work on what sort of events are forecastable (and which are not) was a key influence on the books *Thinking Fast and Slow* by behavioral economist Daniel Kahneman and *The Signal and the Noise*, by Nate Silver, two other fantastic books for investors.

In *Superforecasting*, Tetlock does a wonderful job of explaining both why so many things are not forecastable –

even by highly informed experts – as well as what sort of events lend themselves to making informed judgements of the probability that they will happen. Rather than just warning how difficult forecasting is, Tetlock really delves into how to make well informed forecasts and, importantly, how to update your forecasts as new evidence becomes available.

**MOI:** Why did Ensemble Capital launch the [Intrinsic Investing blog](#) and what are your goals for the publication?

**Stannard-Stockton:** Ensemble Capital has long had a special focus on serving philanthropically minded clients. From 2006-2012, I wrote a blog called Tactical Philanthropy that became the most influential blog within the philanthropy community. The blog built a readership of 25,000 monthly visitors, I ended up writing a monthly column on philanthropy for the Financial Times and I was quoted on philanthropic topics quite regularly in media outlets such as the *New York Times*, *Wall Street Journal*, and *Washington Post*. What I learned from

that experience was that writing regularly is the best way to refine your own thinking and to constantly learn. On top of that, I learned the value of building a community of likeminded people who care about building a constructive dialog.

During the same time period, we grew Ensemble Capital and successfully managed the business and our portfolios through the financial crisis. I learned that being able to talk with private clients one-on-one about their portfolios, our strategy and individual holdings was the best way to build our clients' conviction so they can make it through the worst part of a market cycle.

With Intrinsic Investing, we hope to leverage these two areas of learning we did in the past to expand our ability to create a narrative driven sense of conviction in our investment process. It surprises us that so many investment firms behave as if their process is top secret and cannot be shared with clients. We think that while there are aspects of our process that we do not intend to publish, our core thesis on our holdings and our investment philosophy are relatively timeless and sharing our thinking is both the best way for us to refine our thinking as well as the best way for people to develop a clear understanding of what we're trying to accomplish.

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