A Method in the Madness

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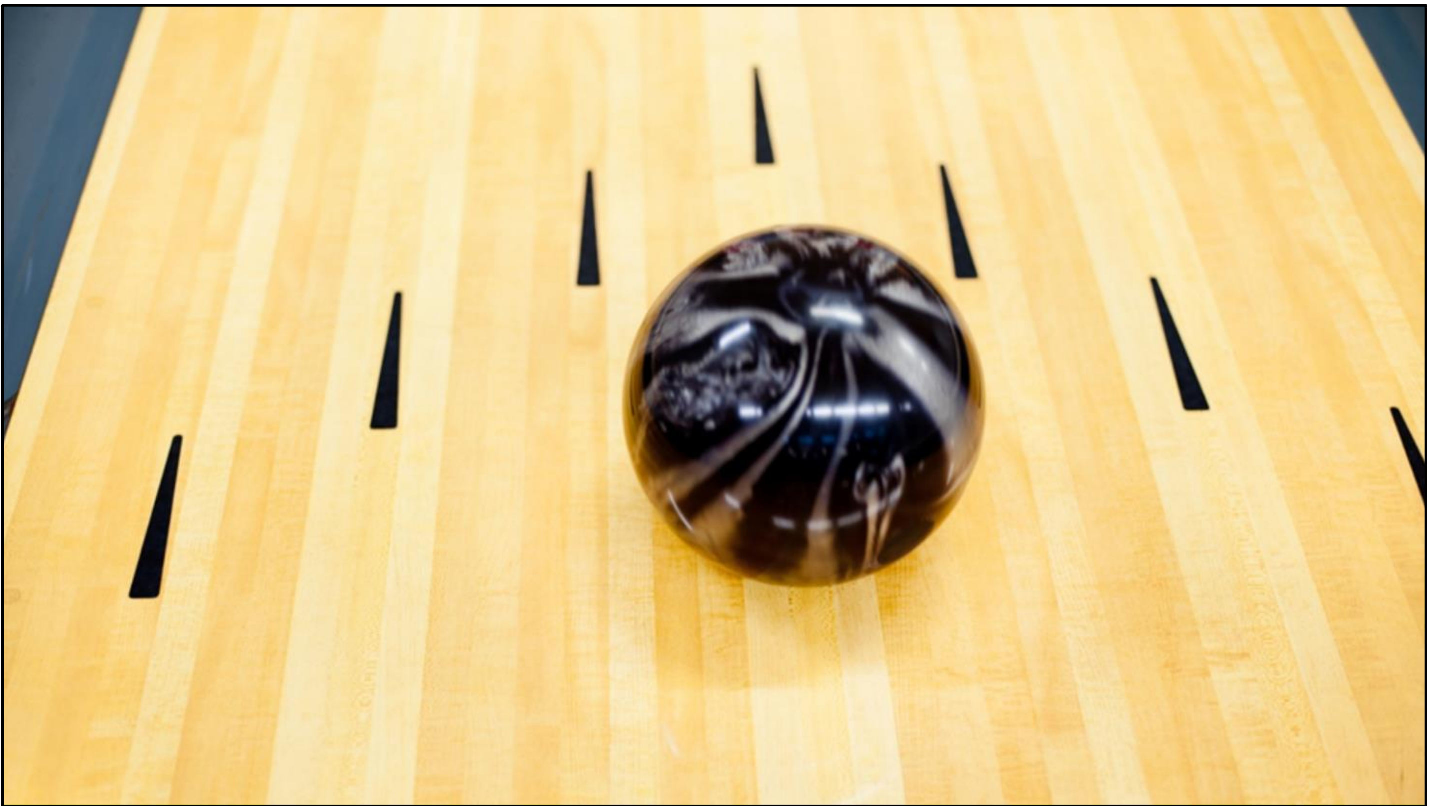
When I was 8, I wanted to play ice hockey. My friend Jeff played, so naturally I wanted to as well.

But my parents looked at the cost and the early mornings and…



… convinced me to join bowling instead.

I don’t know how we reached that compromise, but I ended up getting pretty good at bowling.

The first year, I was mediocre. But in my second year, I had a coach named Fred.

Fred told me to “stand on the second dot and throw over the third arrow.” For those who have bowled before, you know that there are dots and arrows on the lane – and they’re there for alignment.

Fred had set me up in a position that he thought would work best for me. So I practiced and practiced what he told me, and by the time the year had ended…

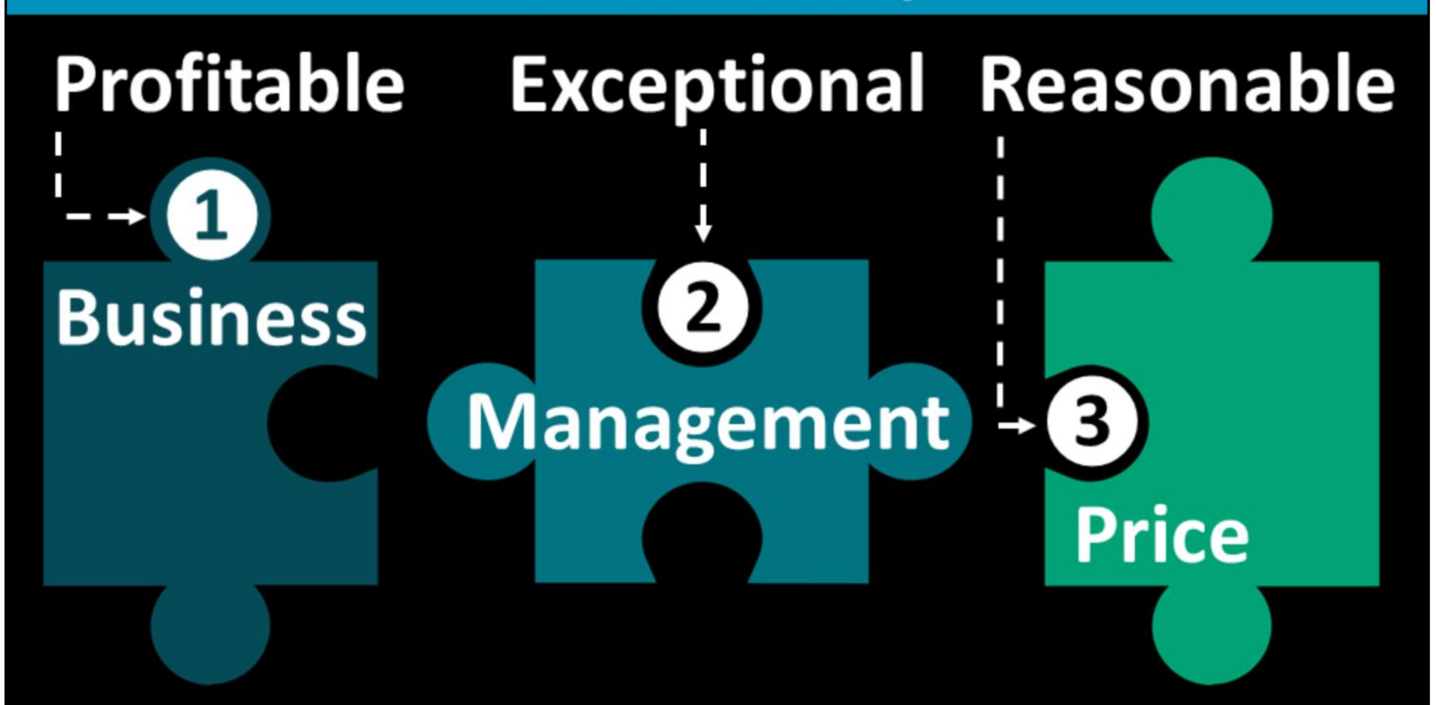
Photo credit: Gary Boland

I had won a national gold medal for my age group.

That's me in the front, on your left, holding the purple banner.

Over the next 10 years, I won two more national championships. The whole time I bowled, I stuck to what Fred had taught me. He had given me a method that worked and I learned to consistently apply that method.

In some ways, investing is not that different. You find a method that works and you work hard to consistently apply it over time.



In my view, the best method for us is the one that Warren Buffett teaches.

He says to look for three things when buying a stock: a highly profitable business, exceptional management and a reasonable price.

That’s how we get comfortable with the stocks we recommend.

We look for these three things – and if we find them in 40 or 45 names, then I believe things will work out well.

Let’s look at the points in more detail.

We’ll start with the business.

We want to own businesses that are highly profitable, and – importantly – are likely to stay highly profitable.

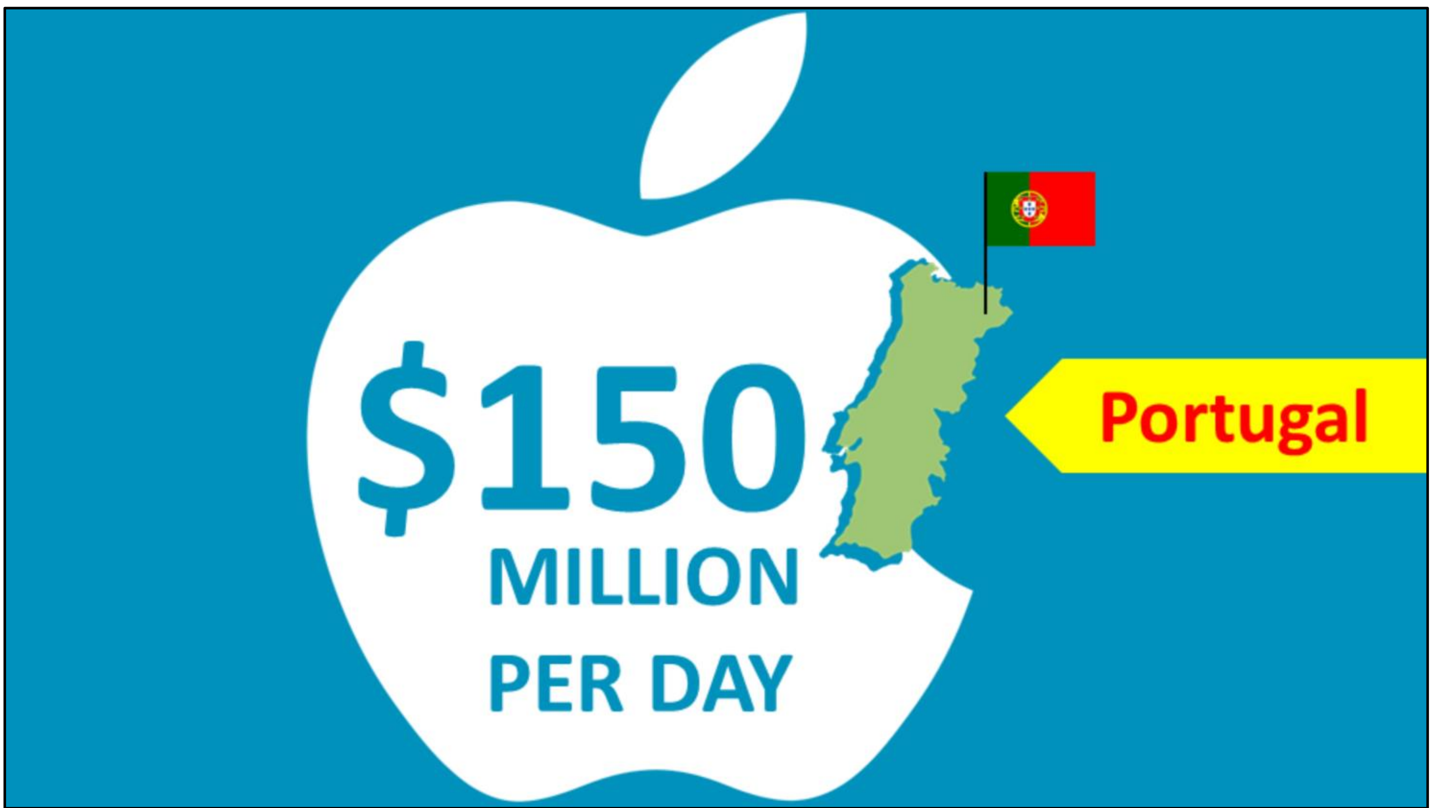
Apple is a great example.

Apple gets more than 60% of its revenue by selling iPhones.

A lot of people buy and sell Apple stock based on how many phones they think will sell next quarter.
In fact, you wouldn’t believe how much effort goes into trying to answer that question.

But it’s not the right question.

While the number of phones they sell – over time – is extremely important, the questions should be:
Is Apple a good business? Is it highly profitable?



Well last year, Apple’s revenue was greater than the GDP of Portugal. Its return on equity was 50%.

On average, Apple earns $150 million of profit – every single day.

Apple is a terrific business.

But will it stay that way? It’s easy to look at the past. We need to know, will Apple stay highly profitable?

I took this picture one day while walking home.

How many times have you seen this? People standing around, their heads down, looking at their phones. You see it everywhere. When we have the slightest bit of downtime, we turn to our phones.

It makes sense.

Think about all you can do on your phone. You can check the weather, play games, take pictures and book vacations. These devices have become an indispensable part of our lives. And, it's a way of life that's here to stay.

Apple sells a key piece to that way of life. So, I believe their product will stay relevant for years to come.

But what about profitability?

Apple makes a ton of money and we know that high profits attract competition. Well, it's really hard for competitors to take Apple's customers.

When you buy an iPhone, you tend to build an ecosystem around it.

You buy an iPad and sync it with your phone. You buy an iMac and Apple TV.

It all links together and it becomes really hard to leave the Apple system.

When you're in the system, Apple sells you more stuff. You have to buy a new phone every few years to keep up with technology and they keep coming up with new products.

Murray wears an Apple Watch. It’s a terrific product.

You can check your email, make phone calls or measure your heart rate. It even detects if you fall down. If you don’t respond within 60 seconds, it automatically calls 9-1-1.

At the same time, Apple is selling more and more services.

I signed up for Apple Music recently.

I've got stacks of CDs sitting at home that I paid $10 - 20 a piece for. With Apple Music for $10 a month, I get any song I want, any time I want it.

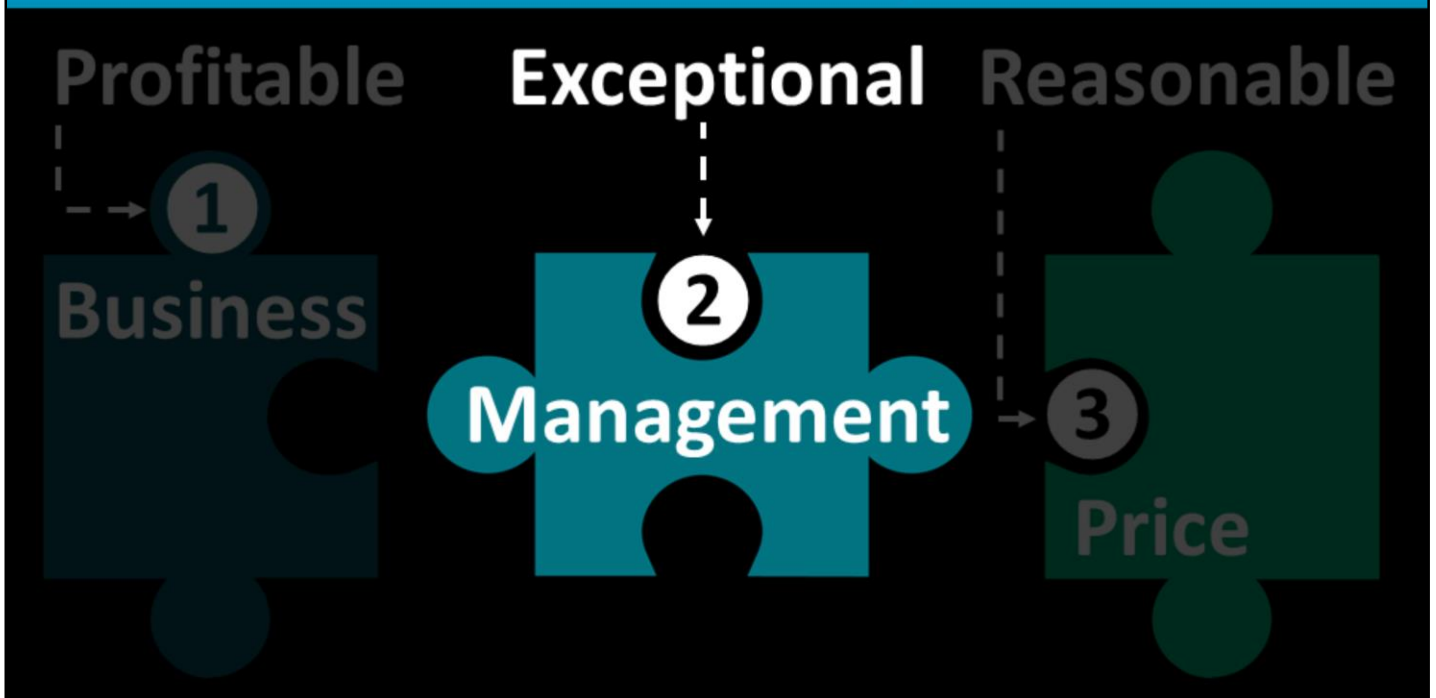
For $3 a month, you can store your photos in the iCloud.

These are subscription businesses. People sign up, they pay every month and they generally don't leave.

All of these products and services are further ingraining Apple into our lives – that should keep profits high and growing.

So, I think Apple is a wonderful business and it's likely to stay that way.

As shareholders, we get a little slice of every dollar that Apple makes and that gives me a lot of comfort.

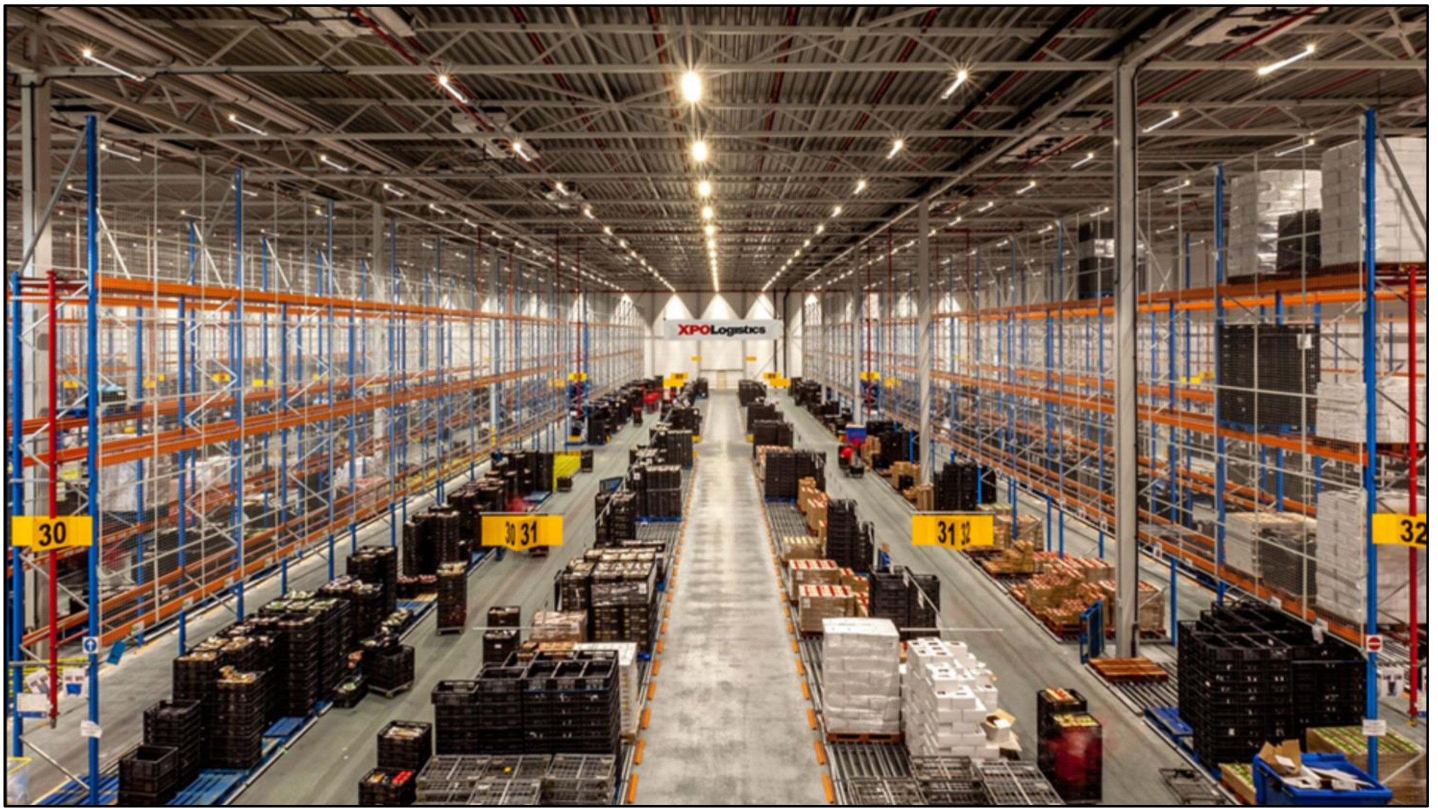


Let’s turn to management – the second part of our method.

We look for two things with management:
1) A track record of excellence (anyone can talk, but what have people done historically) and
2) Alignment (we want management incentivized to act in our best interest).

Source: XPO Logistics

Let's look at management at XPO.



Source: XPO Logistics

XPO is one of the world's largest logistics companies.

They help customers transport goods through their supply chains. They also operate high tech warehouses for customers like Nestlé and Amazon.

Source: XPO Logistics

XPO is run by Chairman and CEO Brad Jacobs.

He owns 14% of the company, a stake worth $1.2 billion. That’s almost all of his net worth. So, that’s pretty good alignment.

In terms of track record, he built four businesses from scratch into billion-dollar-plus revenue companies.

In the ’80s, he built an oil brokerage firm and then an oil trading firm.

In the ’90s, he got into garbage collection and built United Waste.

It delivered a 600% return in the five years it was public.

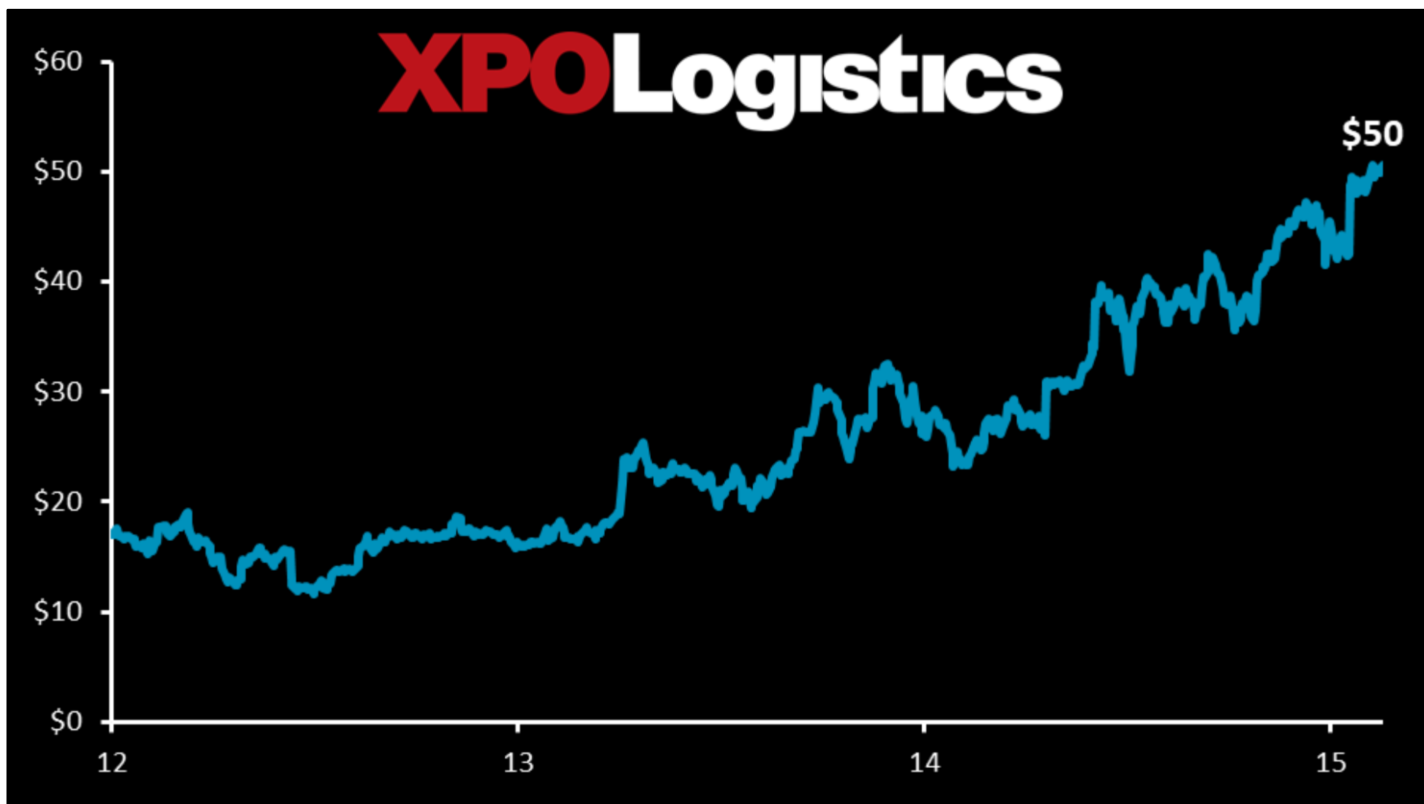
Source: United Rentals

Then, he started United Rentals – there's a location here in Kelowna.

He made United Rentals the largest equipment rental company in the world.

While he ran it, the stock doubled the return of the S&P 500.

That's the type of track record we want to see.

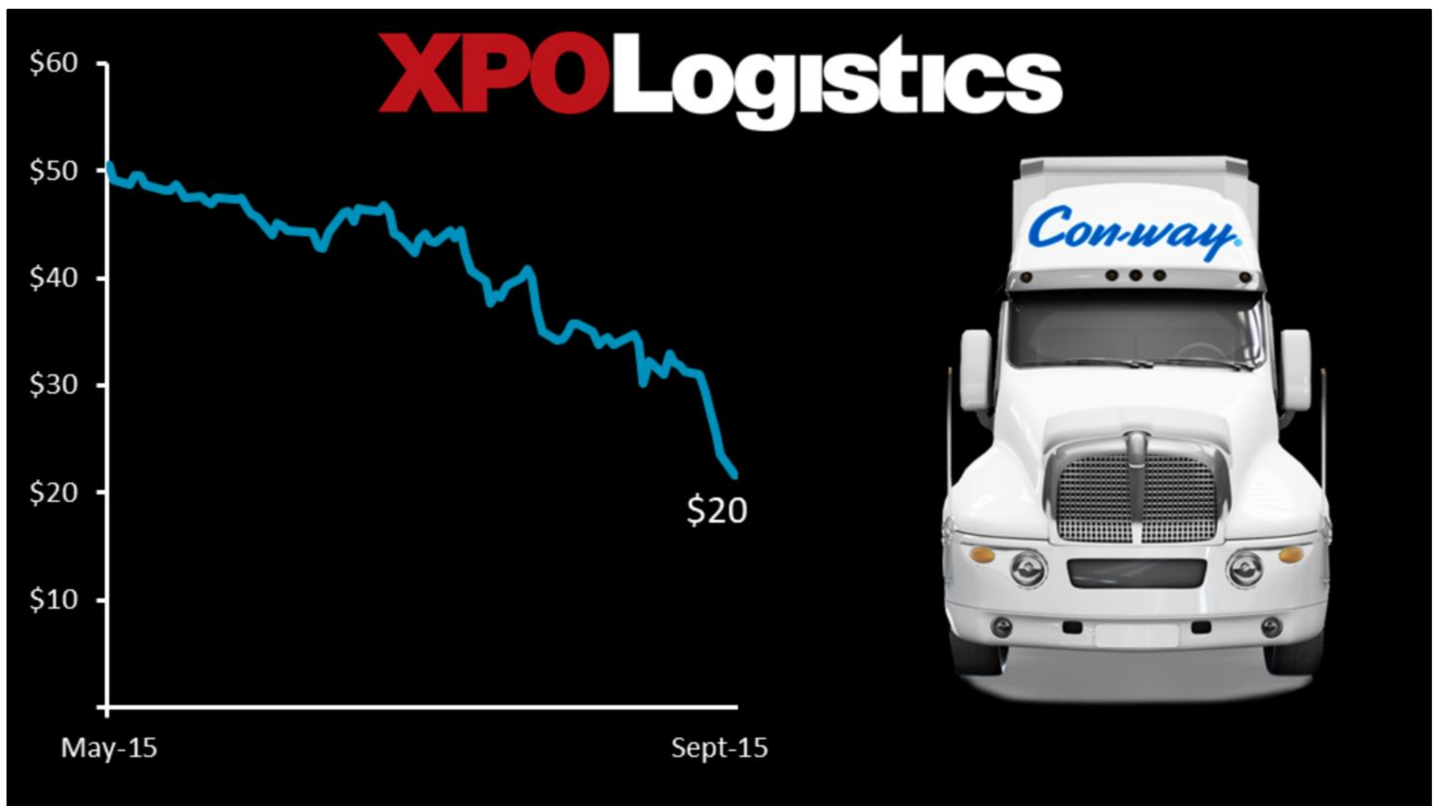


In 2011, Brad took control of XPO.

We recommended the stock in 2012 at just under $17 a share. Things started well. XPO opened new locations and they bought several companies.

By 2015, revenue was a lot higher and the stock hit $50 a share. We had tripled our money and it had felt pretty good.

But how does it feel when things go the other way.



In the summer of 2015, the stock started to fall.

The company's growth had slowed and people were worried about the economy. On top of that, companies that were growing by acquisition – like XPO – were falling out of favour.

Then in September, XPO announced it was buying a trucking company, called Conway.
Conway doubled the size of XPO – and it made XPO more cyclical and capital intensive.

The market hated the deal. One Wall Street analyst wrote, "investors have shown a virtual universal disgust" toward the acquisition.

XPO's stock fell 11% on the day it announced Conway. Within 3 weeks, it was down 30% and it eventually bottomed below $20.

This puts you to the test. I'm convinced that at least some of the hair I'm losing can be traced back to XPO.

It was not fun. Not for you, not for your advisor. Not for me.

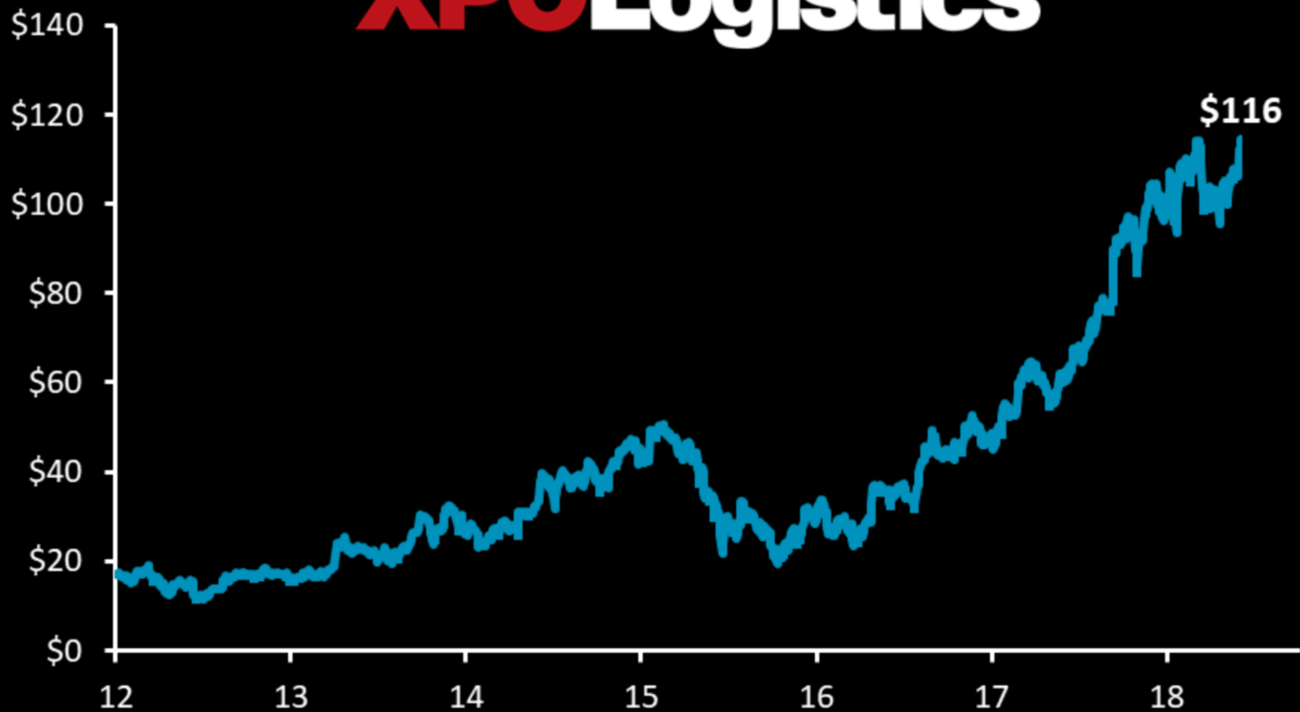
Murray talked about the need to be comfortable. Well, how do you stay comfortable when the stock you own is down 60%? When everything you read and hear is negative.

We did a lot of work to understand the deal, and that helped. But ultimately, it was our belief in management that was key.

Source: XPO Logistics

We knew Brad’s track record.

And, we knew that everything he had built in his career – his reputation and the bulk of his net worth – it was all on the line with XPO. So, we stuck with it.



In September of last year, the stock hit $116.

That painful decline didn't seem so bad.

Profits had gone way up, XPO was winning new business and that "hated" Conway acquisition was seen as a home run. So, that was the Fall, I actually gave this presentation back then.

Today, the stock is around $60. It went as low as $40 in December.

The European economy has softened, XPO's growth has slowed a little, and investors are worried about the economic outlook. The stock is now priced as if conditions are going to get a whole lot worse.

On top of that, a short seller – someone who profits from a drop in the stock – released a very negative report on XPO in December.

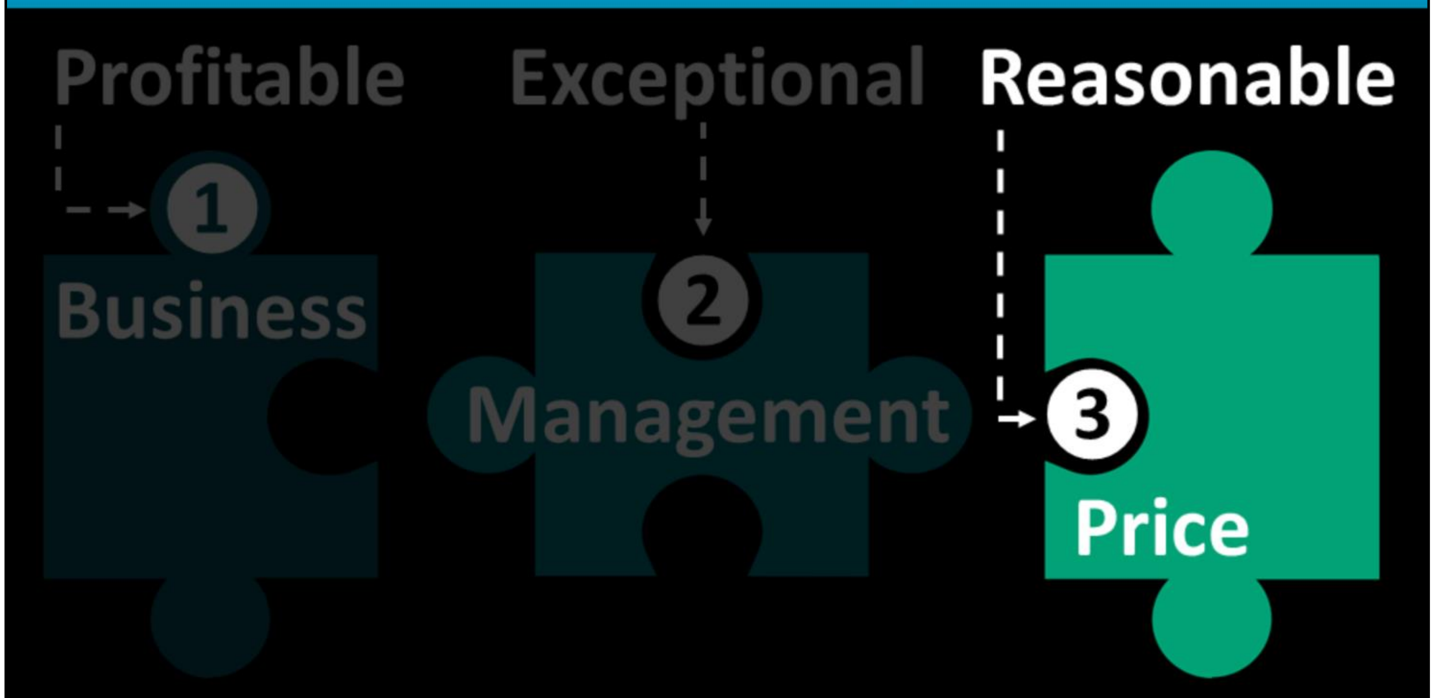
We spent a lot of time going through that report, in a lot of detail, and we held multiple calls with Brad to ask him questions. We ultimately found the report to be misleading, but it all came together to weigh on the stock.

Our view on XPO is unchanged. The long-term outlook remains bright.

XPO is still a good business – Brad Jacobs is still running it. He's as talented as ever. He still owns all his stocks and still wants to grow the business.

In fact, XPO is back on the hunt for acquisitions and if they can come anywhere close to replicating their past success, the stock can reach new highs.

We believe the lower price today just means the upside from here should be all the better.



That brings us to step 3 of our process – price.

There are two points I want to make on price.

One is if you find a truly great business run by excellent management, there's more flexibility on price. As long as the price you pay is reasonable, you should do well in the long run.

The second point – prices are cheapest when headlines are at their worst. When news is good, prices are more expensive.

That's a simple statement, but it makes investing really hard.

We all want to be comfortable, but sometimes the best returns come from names that don't feel very comfortable.

Any company at any time can feel uncomfortable.

You’d think Starbucks would be a solid holding. Customers line up every morning for their coffee.. You see their stores everywhere – there are 30,000 of them in the world. The stores are extremely profitable and there’s room to grow.

There has always been a lot to like about Starbucks. But in 2008, it was the most hated stock we owned.

Back in 2006, Starbucks' stock hit an all-time high of $20 a share.*

The store count was growing rapidly and everyone saw a lot more opportunity ahead. The P/E multiple – which measures how much you're paying for every dollar of profit was 45 times. That was 3 times higher than the average company. Starbucks was a very popular stock.

We didn't own it because we thought the price was too high.

** The share prices of Starbucks listed in the next few slides have been adjusted for stock splits.*

In 2007, we saw an opportunity.

The stock had come down to $13. The P/E multiple was cut in half and was close to its lowest level ever. The stock had come down because growth had slowed and profit margins were being hurt by higher dairy costs.

We began to work on Starbucks. We concluded that it still had a lot of potential and that the business was worth more than the current share price.

So, we recommended it. That call proved right...

… but it also proved early.

It turns out, the problems were deeper than we thought. Starbucks had grown a bit too quickly – unprofitable stores had opened and the customer experience had suffered.

Then, we had a financial crisis.

Who was a client in 2008?

It was a brutal time. U.S. house prices were falling, trust in the banking system was faltering and the stock market was in free fall.

The narrative around Starbucks was that a weak consumer would not pay $4 for a cup of coffee anymore.

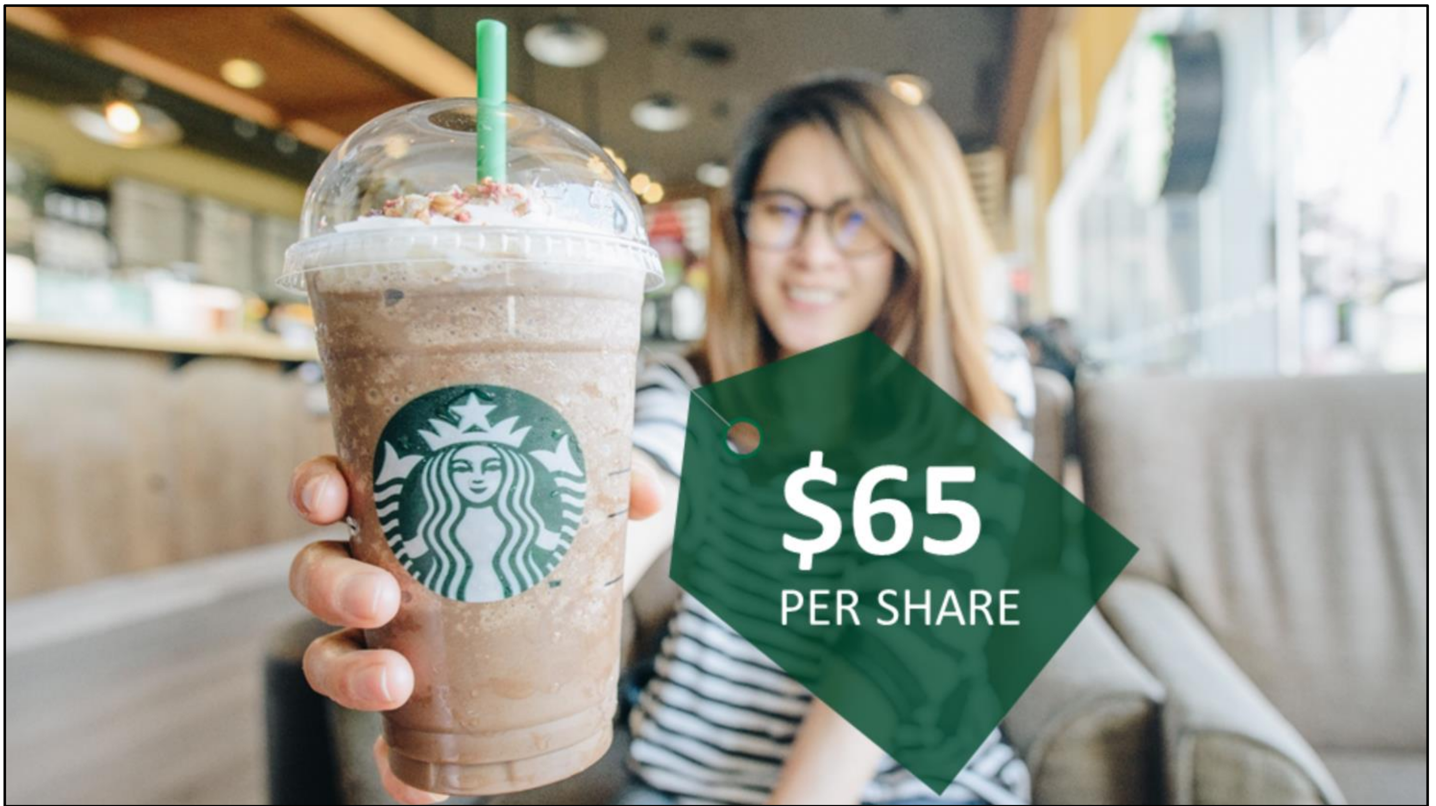
So, Starbucks – which was so desired in 2006 – was now despised.

The P/E multiple fell below 9 times and the share price hit a low of $3.50 in November of 2008.

The stock was down 75% from where we bought it a year earlier.

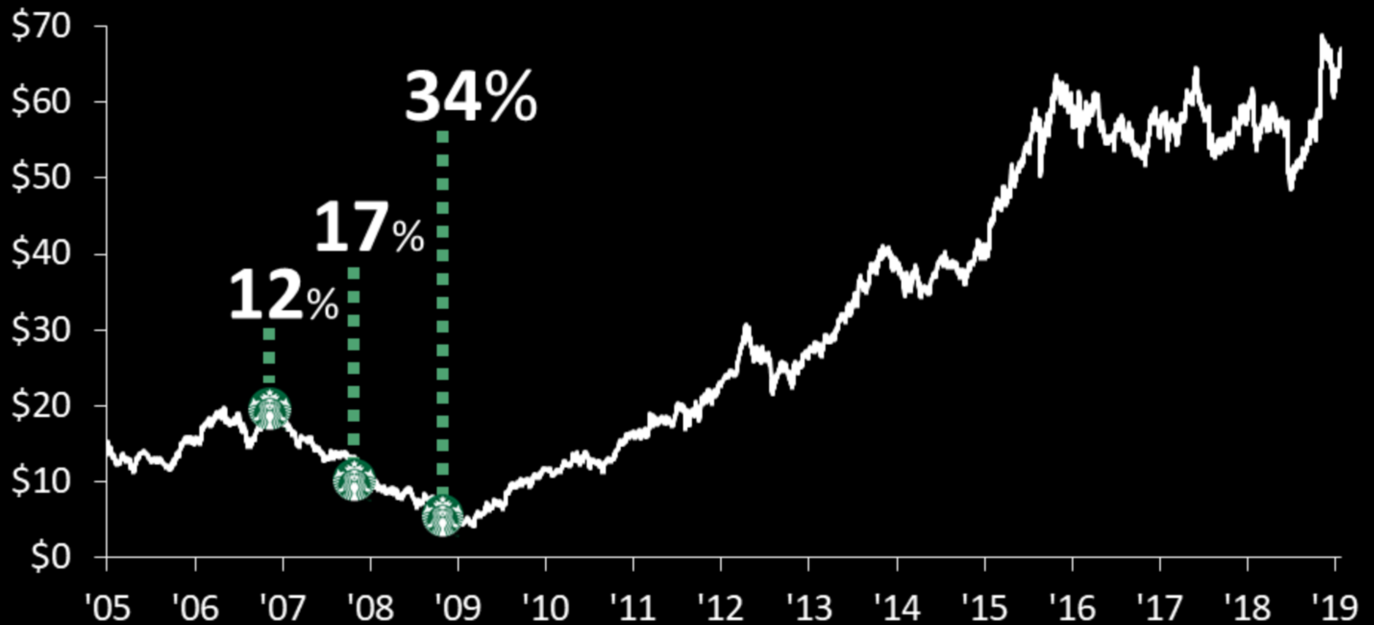
Starbucks had its problems and we could understand why the stock was down, but there was no way the value of Starbucks had fallen by 75% in one year.

At some point, the economy would turn. Drinking coffee was still a daily habit. Selling coffee was still a great business. Management was working to right the ship. And, the stock was cheap.



Today the valuation is reasonable and the stock is above $65.

Starbucks



What's interesting is that you would have made money on Starbucks where ever you had bought it.

If you had bought at the top in 2006 (your timing was terrible) but if you held on until today, the outcome was good. Despite a massive initial drop, the annualized return has been 12%.

If you find a terrific business with excellent management and a price that is not too excessive, time should ultimately be your friend.

To get a better return, you generally have to buy when news is bad.

If you had bought Starbucks at the bottom when the business was struggling, the economic outlook was bleak and no one wanted to own the stock, your annualized return would be 34%.

We first bought Starbucks between those extremes. Sentiment had turned negative, which gave us a good price. The annualized return since then has been almost 17%.

You may wonder, why did we buy Starbucks early? Why not just wait for the bottom?
Unfortunately, there's no way of knowing where the bottom is.

We evaluate businesses and management teams. Based on that, we try to figure out how much a company is worth.

Over time, the price and the value of the business should converge.

In the short run, value and price can differ – sometimes by a lot.

I believe we do a good job of valuing companies, but we cannot predict every bump in the road or every change in sentiment along the way. I don't think anyone can.

What we can do, is focus on a process that works.

We can own good businesses, run by great people at a reasonable price and that should tilt the odds firmly in your favour.

I believe in our method.

It may not be sexy, it’s a little like bowling that way too, but it works.

At the end of the day, that makes me comfortable and optimistic.

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