MAR VISTA
INVESTMENT PARTNERS

January 2018

The Fallacy of the Benchmark Game

Benchmark weights act as gravitational bodies that influence the way many professional managers construct portfolios. As a high active-share manager (82% for Strategic Growth and 88% for Focus), we often receive questions about our "active" decisions against large benchmark stocks or sectors. "How can we be less than half the Technology weight and almost quintuple the weight of Financials compared to the growth benchmark? Isn't that risky?" or "With a fraction of Apple's huge benchmark weight, aren't you really expressing a negative opinion of the stock?" Put simply, the composition of either benchmark is irrelevant to our portfolio construction. While sitting far away from a bogey at the peril of being wrong can be uncomfortable for the psyche, there is tremendous logic in building a portfolio using factors very different from those of a benchmark. We believe business pressures and behavioral biases, not rational investing, unduly influence how active managers weigh positions.

Consider the four variables that influence a stock's weight in the Russell 1000® Growth Index:

- Market capitalization
- Valuation (as measured by Book Value to Price)
- Revenue per share growth for prior five years
- I/B/E/S near-term (two year) growth forecast

We are simplifying but, all things being equal, the faster a business grows and the higher its stock climbs, the larger its position in the benchmark (and, logic follows, the larger its influence on active portfolios). A few observations and questions we've pondered:

- Growth benchmark weights are inherently momentum-oriented. Does it follow that intelligent investors should increase their exposure to an inferior business enjoying near-term growth and a parabolic stock chart simply to reduce the potential for near-term underperformance? Where does the stock's price relative to intrinsic value come into consideration when playing the benchmark game?
- If we invert the problem, does it follow that we should put less capital behind undervalued, competitively advantaged businesses that rank low on the four criteria listed above? Markel, for example, is not in the Russell 1000® Growth Index. Much of its intrinsic value growth flows through the balance sheet, not revenue or earnings. Does that mean we should limit our exposure despite its superior business model and growth outlook?
- From time to time, typically after a sustained period of strong fundamental and stock performance, a sector or narrow group of stocks will represent an outsized portion of the growth benchmark. Today, Technology (excluding Amazon) represents 38% of the Russell 1000® Growth Index, a weight exceeded only by the 40%+ weight at the end of the '99-'00 Tech Bubble. Is risk defined as "high tracking error" or "near-term underperformance" caused by not putting enough capital in crowded sectors? Or is risk defined by owning overvalued but popular stocks?

In contrast, Mar Vista applies an **indirect, private equity-like framework to investment decisions: to outperform the passive benchmarks over time, one must invest independently of them.** Our portfolio optimizes for the following factors:

- **Maximize intrinsic value growth:** sustainable excess returns on invested capital drive intrinsic value. Earnings and revenue growth are components of the equation but the amount of capital required is equally important.
- **Maximize margin of safety:** a stock's discount to fair value influences both expected returns and the risk of permanent capital loss. Simple multiples are the result of value, not the driver.

- **Minimize the range of outcomes:** probability-weighted scenario analysis and asymmetrical opportunities (i.e., heads we win, tails we do not lose much) influence our weights more than simply emphasizing those with the most upside if our thesis is right.
- **Maximize competitive advantage periods:** the period that a business can generate excess economic rents drives value much more than near-term earnings or revenue growth. We will favor a business that can sustainably compound intrinsic value at 10% than one that can enjoy 15% earnings growth for a few years followed by more uncertain growth.

Our portfolio's relative exposure to the various factors will vary over time depending on the opportunity set. In late 2008/early 2009, our average margin of safety, or discount to intrinsic capital peaked at 75% and we had many asymmetrical opportunities. Today, with the average margin of safety at a record low, we are finding far fewer fat pitches but have outsized positions in mega-wide moats that can grow in a variety of economic environments.

Investors in Mar Vista's Strategic Growth, Focus or Global strategies acknowledge and agree that (I) any information provided by the Firm is not a recommendation to invest in the strategies and that the Firm is not undertaking to provide any investment advice to the investor (impartial or otherwise), or to give advice to the investor in a fiduciary capacity in connection with an investment in the strategies and, accordingly, no part of any compensation received by the Firm is for the provision of investment advice to the investor and (II) Mar Vista has a financial interest in the investor's investment in the strategies on account of the fees and other compensation the Firm expects to receive from the client.

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. The securities mentioned in this letter were held in the account of a Strategic Growth client that Mar Vista believes to be representative of the accounts that Mar Vista manages for this investment strategy during the period from September 30, 2017-December 31, 2017. Other Mar Vista clients managed with different investment objectives may hold different securities than those listed. 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 and Focus 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.