Value Investor INSIGHT
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Standing Tall

Ruane, Cunniff & Goldfarb's Arman Gokgol-Kline, Trevor Magyar and Chase Sheridan explain why they're okay with spending months on a potential idea that might go nowhere, how they've tried to upgrade a venerable strategy and process, and why they see mispriced value in Charles Schwab, Universal Music, CarMax and Intercontinental Exchange.

INVESTOR INSIGHT

Ruane, Cunniff & Goldfarb
(*l to r*) Arman Gokgol-Kline, Trevor Magyar, Chase Sheridan

To explain Ruane, Cunniff & Goldfarb's approach, Chase Sheridan offers a hypothetical investment choice: a stock you believe can compound at 20% for five years, or one potentially doing so at 15% for 20 years. "The rational choice for most is to take the first option. If you're right, you'll get promoted faster, your bonus will be higher, and you might have a new job before you have to reinvest the money," he says. "There's nothing wrong with that, but we're set up to take the second option every time."

The firm's $4.8 billion (assets) Sequoia Fund since 1970 has earned a net annualized 14.0%, vs. 11.5% for the S&P 500. We spoke with portfolio managers Sheridan, Arman Gokgol-Kline and Trevor Magyar about what they seek in long-term compounders and a few they're high on today.

All long-standing investment firms are challenged with, as you put it recently, "evolving and adapting in response to change while holding fast to core principles." Talk first about the core principles to which you as a firm have held fast.

Arman Gokgol-Kline: Our North Star principle has always been to act as an owner of a business as opposed to the owner of a piece of paper. Our process and thinking is focused on understanding and assessing the businesses we're investing in over long periods of time, because we ultimately expect to earn the returns the business does.

There was no better year than 2020 to illustrate the humbling nature of the investing profession. We readily admit that we were completely blindsided by the onset of the pandemic. More importantly, even if somehow we'd seen it all coming, we still wouldn't have guessed how governments and markets would react and the second-order impacts those reactions would have. Answering questions about the future turns out to be a sobering challenge even if you have a crystal ball. Which is why we try to answer as few of those types of questions as possible, and why we try to confine ourselves to the easier questions rather than the harder ones.

We believe with enough research and thoughtful debate, we can make useful predictions about the future performance of an individual business. That task is more manageable if we focus on competitively advantaged businesses, which are naturally easier to assess. It's even more manageable if we invest only with gifted management teams, who are more likely to navigate the potholes that will inevitably open up. It's more manageable still if we focus on businesses that can grow independently of economic circumstances, allowing us to ignore the weather, so to speak, and worry only about if we're right, not when we're right. Finally, as value investors, it helps to purchase stocks at prices that incorporate a margin of safety, because then when we're wrong, we're less likely to be very wrong, and when we're right, every so often we'll be really right.

What's typically going on that makes these types of companies trade with a margin of safety?

AG: The list is long and you've likely heard it many times before, but in general there are things going on in the economy, the industry and/or the business that are disrupting the equilibrium and causing the market to be skeptical or less optimistic about a company than we are. In those moments of flux, when the market seems to have an unsure or bifurcated view, we try through our research and process to see if we can arrive at a clearer view of the company's future over time.

Trevor Magyar: One thing I'd add is that our hit rate on research projects is low. Sometimes we can't get comfortable with a business. Other times we can, but we don't arrive at a sufficiently differentiated view of it. It's not uncommon for us to spend months or sometimes years on a potential idea and in the end decide not to move ahead. But because we have 30 investment professionals and run a concentrated portfolio with positions we tend to hold for a long time, we have the luxury of spending a lot of time on ideas that may not go anywhere. That's a totally acceptable and even expected outcome of our process.

I would also add that we believe markets are prone to undervaluing long-duration growth potential. It's not because other investors aren't smart, it's just very hard for a prudent person to project something like 20% compound annual earnings growth over a decade or more. But when you go back to the video tape, so to speak, there are companies that have done exactly this. A significant portion of Sequoia Fund's outperformance over its 50-year history has been driven by a relatively small number of investments in companies that created incredible amounts of value over sustained periods of time. Identifying these companies ahead of time is extremely difficult, but we want to own businesses that we think have at least the possibility of producing these sorts of outlier outcomes.

As a topical example, describe how a company like Taiwan Semiconductor [TSMC] fits the profile of what you like to own, and explain why you believe it might be underappreciated today.

Chase Sheridan: Investors have a conundrum: you can find businesses that earn high returns on invested capital, but they typically don't require a lot of capital. It's rare to find businesses that can invest lots and lots of capital while still maintaining that high ROIC. We believe there are very few businesses in the world that can do that on the scale of TSMC.

The company is going to invest more than $100 billion in capex over the next three years, and we have high confidence the return they earn on that will be commensurate with historical rates, with after-tax ROICs of around 30%. What is it about this business that allows that? Those kinds of returns obviously convey a very strong market position. Each generation of logic semiconductor is defined by its process node, which corresponds to its feature size. Generally the smaller the node the better the performance and power efficiency. For TSMC's chips, there's quite a lot of competition at 28 nanometers or greater. From 7 to 28 nanometers the only real check on TSMC's pricing power is Samsung, maybe at times Intel. But below 7 nanometers there's really no one. Others have struggled to keep up at the leading-edge node, where TSMC's lead has only extended. For those products they're the only game in town and they charge accordingly.

ON EVOLVING:

Perhaps the most significant change with regards to portfolio construction is our approach to cash.

That type of competitive lead in integrated-circuit manufacturing doesn't change often or easily. Customers like Apple are highly reliant on TSMC's design and manufacturing expertise, and a competitive product would have to be better for a number of years before a customer will switch foundries. And this is in a market with products that are incredibly important to the world; they truly drive the progress of technology forward. In smartphones, unit growth potential for TSMC is low, but they are constantly able to increase their content per phone. In high-speed computing there's considerable unit growth, driven primarily by investment around artificial intelligence and cloud computing.

So TSMC has a leading position in a vitally important market, and we think there's a pretty high level of visibility that they'll maintain that position for many years. They outspend their competition on R&D. They have a very entrepreneurial culture, so no one is going to outwork them. It's a great position to be in.

Even with all that, the stock today trades at 24x estimated 2022 earnings. You're paying just over a market multiple for a business that is wildly better than your typical business. Why is that the case? I'm just speculating – you often don't really know why something trades for a price you deem attractive – but there are a few reasons that might be the case here. There is China's relationship with Taiwan and the increasingly hawkish stance of Premier Xi toward Taiwan. There may be concerns over competition, both from Intel trying to reclaim the lead in manufacturing and from the Chinese investing to build their competitiveness in the lagging nodes. It's always an ongoing discussion, but we've satisfied ourselves that these issues at least over the next five years are not likely to materialize. That's why the shares, in our view, remain attractive even after a considerable run.

The investment committee on which you all sit was a new construct put in place in 2016 for managing the Sequoia Fund portfolio. Coming back to the subject of adapting to change, why did you set it up the way you did?

AG: We set up a five-member investment committee, four of whom vote on any portfolio activity. We did it that way to bring more perspective and creativity to the management of the team, the process and the portfolio. Rather than having one or two people driving everything, we have five who all have a long history with the firm but think slightly differently about companies and businesses and the opportunities they present. We want to ensure we're keeping an open mind and that we're looking for new ways to execute our core philosophy as markets and industries evolve. In this regard, we think more heads are better than one.

Another thing we did was to not require that committee decisions be unanimous – we can buy or sell with three votes. We think that improves the quality of our discussion because we don't have to "go along to get along" and reach a consensus. Dissent can be a virtue in and of itself, and in the firm's history there have been times when dissenting arguments either weren't voiced or weren't adequately heard. We hope our current structure and decision process minimizes the risk of that.

What types of portfolio management changes have you instituted under the new structure?

TM: In terms of portfolio construction, I don't know that a whole lot has changed. We've always taken the view that the only way to outperform is to concentrate. The weighting of the top-ten positions in the fund hasn't moved around a lot over the past 50 years, and today is right around the long-term average of 60%.

We did institute a limit on single position size, which is 20%. For what it's worth, the largest holding at the end of September was in the 8% area.

Perhaps the most significant change with regards to portfolio construction is our approach to cash. For much of Sequoia Fund's history, cash levels were in the 15-20% range and sometimes even higher. We concluded that this hasn't served our clients terribly well. It can feel comfortable at times to hold a lot of cash, but for it to make sense you have to be convinced you can deploy it into just the right things at just the right moment. I don't know that we were bad at that, but it wasn't a core competency. We believe our clients will be better served if we're more fully invested on average and over time.

The cash balance in the Sequoia Fund was 15% or so when the investment committee was formed in 2016. At the moment it is running in the low single digits.

Does that imply you're finding plenty to do in today's market?

AG: What's more attractive at any given time in the market obviously varies. Five or six years ago we were finding incremental opportunity in higher-growth companies like an Amazon and Alphabet, but we'd probably say at the margin today we're seeing more to do in lower-P/E ideas like a Micron Technology [MU] and Anthem [ANTM]. We think there's always opportunity somewhere, it's our job to go find it.

We wanted to ask about a couple in-the-news portfolio holdings you added to in the third quarter. First, how are you processing what's going on at Facebook [FB], aka Meta Platforms?

TM: Facebook has many of the characteristics you'd expect to see of a highly advantaged business. It has strong network effects. It benefits from a massive move of advertising dollars to the digital space.

ON FACEBOOK/META:

We could talk about this for hours, but the fact that we own it tells you where we come out on it.

Profitability is extremely high, and earnings continue to grow at a healthy clip. By the numbers, if the future looks anything like the recent past the stock is objectively quite attractive.

Of course, that's not the end of the story. To really regard the shares as attractive you also have to believe in the sustainability of the various businesses they have today. That's much more of a qualitative exercise, involving difficult judgements on how users, regulators, legislators and competitors will act going forward. We could talk about this for hours – and we continue to wrestle with all of it intensely – but the fact that we own it tells you where we come out on it.

Same question on Prosus [Amsterdam: PRX], which is more or less a proxy for Chinese Internet giant Tencent.

AG: The answer is similar to what Trevor described for Facebook. Tencent has some dominant Internet franchises in an extremely dynamic and growing market. The stock if those franchises stay even modestly on the path they've been on looks inexpensive. Then, of course, there's the next level, with questions about the regulatory environment in China that are even tougher to answer than they are with Facebook.

Where we come out is that Tencent's businesses have earned their place, deserve to exist, and can prosper even in a more restrictive regulatory environment than the past. At the valuation we're paying at the moment, we think we're being compensated for the prevailing risks. That we're less certain about that is reflected in the relative size of our position in Prosus versus our position in Facebook.

Explain your broader investment case for Charles Schwab [SCHW].

TM: Schwab pioneered the discount-brokerage business in the 1970s and today is a large and well-rounded investment-services firm with around $7.5 trillion in client assets. That makes it one of the largest asset managers in the world, right up there with Vanguard and a bit behind BlackRock, just to provide some perspective.

We like the combination of Schwab's scale and its low-cost, consumer-friendly model. For decades the company has been pulling large sums of capital away from the full-service wirehouses and other higher-cost channels. The percentage growth rate of Schwab's net new assets has of course moderated over the decades, but over the past five years it has averaged 7% per year. At Schwab's size, that's pretty incredible. The crux of our thesis is that this asset gathering continues and that the company's scale will allow it to keep giving back to consumers in the form of lower prices and more services and products, while at the same time delivering attractive returns to shareholders.

How are you assessing today's quite dynamic competitive environment?

TM: At the moment people are focused on Robinhood and other similar outfits. A few years ago the concern was more about robo-advisors. I wouldn't say these concerns or other similar ones are outright misplaced. But when we step back, we see that over the past five years Schwab has actually improved its competitive position. It launched its own robo-advisors. It took

INVESTMENT SNAPSHOT

Charles Schwab
(NYSE: SCHW)

Business: U.S. provider of brokerage, banking and asset-management services; last year bought top competitor TD Ameritrade and now has roughly $7.5 trillion in client assets.

Share Information (@11/29/21):

Price	**80.10**
52-Week Range	48.51 – 84.49
Dividend Yield	0.9%
Market Cap	$149.44 billion

Financials (TTM):

Revenue	$17.99 billion
Operating Profit Margin	43.4%
Net Profit Margin	30.1%

Valuation Metrics
(@11/29/21):

	SCHW	S&P 500
P/E (TTM)	31.4	28.8
Forward P/E (Est.)	23.9	22.4

Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
TD Asset Mgmt	14.1%
Vanguard Group	6.1%
T. Rowe Price	4.7%
Wellington Mgmt	4.4%
Dodge & Cox	4.1%

Short Interest (as of 11/15/21):

Shares Short/Float	0.7%

SCHW PRICE HISTORY

THE BOTTOM LINE
The company's scale and asset-gathering prowess should allow it to keep giving back to customers in the form of lower prices and more products and services, says Trevor Magyar. From today's valuation, he expects as a long-term business owner to continue to benefit from double-digit annual profit growth as well as at least modest return of capital.

Sources: Company reports, other publicly available information

the proactive step of entirely eliminating commissions on most equity trades. And then soon after commissions went to zero, Schwab bought TD Ameritrade, adding $1.5 trillion in client assets, significantly expanding its business with Registered Investment Advisors, and bringing on the thinkorswim active-trader platform, a strong asset in a strategically important part of the market. As it has consistently done, the company uses scale to improve its position against the competition.

Usually when people talk about Schwab they mention its interest-rate sensitivity. Do you see that as a plus or a minus?

TM: Building out Schwab Bank took the company down a somewhat tougher road in terms of the business model, but given the fee compression on the brokerage side we believe monetizing client cash through net interest margin was a logical direction to go. You could argue that Schwab Bank resulted in a step down in business quality for the company, but strategically it has absolutely been the right thing to do.

The fact that Schwab Bank is a material driver of revenues and earnings means that you as an investor looking to value the business have to confront the resulting interest-rate sensitivity. If you have a clear and firm view that rates are going to rise, then Schwab might look dirt cheap. If you have a clear and firm view that rates are destined to go to zero and stay there forever, then Schwab might look overvalued. As much as possible, we're trying to avoid making a big call on the rate environment. From when we first bought this in 2016 up to today, we think we're paying a reasonable multiple of earnings across a range of rate environments that we'd characterize as normalized.

How reasonable do you consider the valuation at today's share price of $80?

TM: Schwab can continue to gather net new assets at 6-7% a year or so, which gets you double-digit revenue growth or at least close to it when you factor in long-term market appreciation. Expenses have been quite well managed, growing at a mid-single-digit rate over long periods of time. If that trend continues, profits should grow faster than revenues. Then on top of that there's the potential for modest return of capital.

Consensus earnings estimates for this year are $3.25 per share, so the P/E is less than 25x. For the business I just described, we think that's attractive. Earnings may bounce around with rates and the equity market and then how people value those earnings may bounce around as well, but we've approached this investment with the mindset of a long-term business owner and that's what we'll continue to do.

Describe why you're high on the long-term prospects for Universal Music Group [Amsterdam: UMG].

AG: The global music industry, which really implies recorded music from Western artists, peaked as a business in 1999 when CDs were the main way people consumed music. Primarily due to digital pirating, the industry collapsed soon thereafter and went into decline for 15 years. Even today, revenues from recorded music in nominal terms are below 1999 levels.

What changed everything in the mid-2010s was streaming, with companies like Spotify offering all-you-can-eat digital subscriptions to replace an interim step where people were buying one song at a time on services like iTunes. This solved a number of key issues for consumers and allowed the music business to stabilize and start growing again. From 2014 to today, streaming went from a small minority of Western music distribution to the major driver.

This created a very interesting dynamic in the market, and the big question to answer was whether the power dynamic in the industry would shift away from the traditional labels as digital streaming providers moved to create and own content themselves. Our view was that this was not going to happen. Unlike with video content, more than half of the consumption of music was from the "catalog," which means at least 18 months old, and just under half is deep catalog, which means several years old. If I'm Spotify it's hard for me to disrupt the existing players for the simple reason that I need their content.

In addition, we thought the big labels had an important role to play with their ability to match the market power of the biggest distribution platforms. Even if I'm a global superstar, I can't have the same conversation with a distributor that my label with 30-40% of the market can have with that same distributor. That's even more relevant in the case of Universal, which arguably has the strongest catalog of recorded and published music. Last year it had nine of the top ten streaming artists on Spotify, and artists it represents account for around four in ten of the total streams across the leading platforms.

Is this a growth market?

AG: The cost to consume incremental music under a premium streaming subscription is zero, so consumers are incented to listen to more music. In 1999 the average American consumer spent something like $80 per year on new music content, which was, say, five albums. Today for an only somewhat higher annual cost that consumer has access to tens of millions of songs on demand, a base that's growing all the time.

Another driver of demand is that music today is easier to consume. In the old days I had to carry around a tape or CD and have something to play it on. In the house I needed a stereo system. Now we have access to music through a variety of devices that are both more affordable and more user friendly. Smartphones with high-fidelity ear buds. Smart speakers in homes. I can just ask Siri or Alexa to play whatever I want whenever I want it. Americans' music consumption in the past five years has increased 25%, and it continues to increase.

The last thing I'd highlight is that the adoption curve for streaming music hasn't yet matured. In developed markets that's characterized more by older demographics getting on board, while in developing markets younger adopters are still increasing rapidly. All in, the value proposition for music remains compelling, and the economic, technological and geographic barriers to accessing it are receding. We believe all that drives continued healthy growth for the global industry.

INVESTMENT SNAPSHOT

Universal Music Group
(Amsterdam: UMG)

Business: Discovery and development of musical artists and songwriters and the marketing, distribution, sale and licensing of their related audio and audiovisual content.

Share Information
(@11/29/21, Exchange Rate: $1 = €0.89):

Price	**€25.01**
52-Week Range	€22.55– €27.96
Dividend Yield	0.0%
Market Cap	€46.24 billion

Financials (TTM):

Revenue	€7.80 billion
Operating Profit Margin	18.0%
Net Profit Margin	13.9%

Valuation Metrics
(@11/29/21):

	UMG	S&P 500
P/E (TTM)	43.2	28.8
Forward P/E (Est.)	33.3	22.4

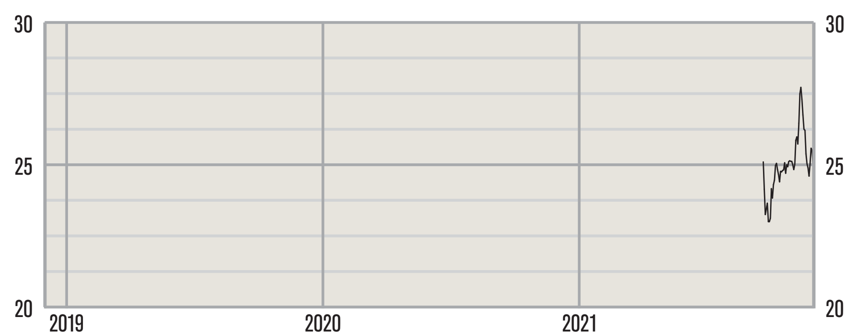
Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Pershing Square Capital	10.0%
Fidelity Mgmt & Research	1.4%
Capital Research & Mgmt	1.3%
Vanguard Group	1.0%
BlackRock	0.6%

Short Interest (as of 11/15/21):

Shares Short/Float	n/a

UMG PRICE HISTORY



THE BOTTOM LINE

The company is well positioned to benefit as the economic, technological and geographic barriers to accessing music continue to recede worldwide, says Arman Gokgol-Kline. Through earnings growth and an increasing dividend stream he expects the return profile on the stock to remain attractive even if there are headwinds from the multiple over time.

Sources: Company reports, other publicly available information

The shares don't appear particularly cheap at today's price of €25.

AG: On consensus estimates the stock trades at 33x forward earnings, which is obviously a healthy multiple. The question is what are you getting for that? As streaming takes more share, as consumer penetration increases in both developed and developing markets, and as new venues like TikTok, Roblox and Peloton drive incremental demand, we think annual top-line growth for Universal – with significant duration – can be in the high single digits if not 10% or more. The profitability of the new revenues is better than that of the old, and there is fixed-cost leverage in this business, so margin growth should allow earnings to grow faster than that. Add in what is likely to be an increasing dividend stream, and we consider the long-term return profile here to be attractive. That remains the case even if there are some headwinds from the multiple over time.

From music to used cars, describe the long-term upside you see in CarMax [KMX].

TM: We've owned CarMax since 2016, but we've followed the company for a very long time – the first memos we have on it in our system go back to 1999. It is a leader in the massively fragmented used-car market, which in the U.S. is a $750 billion market with about 40 million vehicles sold per year. There are over 40,000 U.S. used-car dealers, and the top 100 account for less than 10% of the total market. CarMax has 2% share overall, roughly twice that for the late-model cars on which it focuses.

What has differentiated the company from a buyer perspective is its consumer-friendly, no-haggle model. You could describe the typical used-car sale as a game of three-card Monte, with the dealer playing off the price of the used car, the terms on any trade-in and the terms on the financing. With CarMax, all of those are set and not up for negotiation. The brand promise is that the consumer is going to get a reasonable deal on each and every part of the transaction.

We've always wondered why that's been so hard to replicate.

TM: For a time people weren't sure this was a model that really met an unmet consumer need. As CarMax thrived, that question was effectively answered. But it has still proven to be a hard model for others to implement. Part of that stems from the fact that you have to be all in on it. You change the salesperson's approach – they're no longer selling as much as they are conveying information and helping the customer through the process. That's a difficult transition not only culturally but also economically. If you make the switch, you're guaranteed to be selling fewer cars at the beginning. You have to really stick with it long enough for buyers to understand and believe what you're doing. That's proven difficult for many to do.

In addition to being differentiated in the consumer's eyes, CarMax has also built significant advantages around executing the model very tightly. The used-car business involves a lot of heavy lifting operationally speaking, with regards to sourcing, reconditioning, distributing and pricing. Over the decades CarMax has become very good at all of this, which we

INVESTMENT SNAPSHOT

CarMax
(NYSE: KMX)

Business: Sources, sells, finances and services used cars in the U.S. through more than 220 company-owned retail outlets; increasingly selling direct to consumers online.

Share Information (@11/29/21):

Price	**146.48**
2-Week Range	90.29 – 155.98
Dividend Yield	0.0%
Market Cap	$23.63 billion

Financials (TTM):

Revenue	$27.25 billion
Operating Profit Margin	5.9%
Net Profit Margin	4.3%

Valuation Metrics
(@11/29/21):

	KMX	S&P 500
P/E (TTM)	20.9	28.8
Forward P/E (Est.)	20.3	22.4

Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Vanguard Group	10.3%
Principal Global Inv	5.5%
Primecap Mgmt	4.5%
Ruane, Cunniff & Goldfarb	4.4%
Akre Capital	4.4%

Short Interest (as of 11/15/21):

Shares Short/Float	3.0%

KMX PRICE HISTORY

THE BOTTOM LINE

As it transforms its entire organization toward omnichannel selling, Trevor Magyar believes the company can continue to grow revenues and profits at the rate it has in the past, or better, with potentially even longer duration. He believes annual net income growth can exceed 10% and that capital return should further enhance shareholders' total return.

Sources: Company reports, other publicly available information also think is something very difficult to replicate.

So why is this interesting now? In the past the answer to that question was that CarMax could continue to take share in this massively fragmented market. If the used-car market grew at a GDP kind of rate, CarMax would grow at a multiple of that, generating a lot of free cash flow that it could return to shareholders. It wasn't hyper-growth, but good, solid profitable growth over a very long period of time.

What's changed? Various players have tried to attack this market in different ways over the years, but one that has really broken through is Carvana [CVNA], which sells used cars exclusively online. They've been growing units at a truly gangbusters rate and have shown that some percentage of customers are interested in transacting in this way. That was an important proof point.

The question for CarMax, then, is whether the emergence of online used-car buying is a risk or opportunity. We believe it's an opportunity, and we further believe that the company is sufficiently on the case. They are transforming the entire organization to develop omnichannel selling capabilities, serving customers exactly as they want to be served – online only, a hybrid of online and in-store, and in-store only. As a result of that effort we expect the company to grow at the same sorts of rates going forward that it has in the past, if not better. Significantly, we don't think the online used-car market is winner-take-all or even winner-take-most. Instead, we believe it's winners-take-more. Our thesis is that CarMax will be in the small group of scaled, sophisticated players who take share from everybody else.

From today's share price of $146.50, to what extent do you expect to benefit from that as a shareholder?

TM: Notwithstanding its transformation, we don't expect the company's financial progression to look so different than the past. We see high-single-digit top-line growth, though with a heavier weight on comp-store growth versus new-store growth. We expect some operating leverage, which should push net income growth above 10%. As it has in the past, we expect CarMax to convert the majority of net income to free cash flow and return much of that free cash to shareholders, enhancing the total return.

ON VALUING GROWTH:

It's just very hard for a prudent person to project 20% compound earnings growth over a decade or more.

At today's price the shares trade at around 20x the consensus EPS estimate of $7.25 for the fiscal year ending this coming February. If they execute on omnichannel, we think the business will be future-proofed to a greater degree than it has been in the past and it will be set up for continued success over a long, long time. That duration is quite valuable.

What do you think the market might be missing today in exchange operator Intercontinental Exchange [ICE]?

CS: ICE operates in a number of what we consider very good businesses: derivatives trading and clearing, equity and options exchanges (including the New York Stock Exchange), a data business which provides proprietary financial-instrument pricing and reference data, and a newer segment providing mortgage-related technology that facilitates origination, registration and closing.

The businesses don't require a lot of capital, benefit from network effects, and often reinforce each other. When you trade a futures contract on an ICE exchange, for example, you have to clear it with them as well. The company's trading and clearing businesses generate data that can be repackaged and sold. Operating margins are around 50% and net margins typically run in the mid-30% range.

Part of the appeal here is the better-than-GDP secular growth of the underlying businesses. I worked as a derivatives trader back in the 1990s and it still impresses me the extent to which new financial products are created and trading volume grows – in mature markets and even faster in emerging ones. Liquidity begets liquidity, and ICE is a long-term beneficiary of that.

The mortgage business – dramatically expanded last year with the $11 billion acquisition of Ellie Mae – is the newest and most interesting opportunity. ICE is essentially trying to digitize the residential-mortgage process. Today, loan origination takes about 55 days from application to close in the U.S. There's a lot of back and forth between lender and client. You have to navigate a messy state-by-state regulatory framework and a lot of required paperwork. ICE's goal is to streamline that process from start to finish by providing a connected, value-added platform through which transactions can more seamlessly and rapidly flow. If they can do that, they expect to realize at least a small portion of what could be a massive collective savings in time and money.

This is a good example of the importance we put on management. Jeff Sprecher founded the company in 2000 as a digital exchange to trade energy derivatives and has built it by thoughtful acquisitions since. There have been times in the company's history when he's seen opportunities that weren't at all obvious to others, but turned out to be significant drivers of incremental shareholder value. His approach to consolidating and integrating technology solutions in the mortgage market is an example of that vision. Another example could be the company's early efforts around cryptocurrency, mostly through a 68% ownership in Bakkt [BKKT], which offers a wallet and exchange mechanism for digital assets including loyalty points, gift cards and cryptocurrency. It's very had to model the value of what a Jeff Sprecher is going to do next, but we want our portfolio to be exposed to the potential happy surprises that visionary founder-managers can produce.

INVESTMENT SNAPSHOT

Intercontinental Exchange
(NYSE: ICE)

Business: Operator of derivatives, equity, fixed-income, energy and other exchanges; also provides a variety of financial and mortgage-related data and processing services.

Share Information (@11/29/21):

Price	**131.90**
52-Week Range	104.55 – 139.79
Dividend Yield	1.0%
Market Cap	$73.06 billion

Financials (TTM):

Revenue	$6.98 billion
Operating Profit Margin	48.9%
Net Profit Margin	33.7%

Valuation Metrics
(@11/29/21):

	ICE	S&P 500
P/E (TTM)	24.4	28.8
Forward P/E (Est.)	24.3	22.4

Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Vanguard Group	7.3%
Capital Research & Mgmt	6.4%
BlackRock	4.4%
State Street	4.4%
Magellan Asset Mgmt	3.8%

Short Interest (as of 11/15/21):

Shares Short/Float	0.7%

ICE PRICE HISTORY

THE BOTTOM LINE
The company's businesses are capital-light, benefit from network effects and often reinforce each other, which combined with end-market expansion can result in double-digit annual profit growth, says Chase Sheridan. He doesn't believe that potential is well reflected in the stock's forward multiple at only "a couple turns higher" than the S&P 500.

Sources: Company reports, other publicly available information

How inexpensive do you consider the shares at today's $132 price?

CS: Going business by business we think ICE can generate roughly mid-single digit annual revenue growth, with higher potential growth for the mortgage business. We consider the company appropriately levered and there is a high proportion of fixed costs in many of its businesses. The financial and operating leverage combine to give you potential double-digit growth on the bottom line. Much of the growth is very low cost, so you should also get a yield of more than 3% between dividends and buybacks. For that at today's share price you're paying 24x next year's estimated earnings, only a couple turns higher than the S&P 500.

Why isn't the multiple higher? Part of it may be that the market is worried about the balance sheet, but we think the current 3.2x (and falling) net debt to EBITDA ratio is more than manageable. Part of it may be an unwillingness to contemplate the upside if the mortgage business really works. And part of it just may be that ICE lacks a visible near-term catalyst, so the investment may require some patience, which goes against people's wiring. There's a famous mathematical example of folding a piece of paper: If you start with a sheet of paper one-tenth of a millimeter thick and fold it in half 42 times it will stretch to the moon. But after the first ten folds you've made it only to five centimeters. It's just hard to appreciate what's possible in a company like this when the founder reinvests capital at attractive rates for a very long time.

To get a sense of what prompts you to sell, tell us about two stocks you sold earlier this year, starting with Mastercard [MA].

TM: Mastercard remains the same fantastic business that it has always been, with an extremely strong position in a secularly growing market. I'd say upfront that we don't know if we exited at the perfect time. There have been many times during our holding period when we could have created plausible and smart-sounding arguments for selling, and we feel good about not having done so.

Why sell now? We basically concluded that the payments space was increasingly dynamic and that some of the competitive threats that seemed distant in the past now seem somewhat less so. The number of companies trying to develop alternative payments systems is exploding in the U.S., the rest of the developed world and emerging markets. In some geographies the new technology is beyond what's being used in the U.S. We're not convinced any one competitor is the primary challenge to the U.S. card networks, but when you see the sheer number of threats and the traction some of them are getting, you have to worry about it, and we did. Time will tell if we were right.

With a2 Milk [Sydney: A2M], you described selling because "changed facts caused us to change our minds." Please elaborate on that.

AG: To introduce the business, this is a New Zealand-based company that early on caught onto the idea that because the a1 Beta-casein protein in cow's milk can be problematic health-wise for some people, there was a market for developing herds that produce only a2 Beta-casein proteins and selling that as a2 milk or a2 milk-based infant formula. The idea caught on in New Zealand and Australia and then started to have success in export markets, most prominently with infant formula in China. We found the concept intriguing, with a disruptive product at a very positive but still relatively early stage of consumer adoption.

A couple of things happened. First, the CEO who we thought highly of left the company due to what were described as internal issues with the company's board. Second, the pandemic disrupted the key "daigou" sales channels in China, where resellers acquired the infant formula in bulk, imported it to China, and then sold it mostly through online marketplaces. So we had some concerns about the board, and started to question whether the daigou sales channel would return to its pre-pandemic productivity. We concluded the thesis was no longer valid and that the stock had become unattractive relative to alternatives.

Is there a risk that the type of high-quality value investing you've long espoused becomes too popular and it's harder to distinguish yourselves as investors?

TM: It is probably true that focusing on quality, and even more specifically the combination of quality and some amount of growth, has become something like accepted wisdom for value investors. We have Warren Buffett to credit for that, although I'd point out that he was practicing it and preaching it for decades before the world fully came around to the idea.

So just knowing that is not enough. You have to take that and build a process and philosophy around it that is different and better in rooting out companies that can actually compound value at high rates over long periods. We also believe actually investing as a long-term business owner is an advantage that isn't as widely practiced. If you look at the number of investment firms that truly hold over a long period of time – and that outperform as a result – there aren't that many. It's one thing to say you care about long-term value and another to actually behave as a long-term business owner. None of this is easy, but it's never been easy. That's what makes it interesting. VII