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Addressing the topic of "risk" in the midst of an incessant bull market is a bit of a killjoy [cue the sad trombone's three descending notes] but it is especially important during these headier times that our investors understand the lens through which we analyze and manage risk. Definitions of risk can vary from stock volatility to underperformance to high tracking error. For Mar Vista, it is clearly defined as the probability and magnitude of permanent capital loss.

Analyzing Risk

Unless you get lucky and sell to a greater fool, the surest path to permanent capital loss is paying a price that exceeds the value received. We spend an equal amount of time understanding the impact damaging scenarios might have on intrinsic value as we do on the upside in positive scenarios. Only through analyzing a holistic range of potential outcomes are skewed risk-reward opportunities revealed.

Mar Vista's balanced approach certainly does not inoculate us from making analytical or predictive errors; we know that we will be wrong on our fair share of investments. However, if we can anticipate and monitor the key risks, we may also limit their damage. In our experience, the following errors commonly result in permanent capital loss:

Overestimate the durability of competitive advantages
All things being equal, the earnings multiple for a business with only a five-year competitive advantage period should be a fraction of a business with a twenty-year advantage. While both companies may enjoy similar growth over the first five years, the value created in the ensuing fifteen years by the latter company demands a much different valuation. It follows that judging a business' moat and reinvestment opportunities, not near-term earnings trends, are among the most critical, but also difficult, investment factors.

Misjudge management's capital allocation skills
The higher a business' returns on capital and the longer one's investment horizon, the more management's capital deployment strategies will influence per share intrinsic value growth. Warren Buffett gives the simple example that, over a decade, the CEO of a business that retains earnings equal to 10% of book value will be responsible for 60% of all the capital deployed in the business. We spend significant time understanding how capital allocation decisions align with a management's strategy to enhance competitive advantages, not just maximize near-term growth. Still, value-destroying decisions can happen despite management's incentives and best intentions.

Overpay due to shortfalls in unit growth, price and margins
Sometimes, as Forrest Gump would say, "It happens." New products or services may not pan out as projected. Prices or margins fall short of expectations. Capital investments are higher and fail to generate the required returns. Only with hindsight does an investor realize the cash flows required to justify the price paid were overly optimistic.

Incorrectly assess the probability and impact of key macroeconomic factors
A business whose growth depends on external variables, such as interest rates or commodity prices, is inherently riskier than one with more controllable growth drivers, such as margin expansion or market share gains. We know our highest error rate will typically come from predicting the growth of businesses with high correlation to macroeconomic drivers.

Managing Risk

Knowing the potential source of negative surprises means little if the risks are not adequately controlled. Below are highlights of how our process optimizes for reward relative to the risk incurred.

Mandating a discount to fair value provides room for error
Buying stock at a price below our scenario-weighted estimate of fair value should lead to both better returns and reduced losses in the event our projections are too optimistic. The opportunity set for discounted prices varies as optimism or pessimism drives stock prices. Today, we are finding smaller discounts to fair value than is typical.

Position sizes optimize for multiple factors, not just the highest upside
Managing position sizes is critical to controlling risk in high-conviction strategies. Investors commonly put the most capital behind ideas that have the largest upside if their thesis is right. Our approach is different in that we emphasize downside protection as much as upside potential. Multiple factors influence an investment's weight: our edge versus consensus, expected intrinsic value growth, confidence in the size and durability of the moat, and the range of potential outcomes.

Think like private equity investors in the business, not traders of the stock.
We are students of behavioral finance and the common cognitive errors that cause investors to lose sight of rationality. Over the millennia, greed, envy and the fear of missing out ("FOMO") have caused enormous capital destruction. Simple heuristics are poor indicators of value; low multiples do not mean stocks are cheap and high multiples do not mean stocks are expensive. Thinking like owners, not traders, keeps our emotions in check and limits the influence of an irrationally euphoric or depressed market.

Concentrate capital in asymmetric opportunities (heads we win, tails we do not lose much)
We believe the hallmark of successful multi-generational investment managers is superior capital protection in the down markets, not thrilling performance in the bull markets. The power of compounding works against investors on the downside just as it works in their favor on the upside. A manager's outsized returns during a long bull market may provide psychic income but the risk embraced to generate those returns is masked. Investment returns are geometric so many years of terrific returns followed by one nasty year can result in a highly unpleasant outcome.

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 or visit our website at www.marvistainvestments.com.

All the best,
The Mar Vista Investment Team

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