Dorsey Asset Management
Global Moat Strategy

Investor Presentation

Global Moat Strategy

- Concentrated all-cap
- 10-15 positions
- Investing globally in businesses with economic moats & talented managers
- Separate account or partnership structure
- $5 million minimum investment
- 1.0% asset-based fee

The Company: Dorsey Asset Management

- Independent RIA
- Majority owned by Pat Dorsey
- Focused on a single strategy
- Targeting long-term institutional investors
- Committed to capping assets to maintain performance
- $78 million in assets under management

The Strategy: Global Moat

- Invest globally in businesses with economic moats and compounding potential.
- Partner with talented capital allocators.
- Maximize margin of safety, minimize opportunity cost.
- Concentrate in 10-15 stocks.
- Minimize turnover to magnify power of compounding.

The People

- Pat Dorsey, CFA
  - Founder and majority owner
  - BA, Wesleyan University; MA, Northwestern
  - Former Director of Equity Research at Morningstar: Created investment philosophy, built team from 20 to 100 analysts, developed institutional research platform.
  - Author of *The Five Rules for Successful Stock Investing* and *The Little Book that Builds Wealth*. Contributor to *The Valuation Handbook* and to *Investments: Principles of Portfolio and Equity Analysis*
  - Frequent public speaker and media guest

The People

- Research Analysts:
  - John DeMichele, CFA
  - Robert Jackson
  - Matt Libel
- Advisory Board:
  - Brian Bares, Bares Capital
  - Peter Kinney, Acacia Capital
  - Staley Cates, Southeastern Asset Management

First Principles

- A few firms have good economics. Most do not.
- Business values can diverge from market prices.
- Capital allocation matters to value creation.
- The intrinsic value of a company is driven by:
  - The return on invested capital (ROIC) of the business.
  - The ability to re-invest capital at high incremental ROIC.
- Paraphrasing Einstein, "Compounding intrinsic value is the eighth wonder of the world."

Economic Moats

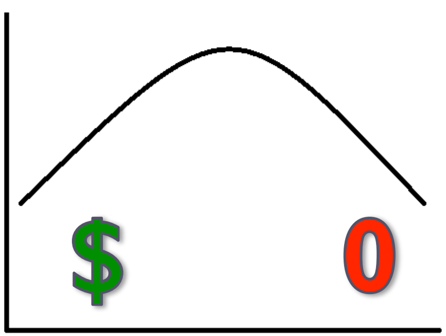
- Absent a moat, high profits will be competed away.
- Moats are structural attributes:
  - High switching costs
  - Valuable intangible assets
  - Network economics
  - Sustainable cost advantages
- Moats insulate businesses from competition, and allow capital to be invested at a high incremental rate of return.

Management: The Value of A Good Horse

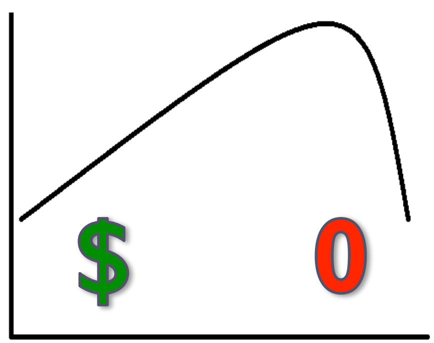
- "Good jockeys will do well on good horses, but not on broken-down nags." (Buffett)
- Curly wins this race

Management: Seek Positive Skewness

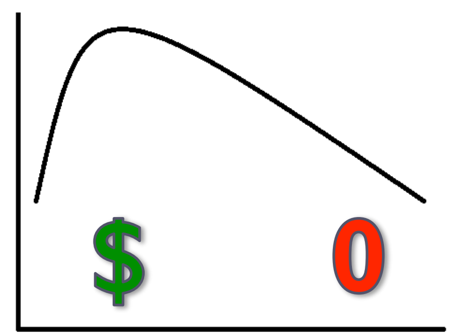
- However, a <u>tiny</u> minority of managers can create enormous value via astute capital allocation – even if they don't start with great horses.
- For great managers, decision outcomes are not normally distributed – they're <u>positively skewed</u>.



Random Outcome



Average Manager



Malone, Rales, Flatt, Markus

Investment Process: Idea Generation

Step 1 → Step 2 → Step 3 → Step 4 → Step 5 → Step 6

- Search globally for businesses with
  - Economic moats
  - Strong compounding potential
  - Good capital allocation

Moat → Compounding → Management

Investment Process: Elimination

Step 1 | **Step 2** | Step 3 | Step 4 | Step 5 | Step 6

- Countries with poor shareholder rights, low disclosure, or capricious legal systems
  - Russia, China, some other emerging markets
- Industries with structurally poor economics
  - Mining, oil & gas, commodity chemicals, etc.
- Managers with a demonstrated lack of respect for minority shareholders
  - Poor disclosure, self-dealing, skewed incentives

Investment Process: Digging Deeper

Step 1 → Step 2 → **Step 3** → Step 4 → Step 5 → Step 6

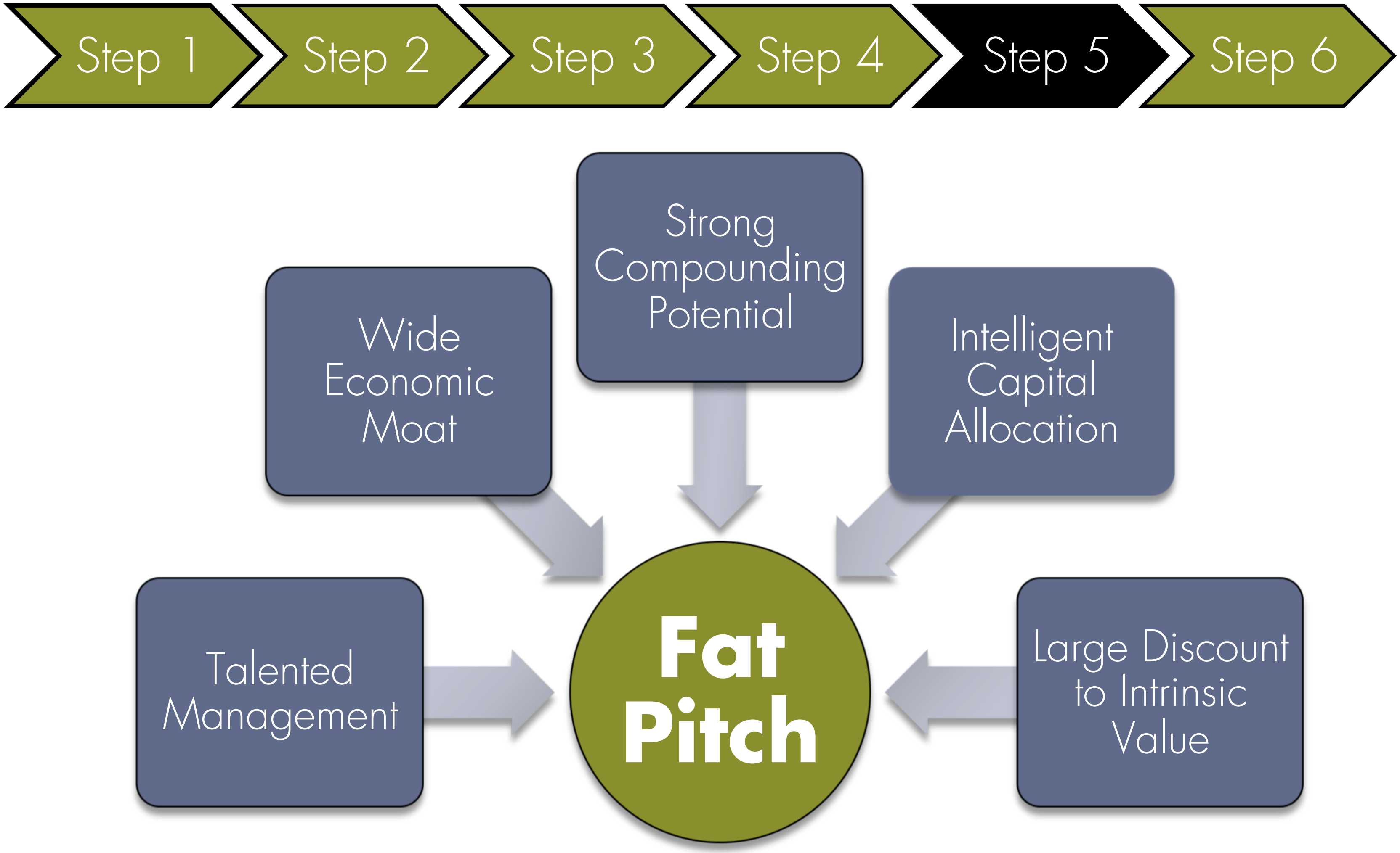
- Filings, background information, trade shows
- Meet management, visit company site
- Analyze competition & assess economic moat
- Contact industry sources for collateral data
- Contact suppliers & customers if appropriate
- <u>Goal is to thoroughly understand the competitive landscape and the opportunities for value creation</u>

Investment Process: Valuation

Step 1 | Step 2 | Step 3 | **Step 4** | Step 5 | Step 6

- Estimate intrinsic value using discounted cash flow
- Triangulate DCF result with other valuation tools
- Avoid false precision
  - "If it takes until line 247 of your spreadsheet to decide whether or not the stock is cheap, you've already lost."
- Maximize margin of safety, minimize opportunity cost
  - The value of a dollar in a high ROIC, high growth business <u>with a moat</u> is higher than the same dollar in an average business.

Investment Process: Adding a Position



Investment Process: Adding a Position

Step 1 → Step 2 → Step 3 → Step 4 → **Step 5** → Step 6

- Unfortunately, "fat pitches" are few and far between.
- When the stars do not align, we have two choices:
  - Pass on the idea
  - Judge that some criteria compensate for others
- A wide moat and strong compounding potential can compensate for a small discount to intrinsic value.
- A high discount to intrinsic value can compensate for a lack of compounding potential.

Investment Process: Selling a Position

Step 1 | Step 2 | Step 3 | Step 4 | Step 5 | Step 6

- Material weakening of moat? Sell.
- Substantially better idea? Sell.
- Loss of confidence in management? Sell.
- Violation of original investment thesis? Sell.
- Excessive valuation? Sell.

Why Global?

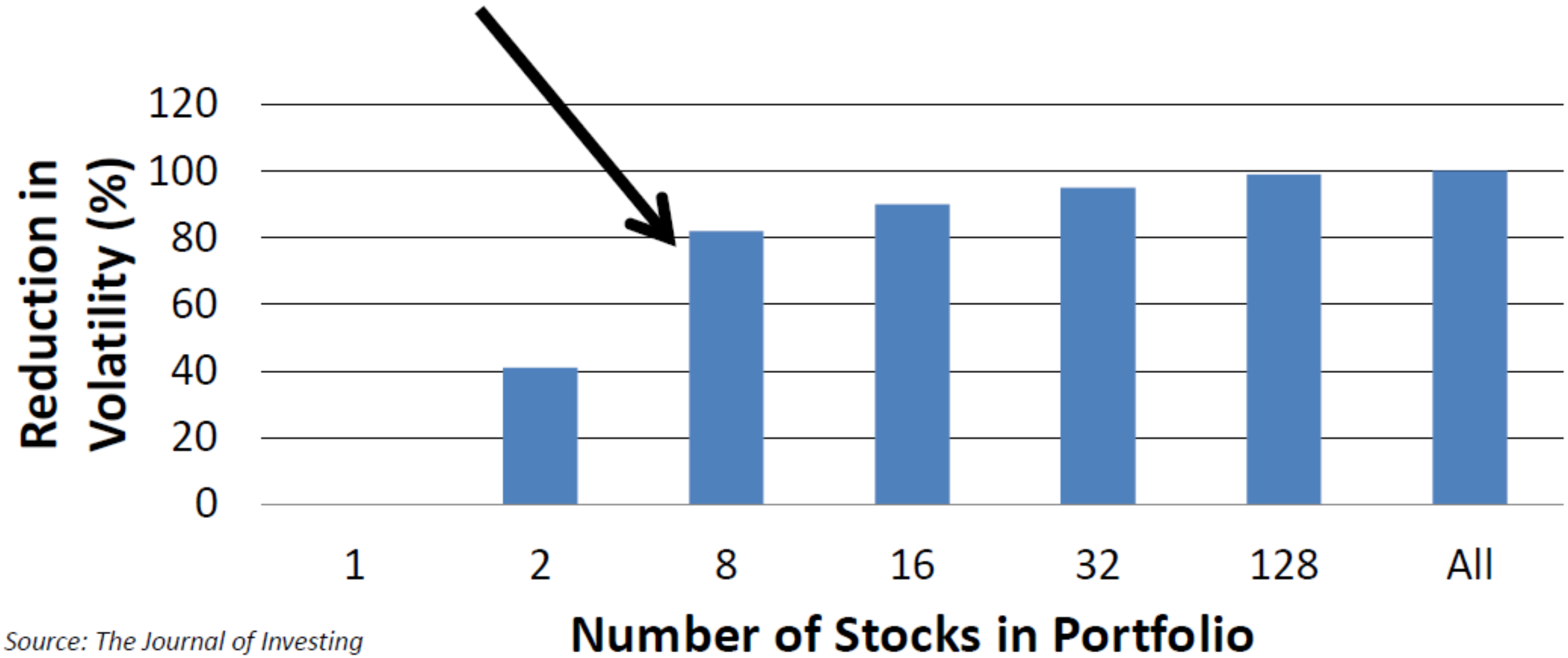
- Significant opportunity set: 60% of global market cap is outside the United States.
  - Many wonderful businesses are listed outside New York.
  - Some high-return industries based outside the U.S. – Flavors & Fragrances; Testing, Inspection, Certification.
  - Can be easier to build a moat in smaller markets.
  - Moats are often not as well-analyzed outside U.S., leading to better pricing of great businesses.
  - Basic principles of competitive advantage apply globally.
  - More complexity → more opportunity.

Why Concentrate?

- Institutional portfolios typically consist of scores of managers – concentration at the manager level does not equate to concentration at the institutional level.
- More efficient time allocation
  - Fewer positions leads to in-depth knowledge of each one.
  - No "stretching" for new ideas – only need a few per year.
- Forces investment discipline
  - No "starter" positions.
  - Fewer decisions leads to better decisions.
- Why own your 30th best idea if you don't have to?

Why Concentrate?

- Because 80% of volatility is diversified in the first 8 stocks



Source: The Journal of Investing

Why Moats?

- Qualitative processes are hard to replicate and arbitrage. <u>You can't screen for switching costs.</u>
- Understanding a moat requires deep knowledge of a business – hard to achieve in a portfolio of 50+ stocks.
- The presence of a moat creates an operational margin of safety that lessens the risk of portfolio concentration.
- Moats force a long-term view – an advantage in a market obsessed with quarterly results.

Why Capital Allocators?

- A rich source of market inefficiency.
  - Unpredictable – impossible for the sell-side to model.
  - Unconventional – creating value via acquisitions when most companies destroy value.
  - Lumpy – value creation is financially messy, and comes in spurts rather than a smooth line.
  - Patient – not focused on meeting short-term projections.

- Lowballed market expectations create opportunity.

Why Invest?

- Differentiated and disciplined strategy.
- Shareholder-friendly investment structure with reasonable fees and high transparency.
- We eat our own cooking: The bulk of Pat Dorsey's personal capital is invested in DAM.
- Commitment to cap assets to protect investor returns.
- Southeastern Asset Management providing operational support.

Our Edge

- Qualitative processes can’t be quantitatively copied.
  - Screens don’t capture management changes, shifts in corporate strategy, or changes to capital allocation.
  - “Quality” is not low volatility and low leverage.

- Process is repeatable.
  - Basic principles of competitive advantage do not change.
  - A framework based on the application of a mental model becomes <u>more robust</u> over time as businesses are added to the collective mental database.

Our Edge

- Pat Dorsey knows moats.
  - Ten years training analysts and building economic moat framework at Morningstar.
  - Analyzed competitive advantages of hundreds of companies, establishing a robust circle of competence.
  - Wrote *The Little Book that Builds Wealth* about economic moats – 50,000 copies sold since 2008 publication, translated into nine languages.
  - Presented on competitive advantage to over 40 CFA societies in U.S., Europe, and Asia.

What About Risk?

- Risk – defined as permanent loss of capital – is mitigated several ways in the Global Moat Strategy.
  - Operational Risk is lessened by rigorous competitive analysis. No moat? Not in the portfolio.
  - Financial Risk is lessened similarly. Most "moaty" businesses have strong cash flow and minimal leverage.
  - Valuation Risk is mitigated by only purchasing businesses at a material discount to intrinsic value.
  - Macroeconomic Risk is lessened by avoiding commodity firms that are price-takers, rather than price-setters.

Thank You

- Concentrated all-cap
- 10-15 positions
- Investing globally in businesses with economic moats & talented managers
- Separate account structure
- $5 million minimum investment
- 1.0% asset-based fee

More on Moats

More on Moats: Intangible Assets

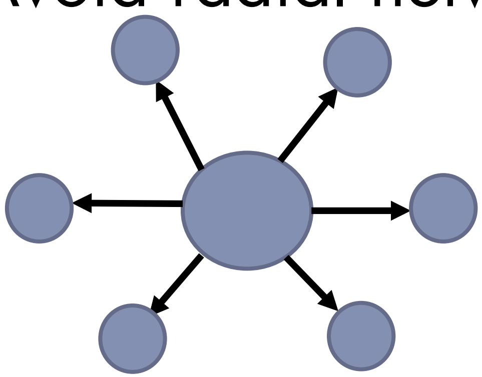
- Brands: Change consumer behavior by delivering a consistent or aspirational experience. Must increase consumer’s willingness to pay or lower search costs.
  - Sony vs. Tiffany
  - LVMH, Calbee, Amazon, Coca Cola Içecek
- Patents: Legal monopoly vs. expiry/challenge/piracy
  - Novo Nordisk, Chr. Hansen, ARM Holdings
- Licenses/Approvals: Legal oligopoly vs. regulatory fiat
  - Casinos, some financial exchanges, aircraft parts
  - Often highly dependent on local regulatory framework

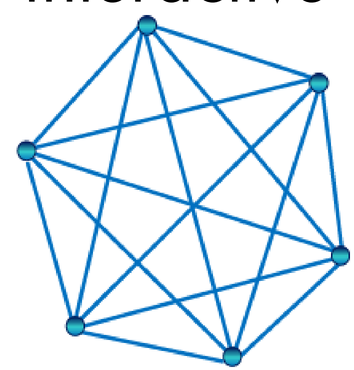
More on Moats: Switching Costs

- Does the cost of switching to a competing product outweigh the benefits?
  - Integrate with customer business processes – upfront costs of implementation & training yield payback from renewals
    - Sartorius, Praxair, Silverlake Axis
  - Sell ongoing service relationships vs. one-time purchases
    - Rolls Royce, Oracle, Kone, Howden
  - Provide a product with a high benefit/cost ratio
    - Fastenal, Ecolab, Novozymes, Symrise

More on Moats: Network Effect

- Provide a good or service that increases in value as the number of users expands.
  - Aggregate demand by connecting fragmented groups of buyers and suppliers.
    - Edenred, Henry Schein, Kuehn & Nagel
  - Benefit from non-linear relationship between network <u>nodes</u> and network <u>connections</u>.
    - Visa, Mastercard, Facebook
- Avoid radial networks & favor interactive networks.





More on Moats: Cost Advantages

- Cost advantages are not always tied to size – dependent on specific industry economics.
  - <u>Process</u>: Invent a better or cheaper way of delivering a good or service that rivals cannot quickly replicate.
    - CDW, GEICO, Inditex
  - <u>Scale</u>: Spread fixed costs for manufacturing or distribution over a relatively large revenue base to reduce per-unit costs. Relative size matters more than absolute size.
    - UPS, Aggreko, Amazon

More on Moats: Valuation

- The value of an economic moat is largely dependent on reinvestment opportunities.
  - If a firm can reinvest large amounts of cash flow in high ROIC opportunities, the moat is very valuable.
    - Fastenal, Amazon, TransDigm, Halma
  - If a firm has limited ability to reinvest, the moat adds little to intrinsic value, but adds confidence to value estimate.
  - We prefer to own businesses with high reinvestment opportunities so we can benefit from compounding.
  - We will purchase businesses with limited ability to reinvest if capital is being returned to shareholders and the business is very cheap.