



April 2017

## The Conviction to Be Different

*“The task is not so much to see what no one yet has seen, but to think what nobody yet has thought about that which everyone sees.” -- Arthur Schopenhauer (1788-1860)*

In an era defined by the massive transfer of capital from active management into passive vehicles, Mar Vista remains steadfast that there is an identifiable subset of alpha-generating investors. We cited in our first quarter letter last year academic research<sup>1</sup> that suggests managers possessing two attributes, high active share and a long time horizon, generate over 2% of annualized alpha on average. By design and disposition, Mar Vista’s strategies align with these characteristics and, over a full investment cycle, the outcomes. We manage a decidedly high-conviction (80%+ active share) and patient (average five year holding period) strategy and, since the last market peak, Strategic Growth has generated 2.6% and 2.0% of annualized alpha compared to the S&P 500<sup>®</sup> Index and Russell 1000<sup>®</sup> Growth Index, respectively.

Measures of active share and holding periods are, however, simply outcomes of our process, not the drivers. Mar Vista has built, we believe, resilient analytical, behavioral and organizational advantages shared among the rare group of enduring, alpha-generating investment firms.

### Analytical Advantages

In truth, there is no “secret sauce” to our investment process. Our advantage comes from a patient, consistent and rational application of time-tested principles that, over the long-term, drive stock prices. We have institutionalized a **private equity-like, owner-oriented framework** focusing on true economic drivers. The math we apply requires nothing higher than what we learned in high school Algebra. Nearly all of our research time is spent studying competitive advantages, reinvestment opportunities, returns on capital, discounted cash flows, margins of safety<sup>2</sup>, management incentives, cultures and the range of potential outcomes. It is not sexy, but it is what works over time. Our variant perceptions do not necessarily come from any single unique perspective but from the confluence of the following:

		 Conventional Wisdom
<b>Definition of "Risk"</b>	Probability and magnitude of <i>permanent capital loss</i>	Beta, tracking error, near-term underperformance
<b>Definition of "Growth"</b>	<i>Intrinsic value growth</i> , ROIC>WACC, durable moats, compounding machines	Revenue and earnings growth
<b>Value vs Growth</b>	<i>Margin of safety</i> : invest at the intersection of growth and value	Mutually exclusive
<b>Probabilities</b>	<i>Scenario-weighted</i> estimate of fair value based on a range of potential outcomes	Price target based on most probable outcome
<b>Time Horizon</b>	~ 5 year average holding period	"outperform this year," < 1 year
<b>Conviction</b>	15 - 40 positions, high active share	> 100 holdings, low active share

<sup>1</sup> Cremers, Martijn / Ankur Pareek. “Patient Capital Outperformance: The Investment Skill of Active Managers Who Trade Infrequently” September 2014.

<sup>2</sup> Margin of safety is the difference between a stock’s market price and estimated intrinsic value.

## *Behavioral Advantages*

While self-preserving emotional responses, like fight-or-flight and loss aversion, helped *Homo sapiens* avoid danger and preserve their sustenance on the savannah, those same emotions drive modern humans to make perfectly irrational investment choices. This conflict between cognitive biases and rationality is a critical driver of poor active performance, in our opinion. The struggle is further magnified when professional objectives (focus on the long-term, limit assets under management) conflict with business objectives (short-term performance pressures, maximize assets under management).

Mar Vista will never completely eliminate these biases (no Vulcans here, yet) but our investment team tries to limit their dilutive impact by (1) studying the influences of poor judgement and (2) institutionalizing governors into our process that help us make more rational decisions. Behavioral finance thought leaders such as Daniel Kahneman, Amos Tversky, Michael Mauboussin and Charlie Munger have significantly influenced our thinking.

Investors hold a powerful and durable competitive advantage if they can minimize internal and external pressures while, at the same time, exploit the manic-depressive nature of the market. We have incorporated numerous elements into our process and culture to achieve these dual objectives:

- **Consistent, Predictable and Repeatable (“CPR”) process** removes much of the emotion and identifies market biases.
- **Time Horizon Arbitrage:** our 5 to 7 year lens unveils a different opportunity set than those with a 12 to 24 month lens.
- **Devil’s Advocate:** confirmation bias and group think are dangers to good judgement so we foster independent, diverse and contrarian opinions and conclusions by assigning a skeptic on every idea.
- **Line in the Sand:** to limit the dilutive impact of “value traps,” a chronic fundamental underperformer must achieve specific metrics or we dispassionately sell the stock.
- **Attract like-minded investors:** investors that share fundamental values, risk tolerances, return objectives and time horizons are more likely to enjoy a successful partnership.
- **Aligned interests:** a substantial part of our partners’ personal equity investments are in Mar Vista strategies or in businesses that are owned by one of our strategies.

## *Organizational Advantages*

“**Organizational alpha**” is the unsung building block of Mar Vista’s unique outcomes. A firm’s culture can be a persistent enabler of success or, if not well articulated and protected, a facilitator of failure. Many firms have hit a wave of hot performance and parabolic growth followed by a fabulous flameout, but it takes an uncommon organization and culture to persevere. Fortunately, our team shares the passion, vision, integrity, work ethic, dependability and alignment required to build a *multi-generational* investment firm. We are building something bigger than ourselves and doing more than just “managing money.” Consider this simple fact that we think speaks to our cultural differences compared to the average:

**The average tenure of Mar Vista’s investment, marketing and operations team is over fifteen years.**

More than half of us have worked together since the turn of the millennium. We’ve survived a volatile two decades together: the heady growth of the tech bubble and its painful collapse, the formation of Mar Vista, an operations transition from Los Angeles to Minneapolis, the Great Financial Recession, numerous data migrations and regulatory changes, not to mention all the personal tragedies and victories that we’ve shared. With experts at the helm of our business operations, the investment team spends nearly all our time reading, thinking, questioning and debating in our library-like Los Angeles office.

In sum, Mar Vista’s “conviction to be different” is supported by a confluence of analytical, behavioral and organizational advantages that we think will drive continued unique outcomes despite the headwinds for active managers.

## Portfolio Outlook

Over time, the expected returns of our portfolio should reflect two components: (1) the compounding nature of our businesses and (2) the discount we are paying relative to fair value. There will be times when the sentiment pendulum swings towards optimism; portfolio returns exceed the underlying intrinsic value growth, and margins of safety contract. Conversely, fear, skepticism and lower stock prices provide opportunities for both higher expected returns and less risk. Judged by our relatively narrow average margin of safety, or discount to intrinsic value, we think the pendulum sits on the more optimistic side of the scale. The 9% portfolio average discount continues to be at the low end of the last decade and the number of stocks that are trading below our estimate of fair value is smaller than is typical.

Our team claims no special skill in predicting the market's direction but, in the fullness of time, we believe a patient, high-conviction portfolio comprised of competitively advantaged serial compounders with stock prices that represent an appropriate margin of safety will generate excess risk-adjusted returns. We remain diligent in adjusting our scenarios for new information and patiently waiting for uncovered opportunities in our wide-moat universe.

## Mar Vista's Commitment to Our Investors

Though there are never guarantees in investing results, the Mar Vista team remains committed to the foundations of our success:

- Focus on the process, not the outcomes
- Emphasize capital protection as much as upside potential
- Think like rational business analysts first, not traders of individual stocks
- Identify good capital allocators that think and act like *Outsiders*
- Exploit the manic-depressive nature of Wall Street
- Take concentrated positions when the expected returns relative to the risks are favorable
- Expand our circle of competence and latticework of mental models
- Align our economic incentives with our investors

As always, we appreciate the trust you have instilled in us as stewards of your capital. Our role as fiduciary is paramount to everything we do and open communication about how we are managing your capital is an important part of that responsibility.

Please let us know of any questions, comments or concerns you have. We look forward to the opportunity to discuss our investment philosophy and thoughts with you through these updates, conference calls and personal meetings. You can reach us by phone at 310.917.2800, via email at [info@marvistainvestments.com](mailto:info@marvistainvestments.com) or visit our website at [www.marvistainvestments.com](http://www.marvistainvestments.com).

All the best,  
The Mar Vista Investment Team

A complete list of portfolio holdings and specific securities transactions for the investment strategy during the preceding 12 months, the top contributors and underperformers calculation methodology and a list of every holding's contribution to the overall performance during the period is available upon request and a presentation that complies with GIPS® for each strategy mentioned are available upon request by contacting Mar Vista directly at (310) 917-2800 or by emailing at [info@marvistainvestments.com](mailto:info@marvistainvestments.com). The securities listed in this letter should not be considered a recommendation to purchase or sell any particular security. The reader should not assume that investments in the specific securities identified herein were or will be profitable. Risk data is being provided as supplemental to the Strategic Growth GIPS® performance presentations, which are available upon request. Past performance is no guarantee of future results. Not FDIC insured, no bank guarantee, may lose value.