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***I very frequently get the question: 'What's going to change in the next 10 years?' And that is a very interesting question; it's a very common one. I almost never get the question: 'What's not going to change in the next 10 years?' And I submit to you that that second question is actually the more important of the two — because you can build a business strategy around the things that are stable in time.***

\- Jeff Bezos

Several years ago, I was on a flight to Chicago when the captain came on the intercom and warned us that we were about to encounter severe weather and that we should expect turbulence on our approach into Midway. It had been a perfectly smooth flight up until then but, sure enough, in a matter of minutes the entire plane began to shudder and shake as we rocked from side to side. Some passengers gripped their armrests while others clung to laptops and other personal belongings. The man sitting next to me was wearing a pilot's uniform. Seeking to confirm we had nothing to worry about, I turned to him and said something like: "I imagine with today's technology the autopilot makes landing, even in these conditions, pretty much automatic." As he replied, his expression intensified and his eyes locked on to mine: "Actually, in these conditions the pilot has to take over. Crosswind gusts are very dangerous and the autopilot can't handle them. Landing in these situations requires courage and judgement." That was not the answer I was looking for.

As the plane descended it felt like we were whitewater rafting. A bathroom door popped open and started swinging back and forth, hitting the wall and then slamming shut again and again—bang, bang, bang. A couple of oxygen masks fell out of the ceiling and started bouncing up and down. A small child a few rows behind me started crying, then screaming. The threatening situation led me to think about how precious life is and how, if I made it through this, I would not take so many things for granted.

Today, as I think about the current investment environment and the smooth ride we had in 2017, I cannot help but think about how suddenly that pleasant flight to Chicago turned turbulent. Market conditions, like the weather, can change quickly. I am increasingly concerned that the boom in exchange-traded funds (ETFs) has led a large number of investors to neglect company-specific due diligence and put stock selection on a type of autopilot. This could prove dangerous should we encounter market turbulence. I believe the more you know about what you own, the better able you are to act with courage and good judgment.

When investing in businesses, we think evaluating management is an important part of getting to know what you own. This letter focuses on how we go about choosing *who* to invest with—our approach to evaluating the management of public companies—and why we think it is more important now than ever.

In commercial air travel you do not get to pick your pilot. Thankfully, industry standards are high and incidents of pilot error are quite low. Errors made by management of public companies, on the other hand, are much more frequent and can be very costly. It is almost a given that CEOs nowadays are going to make a lot of money for themselves; whether or not they will create value for shareholders is far less certain. I believe that in business, as well as in life, people make the difference between success and failure when it matters most. Unfortunately, it took the worst investment experience of my career for me to fully learn this lesson.

I personally owned shares, along with family members and clients, in what for generations had been a conservatively-run Midwestern bank. That changed when an aggressive CEO expanded into new hot areas, presumably in an effort to impress Wall Street. He went on an acquisition spree, paying up to buy banks outside of the core Midwest franchise. He exited the bank's stable but low-growth processing business, choosing instead to expand into subprime mortgage lending with its promise of faster growth and higher margins. When the financial crisis hit, the bank found itself loaded with risky loans, suddenly in such dire condition it did not qualify for a critical federal assistance program. After a desperate but fruitless search for capital, management was left with no option but to sell out to a rival bank for pennies on the dollar. A bank that had survived the civil war and the great depression collapsed in a matter of months.

It was one of the most miserable experiences of my life. Losing money is painful, losing money for others is even worse. In talking with a client about the loss at the time, he responded kindly, saying it was "okay" and then added: "Do not let it happen again." His words echo in my mind to this day. This experience is a big part of why we invest so much time and energy looking for business leaders that we can trust to make good decisions, especially in times of great change. While there is no easy formula, we work to find top management with the following attributes:

> ***Meaningful equity stakes in the companies they lead.*** In our observation, the old saying "you get what you pay for" does not necessarily apply to CEOs. In fact, we think large CEO compensation packages can be a red flag. Clearly, financial incentives play an important role in decision making and behavior. Substantial stock ownership, in our experience, more effectively aligns management's interests with long-term stakeholders than cash, options or other perks. It came as no surprise to us when a recent Harvard study concluded that a strategy based on managerial stock ownership produced "abnormally high returns" when compared to market indices.[1]
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> ***Experienced, humble and customer focused.*** I realize those are really three things, but we group them as one because they typically come together. Jim Collins, in his classic business book *Good to Great*, noted that "two thirds of the comparison companies [the non-great companies in his study] had leaders with gargantuan personal egos that contributed to the demise or continued mediocrity of the company."[2] In his study of high-performing companies, Collins found that 10 out of 11 CEOs came from within while underperforming companies were six times more likely to have recruited outside CEOs. His conclusion: "Larger than life celebrity CEOs riding in from the outside are negatively correlated with going from good to great." We look for CEOs that know their businesses from the ground up and have a laser-like focus on winning at the customer level. We want our companies to be run by management who understand that happy, highly motivated employees tend to create happy customers, which tend to create happy shareholders. It may seem paradoxical, but in our

experience great financial results are far more likely to come from focusing on improving customer satisfaction than from attempts to boost financial metrics.

***Effective capital allocation.*** While a great deal of attention is given to the amount of money a company makes, the critical issue of how earnings are redeployed is often overlooked. Basically, CEOs have five options to consider when allocating capital: 1) expand existing operations; 2) acquire other businesses; 3) repurchase stock; 4) distribute dividends; or 5) pay down debt. Over the long term, returns for shareholders depend greatly on how the CEO chooses to invest across these options. William Thorndike's *The Outsiders*, a book focused on CEOs who generated exceptional returns for shareholders, identified effective capital allocation as the critical driver behind outsized returns.[3] While effective reinvestment of profits can lead to extraordinary long-term results, mismanagement of the company's financial resources can lead to disaster. In our experience, reinvestment in core business growth opportunities offers the highest likelihood of compounding at high rates. We look for CEOs that are capitalizing on investment opportunities where the company has a competitive advantage. For mature companies we prefer dividends over acquisitions of businesses outside the core, a practice Peter Lynch dubbed "diworsification" in his best-selling book, *One Up on Wall Street*.[4]

While these ideas are relatively straightforward, we find that fewer and fewer investors perform this level of due diligence. Years of benign market conditions have made this type of analysis seem unnecessary to many. This is partly because today passive index strategies dominate the investment landscape. More money is being invested on automatic pilot, if you will, than at any time in history, and these capital flows are driving security prices more than ever before. With so much money being invested without company-level due diligence, we believe that individual company analysis will prove to be even more valuable—and the people factor even more critical—over the next few years.

Looking back on our investment activity during 2017, we reduced investments in a retailer, an equipment rental company, a medical supplier and a medical device maker. While the decisions to trim exposure to these businesses were company-specific, they all involved concerns regarding CEO capital allocation decisions. We believe we were also able to take advantage of favorable market prices. We initiated new investments in an internet search company, a grocery chain, a learning management software company and a cable company. Each is led by management with large equity stakes who, based on our due diligence, know their respective businesses from the bottom up, have built customer-focused cultures and have a track record of effective capital allocation.

Markets and economies go through cycles and we believe it is important to refrain from getting too excited and aggressive after major market advances, just as it is important not to panic and get too defensive after major market declines. As the market has been making new highs, we have been increasing our allocation to treasury bills, building reserves that may prove useful should the investment environment turn more challenging. We view building portfolios much like building a home. They should be built with high winds and torrential downpours in mind. We do not predict adverse conditions so much as we prepare for them.

I will close with another commercial air travel story. Back in July, I was booked on a flight to O'Hare that finally took off after a three-hour delay due to severe weather conditions in Chicago. I am sure you have all "been there," so to speak. Not long after take-off, the captain informed us that air traffic was backed up into O'Hare and that our landing would be delayed. He did a good job keeping us informed as we circled south of Chicago waiting for permission to land. Over an hour into our scheduled 45-minute flight, the captain announced that our plane did not have sufficient fuel reserves to continue our holding pattern without assurance from O'Hare that they would have a runway for us soon. As a result, he was making the decision to return to Louisville while we still had enough fuel to make it back safely. This announcement sparked a near mutiny by a group of young men in the rows ahead of me who had been ordering drink after drink for the last hour.

When we finally landed back in Louisville, the captain stepped out of the cockpit and stood by the exit apologizing to passengers for the inconvenience as they left the plane. A few of the young men ahead of me muttered insulting comments as they passed the pilot: a sarcastic “nice job” and a “thanks for nothing.” Not to his face, mind you, but loudly enough for him to hear. An elderly gentleman in front of me followed behind the rude young men. He paused before exiting the plane and reached out to shake the pilot’s hand while cheerfully saying: “Thank you, young man; I appreciate your good judgment. Better safe than sorry as they say.” The captain smiled and nodded in appreciation. While I was not happy about the situation, I admired the elderly gentleman’s point of view and respected the pilot’s decision. Letting reserves get too low is risky.

Our focus is on building portfolios that help clients get where they want to go. We are grateful for the market tailwind that helped us move ahead faster and more smoothly in 2017 than we expected going into the year. While we hope the favorable environment continues, we are also keenly aware that conditions can change without warning. Very few things stay the same. One of the few constants in life and investing is that people make a critical difference.

We appreciate the trust and confidence you have placed in us and wish each of you a happy, healthy and prosperous 2018.

Phil McCauley III
January 2018

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[3] Thorndike, Jr., William N., The Outsiders (Boston, Massachusetts: Harvard Business School Publishing, 2012)
[4] Lynch, Peter with Rothchild, John, One Up on Wall Street (New York, NY: Simon & Schuster, 1989)



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