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Discussion Agenda

- Brief Overview of Saber's Investment Approach
- Two Key (Related) Points
- An Example
- Q&A/Open Discussion

Saber Firm Principles & Strategy

- **Firm Goals**
  - Above all else, focus on providing existing investors with a superior investment result on the capital they've already entrusted to us
  - Position my firm, my day-to-day workflow in a way that maximizes the chances of achieving our goal
  - Process-flow prioritizes "deep work", primary research, and patient decision-making
- **Investment Strategy**
  - Build a carefully selected portfolio of undervalued stocks of great businesses with predictable earning power and attractive future prospects

Saber Approach - 2 Buckets

"Every day you either get better or you get worse."

- Former Michigan football coach Bo Schembechler

There are two types of companies in the investable universe:

- Bucket A) Those that are growing their intrinsic value over time
- Bucket B) Those that are shrinking their intrinsic value over time

Money can be made in either bucket, but **I prefer to stick with Bucket A**.

Saber Approach - 2 Categories of Investments

Within "Bucket A" (the companies that are growing their value over time), there are two sub-categories:

- **Category 1:** "Compounders" - Growing Companies with a Long Runway
- **Category 2:** "Stalwarts" - Durable, Mature Companies at a Discount

Saber's investments typically fall into one of those two categories.

Category 1's are very rare but can produce large winners;

Category 2's yield lower profits but occur much more often.

Point #1 - Bargains in Plain Sight

- Even large-cap stocks can get mispriced

This means you can sometimes locate great value in stocks of very well-known and widely-followed companies

Even Large-caps Get Mispriced

Top 10 Largest Companies in S&P 500 (as of 6/24/2016)						
Company	**Ticker**	**Current Market Cap ($ billions)**	**52 Week Low**	**52 Week High**	**% Change (High/Low)**	**$ Change in Market Value ($ billions)**
Apple	AAPL	$511	89	133	49.4%	$239
Google	GOOG	$459	515	790	53.4%	$187
Microsoft	MSFT	$391	40	57	42.5%	$134
Exxon Mobil	XOM	$370	67	92	37.3%	$106
Amazon	AMZN	$330	426	731	71.6%	$145
Berkshire Hathaway	BRK-B	$326	124	148	19.4%	$60
Facebook	FB	$320	72	121	68.1%	$141
Johnson & Johnson	JNJ	$318	82	118	43.9%	$100
General Electric	GE	$274	19	32	68.4%	$117
AT&T	T	$255	31	42	35.5%	$69
	Average % Change High/Low				**48.9%**	
	Average $ Change in Market Value				**$130 billion**	

Why Do Well-Known Stocks Get Mispriced?

- First, it’s important to understand the various categories of “edge”
- **3 Possible “Edges”**
  1. Finding information others don’t have
  2. Thinking about the same information differently than most
  3. Having a time horizon longer than most
- Most investors focus on #1, despite being the most competitive
- Because of the increasing focus on #1, I believe #3 is a sustainable edge (and one that is growing in strength)

Why Time-Arbitrage is Sustainable

- **Information Overload**
  - Information has become easier to get and harder to ignore, encouraging action
- **Long Payoff Period**
  - Human nature encourages instant gratification
  - Gaining an information edge tends to pay off much more quickly
  - Operating with a time-horizon edge involves a very long-term payoff, with uneven results in the near term
- **Incentives**
  - Investment managers and corporate executives are motivated by job security
  - This prevents them from wanting to make decisions that could risk short-term underperformance (which is often necessary to produce long-term results)

Why Time-Arbitrage is Sustainable

“...the analyst interested in value is likely to place only minor emphasis upon the short-term earnings outlook; whereas the analyst who endeavors to anticipate the price movements of the near future will make such outlook his major concern.”

- Ben Graham, Security Analysis

- Despite the common rephrase of “long-term view”, I believe that far more time, energy, and resources are focused on “anticipating price movements of the near future”
- I believe this is true not only in the investment world generally, but even among the value investing crowd specifically

Time Arbitrage Example - Bank of America

- BAC began 2016 at $17; in a month it was $11 ($65 billion market value drop)
- BAC ended 2016 at $22; (a $120 billion change from the low)
- BAC ended 2017 at $29 (a $75 billion change in one year)
- This stock has seen a **$200 billion change in its quoted value in just 2 years**

- Why was the stock cheap in 2016?
  - Low oil prices
  - Recession fears

- Both were likely to impact the bank's 2016 earnings (and stock price)
- Neither were likely to impact the long-term earning power of the business

Summary of Why Large Caps Get Mispriced

- The market is filled with extremely capable and smart investors and analysts with virtually unlimited resources at their disposal
- But the vast majority of these smart people are spending their expansive skills and resources playing a different game
- So their short-term focus (and their buy/sell decisions) create gaps between current prices and long-term values at certain times
- This is the reason why **stocks of all sizes** can become mispriced at times
- I believe it's a sustainable edge, and one that is growing

Key Discussion Point #2 - Culture

- The value of a strong culture is often underappreciated

To demonstrate this, let's think about what it means to be a good business…

What is a Good Business?

- Think about this question from a small business owner's view…
- A good business is one that earns you a high rate of return on the money that you invested in the business
  - A $200,000 investment into a local restaurant that pays you $50,000/year
  - A real estate development project that cost $1 million and now earns $300,000/year
- An even better business is one that can reinvest cash at similar high returns
- How does a business maintain high ROIC?

Best Offense is a Great Defense

A business needs a way to fend off competitors (i.e. a moat). Common "moats":

- **Barriers to Entry** (Waste Management, Exxon Mobil)
- **Network Effects** (Facebook, CoStar, Priceline)
- **High Switching Costs** (SAP, IBM)
- **Brand Power** (Coke, Apple, Nike)
- **Distribution** (Walmart, Kraft, Gillette)
- **Economies of Scale** (Amazon, Costco)
- **Low-cost Producer** (Bank of America, GEICO)

The problem is that **some moats are no longer as durable as they once were**…

But Some Moats Are Eroding in Value

An example is distribution, which have deteriorated for large, profitable, incumbents:

- Costs of distribution have declined
- Companies can sell directly to the consumer much easier
- Products can scale faster
- Social media has leveled the playing field for smaller companies with no ad budget
- Consumers have many more choices now

Moats – This Time is Different

Examples of big incumbents that lived off of distribution advantages:

- Package food brands like Gillette, Heinz, and Kellogg that lived off shelf space
- Retailers like Foot Locker or Macy's who connected brands to consumers who can now easily find each other directly
- Cable networks like ESPN or Discovery that lived off the "bundle"

Most Important Moat

- I believe a management team is focused first and foremost on figuring out a way to consistently provide great value for its customers can be a durable competitive advantage

Why Does Culture Get "Mispriced"?

The reasons for why I think this can be a durable edge are the **same reasons** why large-cap, widely-followed stocks get mispriced:

- Everyone knows that providing value to customers is important, but actually doing this can cause short-term pain (it takes long-term investments, R&D, lower near-term profits and underperformance relative to peers, etc…)
- Very few companies have the structure for such long-term focus (both a patient ownership base and an aligned management team are required)
- **Because of these structural hurdles and near-term incentives that drive behavior, I believe that culture can't easily be copied by competitors**

The Opportunity Bezos Capitalized On

"The balance of power is shifting toward consumers and away from companies. The right way to respond to this if you are a company is to put the vast majority of your energy, attention and dollars into building a great product or service and put a smaller amount into shouting about it, marketing it."

- Jeff Bezos

This type of culture is widely acknowledged as being desirable (just like "long-term thinking" in investing), but yet it is very difficult for most companies to act this way.

Culture

- Amazon's Customer Focus
  - An endless appetite for "a jar of jam tomorrow, never today"
- Tencent's User Obsession - always very slow to monetize their platforms
- Markel's long-term focus on profitable underwriting
- Facebook - news feed changes that are great for long-term users despite possible revenue impact
- Fastenal's Low Cost Culture
  - Executives travel in vans vs. corporate jet, stay at motels, eat at McDonald's
  - Compare to GE (that used two private jets to fly its CEO)
- Apple's Great Products
  - "We can't compete with Apple. They're premium." - Amazon executive on Fire Phone team
- Taobao vs. Ebay in early 2000's in China
  - Entrepreneur vs. Corporate Management
  - "Free is not a business model" - Ebay press release; not long before succumbing to Taobao

Summary

- Both long-term time horizons and culture are widely respected attributes but rarely implemented
- Job security (incentives), an unwillingness to wait long for payoffs, and general human nature make it difficult for most people to make decisions that will create the most value long-term but could have negative short-term consequences
- This leads to two conclusions:
    - Stocks - regardless of how widely followed they are - can become mispriced at times
    - It is difficult/impossible to clone “culture”, which means that those companies that possess it have a competitive advantage

Brief Summary of a Current Example

- I believe JD.com (JD) is an example of a company that has:
    - An outstanding **culture**
    - Owner/operator with a very **long-term vision**
    - A religious-like focus on **customer value**:
        - Authentic products (a big deal in China)
        - Low prices
        - Fast delivery

JD Investment Thesis Summary

- Massive Market
- No Fakes
- Own the Logistics
- WeChat Partnership (My Thoughts on Tencent)
- Price/Volume Feedback Loop (Economies of Scale)
- Richard Liu - Founder/Operator
- Cheap (Possibly Very Cheap) Relative to Future Earning Power

Turtle Mental Model

- Every year on the North Carolina shoreline (among many other locales), turtles hatch in the sand and try to make it to the sea
- The vast majority of these turtles will unfortunately not survive
- Many don’t make it to the water; and the ones that do get eaten by fish
- However, for the few that survive, they grow a very durable shell that offers significant protection, making the turtle very difficult to kill
- Thus, once the turtle reaches a certain point, the odds of survival go from very low to very high

JD is the "Turtle"

- I believe JD.com is the turtle that survived

- It would have been a long-shot bet in the early years, as retail is a very tough business and JD was competing against larger competitors with much greater scale

  - *Note: if you happened to know Richard Liu, you may have recognized that JD was in fact a good bet, even in the early years*

- It faced very near death experiences at numerous times, but managed to survive

- It not only survived, but it built out a **logistics network that I believe is now its protective shell** (very difficult to recreate this), making it likely that JD remains a major player in Chinese ecommerce for years to come

JD Valuation

- $2.2 billion FCF; 29 P/FCF
- Reasonable price for a great business that is growing at 40% per year, earns high returns on incremental investments, and has a very long runway
- Despite owning the inventory and controlling the logistics, JD deploys just $4 billion in capital (even if we assume leases are capital assets)
- Working capital is a source of cash currently; I consider this is permanent capital if you believe that JD's business is both stable and profitable long-term
- JD's warehouse and delivery assets are increasingly being "rented" out to 3rd party sellers, which improves productivity and increases profit margins (similar to Amazon's model)

JD Long-term Potential (~10 years)

This is my view of JD's potential (shouldn't necessarily be considered a prediction):

- China GDP per capita is a fraction of its more developed Asian neighbors
- China retail is $5 trillion, will be $8 trillion in 10 years if it grows at half the current rate
- Ecommerce will be somewhere around ~⅓ of all retail ($3 trillion)
- JD GMV can be a big piece of that market (online retail is not fragmented like offline)
- I believe JD's business will be larger than Walmart's in the long run
- It will include high margin third party sales using JD's owned warehouse network
- $600 billion revenue; 3% margins (could rise further as 3P grows)
- 5-fold+ potential from the current prices ($64 billion market cap; $44 stock price)

Key Point to Consider

- Ecommerce businesses benefit from the classic **Price/Volume feedback loop** that large-scale retailers like Walmart and Costco made famous
- But ecommerce companies also benefit from another important advantage that offline retailers lack: a **network effect** that results in the largest ecommerce companies potentially grabbing much more market share than the comparable largest offline retailers (e.g. Amazon takes 50% of every new dollar spent online)
- Without the physical constraints of brick and mortar retailers and because of the unlimited "shelf space", I believe online retailers can take much greater share of the overall ecommerce market

JD Summary

- My overarching view is that **JD has carved out a durable position in China's retail market**, which has enormous growth potential as China continues to expand
- I believe JD's customer focus, its emphasis on authentic products, its logistics network, and its partnership with Tencent/WeChat are key reasons why it is likely to continue to be a major (top two) player in China's ecommerce market in the long run
- What was a very difficult business initially is now a much more predictable business

Disclosure:

My slides above on JD are only designed as a brief "food for thought" summary; not a comprehensive review of the business or an investment recommendation.

Please do your own research. Thank you!

John Huber and clients of Saber Capital Management own shares of the following stocks mentioned during this talk: Tencent Holdings (TCEHY), JD.com (JD), Verisign (VRSN), Apple (AAPL).

Questions/Comments?

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Thank You!