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Battle Royal Markets

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Dear Fellow Investors,

Over the last ten years we've seen the rise of the Battle Royal markets and the shift away from one-on-one investing. There are all sorts of different battle royal's, but the ones I watched as a kid were the biggest events in pro wrestling, where 12 wrestlers were put in the ring together and they attempted to toss each other out until one wrestler was left standing. Only the winner received prize money.

Being long-duration investors, we seek companies that are protected from competition and have a wide moat around their business. Like the water canal surrounding the castle in the middle ages and the draw bridge pulled back into the castle, a business' moat fends off attacks.

Sometimes a moat comes from being the low-cost producer. Sometimes it is customer affection for your brand and decades of satisfied customers. Other moats are formed because you are willing to do something which other businesses do not want to do. The newest moats have been created by giving away the primary product (search, social media, free delivery) and using the first-mover advantage to aggregate a huge network affect via the internet.

The opposite of an industry with a moat is a battle royal. To us, this is a very competitive industry with many players are fighting over what they perceive to be a terrific future business opportunity. Industries in very competitive situations tend to see marginal profits move to zero. In our stock research efforts, we try to avoid "battle royal" situations in the stock market.

In the past, we have avoided the automobile industry, the energy space, the semiconductor companies and most cyclical industries with heavy competition. When these industries gain favor, you seem to wake up with too many wrestlers in the ring. We do not think it is in our investors' best interests for us to speculate about which wrestler would be left standing after all the others have been thrown out.

Where are today's battle royals? The biggest ring with the most wrestlers is on the tech side of the stock market. Numerous public companies have crowded into the ring in artificial intelligence, data analytics, software as a service, delivery, internet advertising and the streaming of entertainment. Every week a new company goes public in these tech areas, effectively adding more wrestlers to a crowded ring! Economics demands that as the supply of something expands, that prices will fall even as demand stays the same. In stocks, as soon as trouble comes the tendency is for demand to disappear and, when supply surges as demand declines, share prices decline sharply.

In tech, one or more multi-billion-dollar market cap companies go public in the most popular categories. These companies jump into a ring that has the FAANG[1] companies as well as the money-losing or negative free cash flow companies like Netflix and Tesla. Therefore, if anything occurs that takes demand away from tech stocks, they could become a very disappointing place to be over-weighted. If you want to know what that disappointment looks like, go back and look at tech charts from 2000 to 2003.

Another battle royal is in the production of scripted movies and TV shows. For decades this was the domain of the four major TV networks (CBS, NBC, ABC and Fox) and the major movies studios. With cheap money and a boom in tech stock prices came a movement into scripted entertainment. First, Netflix and Amazon could see that investors responded to them throwing billions of dollars at the creative folks in Hollywood, and now Apple and others have jumped into the ring.

As we like to say, money goes into Hollywood, but it never comes out! Coca Cola thought it would be a good idea to make movies back in the late 1970's and that debacle took them all the way to a price-to-earnings multiple of 6 at the bottom of the stock market in 1982. They were one of the best of the "Nifty 50" in 1972. This looks like a battle royal where the only winners are the actors/actresses, writers, directors and producers of scripted shows. They are laughing all the way to the bank.

Ironically, the most profitable side of the TV business is in unscripted shows with low production costs. We own the premier producer and distributor of unscripted shows, Discovery Inc. (DISCA), and it is in a ring with few competitors. Discovery's stock is depressed because of the perception that the scripted wrestlers will ruin their business. While the battle royal is going on, revenue growth is your ticket to enter the ring, not silly things like profits and free-cash flow.

There is also a battle royal that occurs in the psychology surrounding industries and sectors. At bottoms, most of the investors choose to invest/wrestle in another ring. At the top, research analysts crowd into the buy recommendation ring and lavish praise on stocks that have already made parabolic upside moves. If you are a growth stock investor, remember that only one wrestler gets paid in a battle royal.

We believe there has been a battle royal in the bond market as wrestlers bet that the U.S. will end up with the same interest rates as Europe and Japan. We see a battle royal in ETF strategies emphasizing low-volatility stocks and momentum trades. We have been conscious of the battle royal in tech stocks for over two years.

On the other hand, individual and tag-team wrestling matches are available in the banking sector, in the energy sector, in unscripted TV and among retailers who appear doomed by the seemingly unstoppable momentum of ecommerce. Thanks to the political crosshairs and the opioid lawsuits, many healthcare-related stocks appear to be wrestling in an empty ring.

To summarize, we try to avoid industries where too many participants are competing in a battle royal and marginal profit is gravitating towards zero. This usually occurs in an exciting industry that seems to have a seemingly never-ending wind at its back. Instead, we prefer companies with few competitors and those having a moat that is temporarily hard to see for other investors, but will fend off the wrestling invaders.

Warm Regards,

William Smead

[1]FAANG is comprised of Facebook, Apple, Amazon, Netflix, Google

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