Marshfield Associates

Letter to Clients
February 2025

Idée Fixe

"Our faces are lies and our necks are the truth."

Nora Ephron

Can this company be fixed? That is the question we must wrestle with (nearly) every time we buy a new stock. Our discipline around price—that is, not buying a stock at anything other than a steep discount to what we calculate as its intrinsic value—pretty much guarantees this. While market (and individual stock) volatility can be random and entirely without any apparent basis, providing us with the occasional no-brainer pick-up, stock moves material enough to pique our interest are more often than not set in motion by some real event (or possibility thereof) that scares investors. Our hope is always that such fear is overstated and that our more dispassionate evaluation of the facts will give us an opportunity to exploit the overreaction. While the stock market is wicked quick about absorbing and reflecting new information, it is less on-the-money about what that information actually means about a company's current and future health. So how do we understand what's really going on, especially in the face of savvy corporate PR campaigns designed to reassure the investing public that any flaws are purely cosmetic? And what kinds of problems signify that trouble is breathing down the company's neck? The short answer to the first is that we do our diligence with our usual attention to separating signal from noise. The answer to the second is anything that signifies a fatal and lasting blow to a critical pillar of our investment thesis.

It thus falls to us to determine whether the market's discovery of a wrinkle in the company or its ecosystem reveals a defect that is real, material, and likely to be enduring or whether a little operational or strategic buffing will do the trick. And because we know that this scenario is one that repeats itself, it requires something more thoughtful than an ad hoc seat-of-the-pants response when the heat is on. As we've discussed at length in other newsletters, one of the ways we ensure consistency of both thought and process is by creating analytical tools that serve to guide us as we feel our way through a company analysis. We have our philosophical prerequisites nailed down pat: good company (competitive moat, strong and appropriate corporate culture, a resilient operating model, and a high-quality C-suite), good industry (a competitive ecosystem that allows for the generation and retention of economic rents), and forgiving entry price with a margin of safety. We know what clears the hurdles and what disqualifies a company in each of these categories. And as we've discussed over the years, while we may not always find perfection in each of those, we know what we're looking for and we understand what flaws within each category are deal-busters and what are tolerable imperfections ("tolerable" in the sense that they can be mitigated by other positive attributes).

The urgency of turning to mental models to investigate why a stock has tanked is enhanced if the stock is on our "shopping list" or we currently own a position in it, as we have already fully prepped and poked and prodded the investment with an eye toward buying it as soon as it drifts into range. The need to dig deeper with all deliberate speed is greater because we KNOW we want to own it…but are obliged by events to make sure we're not about to walk on a land mine if we take that

final step.[1] Indeed, depending on the outcome of our analysis, not only might we forego buying such a stock (or more of it, as the case may be), we would likely exit the position entirely were we to decide the new event undermines our investment thesis. If, on the other hand, we come anew to a company whose stock has fallen from grace, we're necessarily in less of a hurry, as we have the full process ahead of us, including but not exclusively an analysis of the defects that gave rise to the stock's price decline. Ever mindful of our mantra that we'd rather commit a sin of omission than one of commission, we conduct our usual deep dive into the company, no corners cut, though perhaps we (with due consideration rather than haste) accelerate the timeline for our phone calls, valuation, and checklists. In either case, though, our goal is essentially the same: figure out why the market is penalizing the shares and whether that should matter to us.

Whittled down to its essence, our overarching goal is to determine (1) the likelihood of what the market fears actually happening, (2) the materiality of such event to our investment thesis and theory of the company, and (3) the probability that the issue will be an enduring one. To accomplish this, we first separate the purported issue (to the extent we can identify it) into one or more conceptual buckets: random movements; investor misunderstandings of the fundamental business models and drivers; changes in the industry's competitive makeup; exogenous occurrences such as legislation or the economy, that are beyond the company's control; operational challenges; leadership failures; abandonment of the company's core value proposition; and cultural degradation. Keep in mind that there are sometimes several overlapping and intersecting issues that account for a decline in the price of a stock. This necessitates teasing those factors apart and evaluating each strand independently to achieve our overarching goal of determining the reality, the materiality, and the duration of the issue of (apparent) concern to the market.

C'est Rien

While, as noted above, the rebuttable presumption is that we will buy the stock at the price we came up with outside the heat of the moment, it remains incumbent upon us to make sure that nothing enduring and materially value-destroying is afoot. If a quick check reveals that there is no obvious substantive issue to blame except run-of-the-mill volatility (caused by anything from stock analysts' transitory pique to it being the day before a big holiday—or even more randomly, to Jim Cramer convincing his acolytes to kick the stock to the curb[2]), then our trading team is green-lighted to buy the name within the parameters already established, working their magic with our partner platforms to execute the trade as effectively as possible. This rarely happens, however, and it's typically on the heels of a broader set of amorphous concerns about the economy that trickle down to individual shares. We were able, for example, to buy attractively priced stock in

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[1] While we conduct our company analysis and valuations with a healthy cynicism and an awareness of what could happen along the lengthy axis of possible outcomes, we do not build a case based on a particular narrative unless it's supported by a pretty lengthy history that foretells it. That's why a margin of safety must exist for companies we actually go ahead and buy. But if we actually KNOW something significant has occurred, that's a different story. Also, while we resist incorporating "stories" that may or may not eventuate into our analysis, that does not mean that when something occurs that surprises the market, it by implication surprises us. We understood that one of the risks in owning Chipotle, for example, was a pathogenic outbreak in one or more of its restaurants. What we did not do was predict that one WOULD occur, nor that it would span geographies and involve three different pathogens. Having said that, once we were aware that one had happened and that, especially for a company trading on wholesomeness, it was a potentially material event (or series of them, in this case), we set to work to see whether this blemish was merely skin deep or a systemic problem. We paused our purchase in order to do further diligence, which we will discuss at greater length below.

[2] As happened to Cummins around the end of 2015, allowing us the delicious opportunity to buy more of it.

Union Pacific in the wake of (wave of hands) the financial crisis and what that might mean for the movement of goods—but even that explanation was pure conjecture on our part.[3]

Au Contraire

The opportunity to snap up inexpensive stocks has, perhaps, most often been provided to us by a thorough misunderstanding on the part of the market as to how a company actually makes its money. It usually doesn't take us long to figure this out, and hence our pause in ascertaining the issue and confirming that it's a big load of nothing is pretty short. **Progressive** provides an excellent example. During the pandemic, Progressive outperformed analyst expectations because of the rapid decline in car accidents as people stayed off the roads. As risk declined, rates had failed to drop as quickly because of the regulatory hurdles involved in rate changes for "personal lines" such as auto insurance. As a result, the company coined money and its stock price rose. Fast forward to the easing of COVID restrictions. When automobiles ventured back onto the streets, the result was more accidents than during the period of closure, both from increased volume as well as drivers' lack of practice. But by this time, rates had finally eased to reflect the earlier low-risk environment. As those rates no longer mirrored what was happening on the more chaotic post-pandemic streets, the opposite to what had happened before occurred: both the company's earnings and the stock price snapped back and then some. Our longtime admiration for the company's business model and discipline and our deep understanding of how insurance actually works led us to believe that Progressive would move swiftly to address the risk-rate mismatch. We barely hesitated before moving the company from shopping cart to checkout line.

Nouveau Riche

Changes in the competitive landscape can be quite meaningful, and when we sense a new competitor or business model has or is threatening to enter a space, we pay attention. But often, the bark of new entrants is worse than their bite, particularly if we selected our portfolio or shopping list company with an eye toward the possibility of new entry. Certainly, retail companies in numerous categories have been hammered by Amazon over time. Yet what the market failed to discern was that there exist discrete niches in the retail space where Amazon's strengths: scale, broad selection, and relative convenience were outweighed by other factors that mattered more to customers. It was abundantly clear to us in the case of each of them—the apparel retailers **TJX** and **Ross Stores**, the auto parts purveyors **AutoZone** and **O'Reilly**, and even the B-to-B fastener seller **Fastenal**—that Amazon and its ilk were relatively little threat.[4] In fact, that was a central pillar of our interest in them in the first place.

It was clear to us that investors concerned about Amazon's potential incursions into overstock apparel and smaller household goods misread the value proposition that TJX and Ross were offering. Both companies lure people to their brick-and-mortar stores with a treasure hunt atmosphere that rewards repeat visits and provides surprise "finds" not available elsewhere at the same price. Online retailers have yet to replicate an experience that offers a similar "frisson" of

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[3] We later sold Union Pacific based on a combination of price and our own strong belief that the future would be less attractive for it than the past, but that's a story for another time.

[4] Though we watch it like a hawk for signs that it's figured out how to deliver faster and more cheaply and how to enable its customer to search the vast array of product more efficiently and enjoyably.

discovery through the seamless bridging of shopping and entertainment. Moreover, web-based merchants charge additional fees to their customers, namely for delivery and returns, that their physical counterparts typically do not; because the individual "basket" of a shopper at TJX and Ross is too small to warrant free shipping if purchased online[5], the all-in cost of shopping virtually is amplified. Finally, a primary motivator for shopping for fashion in particular is the burst of endorphins at being able to rock your great 'fit at the neighborhood cookout that weekend. Good luck doing that with Amazon.

Time being of the essence underlies the auto parts retailers' mission as well. On the professional or DIFM ("do-it-for-me") side of the business, mechanics need to move vehicles out of their bays quickly (think minutes, not days) so they can take on new jobs. On the DIY side, if your wiper blades are shot or your battery needs to be replaced, you want each of these addressed right away, especially if you require your car to take you to your job; again, you cannot wait even the one or two days for a quick package delivery. And speaking of weather, harsh weather spurs sales at places like AutoZone and O'Reilly (unless conditions are so harsh it keeps people indoors); mild weather, on the other hand, tends to suppress sales. Thus, when the stock market punished those names for what we understood to be the natural vicissitudes of their business in the mistaken belief that Amazon was taking share, we pounced.

Fastenal's business mantra has always been staying close to its customers both physically and in terms of understanding their ongoing needs. Those in the manufacturing and construction industries need fasteners, safety equipment, maintenance materials, and the assorted odds and ends of their businesses NOW, if not yesterday. Fastenal has retooled its business over time to provide that service even more than in the past through such things as industrial vending and having an on-site presence for many larger accounts.[6] Waiting for a shipment of mission-critical odds and ends sourced from a catalogue is far less efficient than wiring Fastenal into your work flow.

In each of the above cases, we were able to buy shares at good prices because of a fundamental misconception on the part of other investors about the actual value these companies provide to their customers, value that online retailers were neither providing nor likely to be able to provide in the foreseeable future.

Force Majeure

Sometimes exogenous events sweep in seemingly out of nowhere and all a company can do is shrug its shoulders and make the best of its new operating environment—that's just life in the fast lane. Sometimes such events are slow-moving, like climate change, and a company is forced to adapt to it, either incrementally or in one fell swoop, pick your poison. Either way, it is incumbent upon us to determine what such an event might mean for the companies in which we're interested and for how long the external force is likely to endure. In the process, we analyze the competitive impact of the event, such as whether the circumstances in question affect all players in the industry or just a subset of them, what kinds of adaptations a company can make in response,

[5] This is both because Prime membership itself is above the financial grasp of many Ross and TJX shoppers and because retailers of overstock simply don't have sufficient margin to provide free delivery.

[6] One of the brilliant aspects of Fastenal's business design is that for its on-site operations, its employees are effectively embedded within a customer's business; they're able actually to notice when Fastenal could provide a part or group of parts more efficiently than the company is currently doing. Similarly, for industrial vending, it doesn't simply ship the gear and let the customer stock the machines. Fastenal's employees do it themselves, saving the customer valuable time and resources.

and what second- and third-order effects might result from both the event itself and adaptations to it.

We first bought **Strategic Education** at a moment when a series of stringent regulations were being applied to for-profit schools in the wake of a series of fraud investigations and allegations of pretty egregious impropriety. These regulations were considered existential threats by the stock market, which failed to distinguish among players in the industry on the assumption that all were equally inept and malign and, therefore, all were poorly positioned to meet the new numerical targets for such things as how much federal money they were taking in and how well their graduates did in the job market. A fairly rapid review of the situation turned up a more nuanced situation; Strayer, as it was then called, was coloring well within the new lines established by the Department of Education and was, we believed, being unfairly grouped with institutions that were exploiting their students and failing to turn out employable graduates. As it happened, while the company couldn't do anything with respect to the regs themselves, they were nevertheless able to distinguish themselves from their peers, actually gaining an advantage by having been operating consistent with the regulations in the first place. Even better, and over time, the company has worked hard to adapt its business model to procure much of its funding from partnerships with private sector employers, thereby limiting its reliance on government funding and making itself more resilient should future regulations tighten even further or Congress alter the student loan program altogether.

Another example of an exogenous event that caused stocks on our buy list to falter in price is the COVID pandemic. In March of 2020, the stock market fell precipitously. Fears of a protracted health emergency for which we were ill-prepared and which would shutter in-person business transactions for the foreseeable future hit different companies differently, based on the aggregated gut reactions of investors. While we understood that there could well be some short-term impacts on companies we liked, we also believed that, unless those companies had weak balance sheets and insufficient access to funding to tide them over, there would be little likelihood of any profound longer-term consequences.[7] As soon as the shut-down commenced, we sprang into action, calling as many of our companies as we could to get a quick read on what they were doing to meet the moment, how they intended to bolster their balance sheets if revenues were hit hard, and what kinds of contingency plans they had in case the pandemic persisted for a while.[8] We were particularly worried about our auto parts retailers, on the assumption that stay-at-home orders would hit them hardest. Our call with AutoZone was especially memorable. Far from being rattled, the company's head of Investor Relations anticipated relatively smooth sailing, as the company understood that used cars would be selling at a premium given the slowdown in new car production, and that those workers designated essential would still need to drive to their place of work. As it happened, not only was he correct, but the stay-at-home mandate gave hobbyists the leisure to work on their cars, thereby providing unanticipated fuel to a sleepier corner of their business.

Moody's is another useful example of a company hit hard by outside events. It was also one in which the company, following our purchase of it, took a long time to shake off the negative sentiment surrounding it, but our conviction in our analysis was strong—and ultimately borne out. In the wake of the great financial crisis, fingers were rightfully pointed at (among other industries) the ratings agencies, which had blessed certain risky securities with unrealistically high

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[7] It certainly helped that we are not in the habit of investing in companies with excessive debt in the ordinary course of our business.

[8] Of course, we were assuming that the pandemic would in time be addressed through science and medical interventions that would either moderate the impact of the disease or inoculate the population against its worst effects. As it happened, the interventions were more effective than we had assumed.

investment ratings. The sloppiness of companies like Standard & Poor's and Fitch and their embrace of what Ray McDaniel, Moody's CEO at the time, called "poor email hygiene" invited the scrutiny of legislators and regulators, who looked to curtail the traditional "issuer pays" ratings system in favor of something they believed would be less corruptible. Changes such as "investor pays" or randomized assignments would have made it difficult if not impossible for a company like Moody's to maintain its exceedingly attractive margins and its preeminent role in the ratings ecosystem. But we understood both the need for ratings providers to ensure liquidity and faith in the securities markets as well as the fact that the courts have long considered ratings to be "opinions" and thus protected by the First Amendment. We believed that the eventuation of any massively disabling change to the system, though material if it were to transpire, was actually quite slim. It was also clear to us that, as in the case of most such crises, the furor would die down eventually, likely leaving little actual change in its wake. Knowing that Moody's was the class act of the group, we felt comfortable buying the stock at an excellent price, notwithstanding the market's panic.

Note that that these same events—increased regulation of for-profit colleges and universities, the pandemic, and the great recession—actually put some companies without sufficient resilience or thoughtful management out of business or led to challenges from which some are still recovering. Just as climate change has and will continue to have consequences for the coal industry and such events as the California wildfires will likely have a meaningful impact on certain property casualty insurers that sought growth in premiums without taking risk sufficiently into consideration, exogenous circumstances can be every bit as damaging as endogenous ones. In fact, because they eventuate outside the company itself, companies can be less able to address them through the usual mechanisms of working harder and better. What we look for in evaluating the impact of external shocks is, therefore, not just the longevity of those tremors but the ways in which individual companies we hold (or would like to hold) are poised to withstand and/or address them through the levers that they do control.

Enfant Terrible

Sometimes the market vilifies a CEO, either a newly installed one or one whose longer tenure has worn thin with investors. While there's typically an attempt by a company and its board of directors to apply lipstick to the leader's image, we try hard to look past cosmetics to see where the truth actually lies and whether any deficit in leadership signals a worrisome (and lasting) development for the company going forward, even if the price looks appealing today. Our first step is to consider how important the CEO is to the organization; some organizations rely less on the CEO than others—or, put another way, it's more difficult for the CEO to mess things up. Businesses whose industry structure supports oligopolistic behavior, like Moody's and Visa and Mastercard, tend to have less sensitivity to routine management changes simply because their day-to-day businesses are so good. Being embedded in a largely unchanging business (yes, payments is a rapidly evolving industry in many ways, but not with respect to the actual rails on which it operates, which are overwhelmingly operated by Visa and Mastercard) means that a new CEO is less likely to upset the apple cart. Sometimes, though, the CEO plays an important enough strategic and operational role that he or she can become a wrecking ball, going beyond cosmetic surgery to dismantle and change what makes the company great. That can be both challenging to distinguish in the midst of incremental change and a signal that the company is no longer an attractive investment.

Our decision to invest in **Disney** was made in the midst of a crisis of confidence in the company brought on, in part, by disruptions across the entertainment industry and in part by new CEO Bob Chapek's ham-handed attempt to centralize power within a company famed for its independent creative silos. His fecklessness in handling Florida's attacks on the LGBTQ community provoked outrage among both employees and other stakeholders, and his clumsy about-face furthered the impression of haplessness at the storied company. In our experience, however, even a tone-deaf CEO cannot destroy a company whose culture stands strong in the face of internal attack. In the case of Disney, the culture fought back—and eventually won. Based on the level of internal dissent in the face of Chapek's more notorious missteps, along with the company's continuing strength in intellectual property, streaming strategy, theme park success, and box office capabilities, we wagered that, even saddled with slipshod management, the company would continue to thrive and likely be among the handful of existing entertainment titans that would maintain a foothold in the new media landscape. While we were prepared to mash the buy button with Chapek still at the helm, notwithstanding our belief that he was not the ideal CEO for the company, the Board of Directors intervened to reinstate the other Bob—Iger, that is—to get the mouse moving in the right direction again. We await the outcome of the current search for a new successor to Iger, with what we believe to be a more capable board working hard to identify the right fit.

There are also times when a languishing stock price is less explicitly tied to a new CEO but, looking backwards, can be seen as a reflection of a clear series of poor leadership decisions by him or her. Our attraction to TJX has spanned decades. We first owned it in the late 90s and early aughts in the waning days of the reign of its longtime CEO, Ben Cammarata. While the industry TJX inhabits is a resilient one—people love a bargain, and different demographics feed its consumer base during different economies, with the company able to surf on top of trends rather than predict them in advance—it still requires skill and judgment on the part of its buyers to be able to provide the value its shoppers are looking for. A combination of aggressiveness (in buying languishing overstock that has real potential) and restraint (in foregoing "bargains" that customers will continue to eschew) is something of an art. Cammarata's successor, Ted English, proved himself (despite substantial industry experience at Filene's Basement) to be an almost cartoonishly lousy practitioner of that art. There is intriguingly little to find on the internet today about English (we tried!), who ran the company until 2005, having embarked on a buying spree that included one gem, HomeGoods, and a few resounding duds, A.J. Wright and Bob's Sports. He threatened to dilute the merchant culture that was essentially the difference between a thriving overstock company and…a Filene's Basement[9]. We sold the stock, understanding that without a leader who deeply understood the underlying value proposition that mattered to its customer, it was not something we wanted to own, even if it got cheap again. The company must have understood that as well; in 2005, the Board chose Carol Meyrowitz, who had run the critical Marmaxx Group, to lead the organization. Meyrowitz, who earned her spurs on 7th Avenue and who was a born merchant, left the position in 2016 but remains Chairman. She passed the leadership baton to the eminently capable Ernie Hermann, the current CEO. Today, you see a company in good hands, with strong organic growth and a strict adherence to the dictates of its consumer mandate: to sell well-priced product in-season in an appealing treasure-hunt setting. When given the opportunity to jump back into the investment with superior leadership at the helm, we knew what to do.

[9]Which eventually went out of business, as did an astonishing number of other marquee players in the industry, Loehmann's and Syms among them, giving credence to the idea that the overstock business may seem simple, but it's far from easy.

Raison D’être

Sometimes a company flounders (along with its stock price) because it abandons the core value proposition that animated its founding. Certainly, a company needs to adapt to new times and change as its consumer does. But what we see all too often is a company that loses sight of who its core customer is and what value that customer is expecting the company to provide. We’ve struggled, for example, to like Starbucks, which has been knocked around over the years despite its prominence as the coffee utility par excellence (or par mediocre, depending on whom you ask). Howard Schultz envisioned his creation as the “third place”, neither home nor office, but a cafe where someone could feel comfortable and welcome to linger alone or with friends over European-style coffee. Its success begat both imitators and rapid growth—as well as ambitions that extended well beyond its tried-and-true formula of providing a welcoming place to hang and sip your grande iced latte. It pivoted hard to take-out and drive-through, while at the same time introducing a multitude of new flavored drinks and food (which is, at best, tolerable). Along the way, some of its baristas were slammed for engaging in racial profiling and the operational finesse it had generally demonstrated since its inception began to fray. In the course of all this—and through the reappearance of Schultz and his subsequent re-departure to focus on olive oil[10]—it has seemed to lose sight of its mission in favor of pursuing a McDonald’s-like approach to growth, expansion, and mass market appeal. Can the company be fixed? We think it could, in theory—but only if it returns to its roots in a convincing way and offers something closer to the kind of value that it started with. Attempting to be all things to all people and projecting an image in fact antithetical to its origins will not, in our view, get them there. But it’s unclear to us that it understands the need to pivot back to its origins, even with its new CEO in command (Brian Niccol, formerly of Chipotle), especially as investors tend not to be in favor of demi ambitions replacing grande ones. So far, we’ve given it a pass.

Another company that has flirted time and again with a spot on our shopping list is Target. Some of you might recall a pair of newsletters we wrote some years ago about retail businesses. Essentially, we concluded that a successful retailer must stake a claim to either an editorial business model, where customers pay you for a high-quality pared-down selection, or a low-price model. Convenience adds a third node that can support the other two or sometimes stand on its own. Target found its retail niche some twenty years ago when it started attracting a well-heeled crowd looking for decently-priced household items with a “curated” spin. If you shopped at Target for clothing, you might be able to snag a high-style denim mini-dress by Alexander McQueen (in partnership with the store) or if housewares were your thing, a set of sheets designed by Marimekko, the Finnish design powerhouse. While not fully an “editorial” company and neither the lowest cost nor most convenient player, it embraced a straddling strategy that, while raising questions about sustainability in our mind, seemed to work (for a while at least). Alas, the most recent blockbuster design collaboration was nearly ten years ago. And while Target continues to be fine for the everyday necessities—cosmetics, bedding, detergent, and so on—it lost its halo when it no longer tried to be one of the cool kids. Whether it was loss of focus, belt-tightening (partnering with Philippe Starck might cost you), or a lack of understanding of what set it apart, it abandoned its value proposition and became just another retailer in the middle competing with the likes of Amazon (which wins on the convenience node) and Walmart (which wins on price). When the stock price flirted with relative lows, we looked again, but ultimately shrugged.

[10] Don’t get us started.

Faux Pas

Operational snafu, thy name is Chipotle. As alluded to above, the company suffered a devastating series of foodborne illness incidents in 2015. An honor roll of pathogens: E. coli, norovirus, and salmonella all conspired to sicken customers in locations across the country. This was a company that we had long looked to own, notwithstanding the fact that, as long-time investors in the fast food industry, we were well acquainted with the risks of making people sick. What we had not encountered until that point was the extent of the issue; rather than being isolated to a single restaurant, the problem was one that implicated operations across the system. While Steve Ells, the culinary professional who founded the chain, had been extolling the virtues of local food preparation with fresh ingredients and been promoting the idea of employee empowerment, his company was failing to put into place policies to safeguard actual customer health. Allowing food to be maintained at unsafe temperatures and letting employees who were sick or recently ill to come to work were among the more colorful violations of public health standards. While scores of people got sick, thankfully, none died. As soon as our trading team first alerted us that the price was in range, our Research group called for a pause pending further investigation; we needed to get to the bottom of the problem before landing what was, for us, one of the great white whales that we'd been hunting for years. One of the first things we did was something that we rarely do: we called in outside counsel, an expert in food safety and a former official at the FDA, to determine whether (and to what extent) there might be liability on the part of the company for allowing such conditions to occur, either through their own inaction or that of their vendors. We were reassured that material financial consequences from legal and regulatory exposure were unlikely. We also studied the company's plans to address the issues, first announced by Ells on *Today* in early December of 2015 as part of an apology campaign—whether cynical or earnest, it was difficult to tell at the time. But we ran those safety adaptations, which far exceeded industry standards at the time, past people in the industry who were familiar with the sorts of things that needed to be done. Paid sick leave, off-site food prep for certain things that could be refrigerated, stored, and then reheated, and third-party audits, on-site inspections, and microbial testing were all on the menu and described in detail. Our industry contacts were impressed, deeming the proposed changes both appropriate and unlikely to be mere window dressing.

But we were still left with the question of what Chipotle's core customer base would think of the company now that its health lapses were clear and all the full-bore marketing of healthy food, real ingredients, and, almost laughably, "food with integrity" looked specious. Could it transcend a problem that struck at the heart of its business model? This is where long experience with the industry and a deep understanding of another of Chipotle's strengths—marketing—helped us. While we understood there was a possibility that their customers would flee for good, we also knew that fast food restaurants had survived more egregious violations and that a gradual return to old eating patterns was far more likely than permanent disavowal by the hordes of hungry young people who practically existed on its food.[11] We were unwilling to count the company out once it acknowledged its failures and specified a full-bodied prescription to address them; we understood that central to Chipotle's success over the years were its ad campaigns and ability to address a subject forthrightly in a way that spoke persuasively to its target audience. We bought the stock and continued to do so for some time as the market persisted in punishing it notwithstanding its visible commitment to operational improvement.[12]

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[11] Jack-in-the-Box is still around, having caused the death of four children and badly sickened hundreds of people in 1993.

[12] Sadly, we no longer own it because its share price rocketed through our hold range and has not yet come back to earth.

Cri de Coeur

Similar to a failure to preserve and protect the core value proposition is the failure to protect a defining corporate culture, which we think of as the beating heart of an organization. A degradation in culture, of course, can encompass a multitude of sins, like cutting into muscle while trying to eliminate costs, watering down employee benefits and qualifications or, as in the case of Wells Fargo, a misalignment of incentives leading to scamming the customer into opening unnecessary new accounts. Cultural degradation can occur swiftly or incrementally, but it always matters. More often than not, though, by the time the market catches wind of the consequences, the damage has been done.

Cultural erosion is often the result of an agglomeration of many of the issues we've highlighted above. Boeing, the poster child for Everything Everywhere All at Once, is a great example. The aerospace company's problems span operational missteps, C-suite dysfunction, and abandonment of core customer value. Were it simply a question of misplaced resources, faulty one-off decision-making, or one bad CEO, it might be an interesting opportunity.[13] We've whacked at this piñata before in our newsletters, but as we really try to stay open-minded, we spoke about it again at a recent Research meeting. As you likely already know, two of Boeing's MAX narrow-body airplanes crashed in 2018 and 2019, leaving no survivors. A number of defects known to the company but which it failed to address were found to have been responsible. Once characterized by a culture of excellence in engineering, in the late 90s and early aughts under former CEO Philip Condit, it started to embrace instead one of financial engineering, all to the detriment of passenger safety. An admirer of Jack Welch, Condit moved Boeing's headquarters from Seattle to Chicago in order to gain a measly $60 million in state and local tax credits over 20 years.[14] It also spun off Spirit AeroSystems in order to realize lower procurement costs (and perhaps it did, as Spirit, too, lost its commitment to quality over time in an effort to better "serve" its primary customer…Boeing). Unlike Chipotle, which acted swiftly both rhetorically and operationally to address its failures, Boeing tried to dismiss concerns about the harm it had caused, ludicrously arguing in a 2023 court filing that the victims of Ethiopian Airlines Flight 302, the 2019 crash, could not have endured "pain and suffering" because the crash occurred at the "speed of sound". While today the company touts the collaboration of global regulators in allowing the airplane "to return safely to service", there is no solid evidence that the company has either the will or capacity to return to its cultural roots and to once again prize engineering prowess and safe skies over financial metrics. Yet again, we're giving this "bargain" a pass.

Yum! Brands, which emerged from ownership by Pepsi in the late 90s as under-loved and debt-laden, made its mark in due time as a juggernaut in the Chinese dine-out market and as a thoughtful global brand manager of KFC, Taco Bell, and Pizza Hut. We kept the stock when it was spun off (we were owners of Pepsi at the time) and indeed bought more of it. We, correctly as it happens, understood that the company would find its footing as an independent company so long as it understood its mission of being true to the history of its brands and executing well, two things that the then-Board Chairman of the new company assured us were front and center for the team. As a stand-alone company, Yum! was able to hire well, install vigorous operational leadership, and perform with admirable precision in a variety of geographic markets and different kinds of economies. It focused on the small but mighty things, like ensuring that workers had two uniforms, so they could come to work in a clean one without having to stay up all night doing laundry. We continued to be supportive of the investment when it divested itself of its China

[13] Emphasis on "might be". Competing against a state-owned competitor such as Airbus is structurally problematic.
[14] Bill George, Harvard Business School, January 24, 2024

business (whose shares we sold on the spinoff, as we did not want to hold a company exclusively doing business in China), which had represented an astoundingly large share of its earnings.[15] While we sold the China piece, we retained our shares in Yum! because its operating metrics and ethic were second to none. And it still made very good money. The company remained a global QSR juggernaut, with substantial room to grow its geographies. That is, until the Board of Directors saw fit to provide a facelift that involved installing a financially-focused CEO instead of the kind of blocking-and-tackling booster-style leader the company had relied on in the past.[16] Not only did we sell the stock, but we removed it from our shopping list altogether. Distancing itself from its core culture of operational excellence in favor of sterile financial metrics was a step too far for us.

Trompe L'oeil

Companies play tricks on investors all the time: what is visible on the face of things may not be real and what is real may not be visible to even the most discerning of inquiring eyes. The stock market often has trouble distinguishing between façade and reality, which is precisely what, under the right circumstances and with the right company, can provide us with a buying opportunity. It's also what can trip us up if we simply assume that the market is overreacting. That's why understanding the salience of a development, whether from within a company or external to it, that causes the share price to soften is a critical step in our process, even if—and perhaps especially when—we're ready to pounce on a pre-vetted name. Markets spook easily, though it can be difficult to remember that during times like today when all news absorbed by investors seems to take on the burnished glow of success. But when a company (or market) loses its sheen, as can happen swiftly in response to any number of things, we need to look past its face to its neck. A company with a resilient business model and crack management team, a supportive culture and an enduring value proposition can often suffer the slings and arrows of a bad CEO, operational glitches, and new competition that others cannot. But even good companies are at risk of faltering if the core of the company is under assault. When the value proposition of a business is undercut, if the culture that undergirds it rots, or if the fundamental reason for its existence is abandoned, a cheap price probably can't compensate for a neck that's been exposed to the forces of gravity. And in most such cases, it takes more than a nip and a tuck to straighten it out.

Marshfield Associates

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[15] Activist pressure from a hedge fund, along with fear on the part of the company that it had less control over operations in China than it would like (which had resulted in some food safety scares and marketing missteps) prompted this change.

[16] At every company meeting—including those for investors that we attended—they used to have the whole room (or auditorium) belt out the "Yum! Cheer". There's something about participating in an explosion of company pride led by Muhammad Ali that a CPA simply can't replicate.