Todd Wenning on Sell-Side Analysts and How Company Culture Can Effect a Stock

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[00:00:00] **Dave:** All right, folks, welcome to Investing for Beginners podcast today. We have a very special guest with us today. Today we have Todd Wenning, who is the senior investment analyst with Ensemble Capital. He's here to talk to us about all things, stock investing. So Todd, thank you very much for taking the time to come talk to us today. We really appreciate it. And with that, I'm going to turn it over to you guys, and we'll go ahead and get our conversation started.

[00:00:23] **Andrew:** Yeah. Todd, thanks for coming on. Want to start with moats because I feel like it. Investors probably can't talk enough about them, in my opinion. They're fascinating, and they are key when it comes to looking at good companies. Maybe for somebody who's just tuning in for the first time as a beginner, can you explain what the moat is? And then maybe we can talk about how you look for them?

[00:00:44] **Todd:** Sure. Thanks very much for having me. It's a real pleasure to be here. I would say my introduction to moats came from joining Morningstar as a sell-side analyst in 2011. And that was really a transformational educational moment for me as an investor because before, I would think this company's done really well.

Look how big it is. Look at its market share. Maybe that key part of its advantage, but that isn't enough. You kinda need to have a framework for filtering companies and understanding Competitive advantage durable. And so that's the key part of economic mode analysis. So moat, the term moat comes from Warren Buffett's moat described, in capitalism, you have a castle, and everybody's trying to attack your castle, especially if you start generating good returns.

And so what you want is a wide moat around that castle to keep people from attacking your castle. Yeah. A few people can elaborate and illustrate modes better than more than Buffett's. That's the best analogy to think about what it is, but from a more technical aspect, thinking about moats is a durable, competitive advantage.

So what Buffett's trying to get at is that when you have success with a product or a service, And especially in today's world where competition is strong and its increasingly global capital is no longer a barrier. So if you look back and you read the biographies of Nike or Walmart, they had trouble getting capital; even though they were extremely profitable growing quickly, banks wouldn't give them a loan.

And today, that's just unheard of; you can walk down the street and get, can capitalize if you have a compelling story. Capital is no longer a constraint. So what it really comes down to is barriers to entry and barriers to scale. And so those two factors are the way to think about economic modes.

And in capitalism, if you have a good product or a good service, people are going to try to copy it. And what is it structurally about your business, the way you operate of your corporate culture, your attitude, whatever it might be, your what prevents people from doing the same thing that you're doing?

And so, at Morningstar, one of the things I learned was there are a couple of buckets for thinking about competitive advantages about the moat. So one is network effects, and we hear a lot about that now with tech, especially with Facebook and the idea being the more people that join a platform, the more valuable that platform becomes.

And it becomes harder to replicate or do something similar to that model when everyone's already on Facebook. If we try to launch our own Facebook today, it is much more difficult to do it because Facebook has this billion user lead ahead of everybody else. Then you have switching costs.

This is classic, like business to business sort of service, where once it's ingrained in your process, this service, the software, the cost of switching to another service or piece of equipment, or whatever it might be is. Very costly. So you have to retrain your employees, or you have to learn a whole new process.

And all of these things take time, and that adds to the cost. So companies are unwilling to change to another product unless the new offering is extremely compelling, is at a lower cost, or has some sort—material advantage. So if you have switching costs that help companies defend against new competition, another is intangible assets.

That's a pretty wide range of inputs. So that could be brand. It could be the way you do something that you have some sort of patent-protected process or some unique process at other people's. I can't do, so that's a pretty wide bucket. Then you have low-cost production. So this is primarily in the industrial or basic materials industry, where you're able to produce widgets or products or services at a price that's well below everybody else.

And they would have a really hard time getting to your price point. We, we can see that also, however in The manufacturing space, people creating products that are extremely cheap and hard to replicate. But you also have that in retail. Trying to match what Costco is offering is really hard to do.

So you have a cost advantage there. And so, those are really the four main buckets for filtering. No, it's not the only buckets, but they're really the best way to start thinking about what the source of the company's competitive moat is and really what we're looking for and as investors at Ensemble our unfair advantages, whether they basically, these guys are playing games that nobody else can play, they're just so far ahead of everybody else that they're almost working on it at a different wavelength as everybody else.

And so those companies are extremely rare, and we're, that's what we're trying to find is companies that have these advantages that nobody else can do, or it would take ten years to do.

And so that gives us confidence as investors to forecast the business and say, this company is going to compound value at a high rate over many years, and that is an attractive setup for us.

[00:06:26] **Andrew:** Yeah. That's such a good overview of having those different buckets, and really it's so many different businesses that can have one part of that or maybe a mix of those.

And so when you look across the stocks that we can buy, and you see a moat or two moats, or a combination. Is there a price that's too expensive for these moats, or is there some gray area where maybe you pay more for a price for a good moat, but not too much. And like how has that been defined in your case?

[00:07:00] **Todd:** Let's take a step back because valuation is a poor important to understand, and really what a company's moat enabled it to do is generate returns on its invested capital well above its cost of capital. So it's creating a spread between return on invested capital and its cost of capital. And that adds shareholder value every single year.

And certainly, there are times where the market has already priced that in, but a lot of times, Misses misses the mark with them. And there are two kinds of broad categories where that happens. One is a company whose return on invested capital is growing at a high rate. So it, maybe it goes from 8% to 30%, and the market has not figured that out yet.

It's rare for a company to grow and expand its advantages at that rate. And so that's one thing that we've talked about is moat trend is this company's moat getting wider, and sometimes the market doesn't fully appreciate that, and that's an opportunity. Another opportunity is when you have a very persistent return on invested capital.

So the market is smart, and in most cases, companies are generating high returns on invested capital. It starts to fade closer to the market average over time. And so companies that continue to what they call beat the fade continue to produce high returns on invested capital for longer than the market expected.

The market has to continually rerate its expectations higher. And so you look at a company like Fastenal, which we own in the portfolio; it's generated very consistent returns on invested capital for decades. And you would think that the market would have caught on, but Fastenal has been one of the best-performing stocks in the US market over the past 30 years or so.

And so it's, and that comes back to the persistence. They continue to generate returns on invested capital, above what the market had them pricing it. They had expected things to the competition to come in, whether it's online or from another competitor, and it just continued to hold their lead. And so those are the types of situations that we look for you, whether it's a company that's getting stronger and beating expectations or is just more persistent than other companies.

But we are just going back, tying that into the valuation. There are certain situations where the market gets very enthusiastic about a story, and its prices in expectations about returns on invested capital are well beyond what the company is likely to do. In which case, if we own that stock, we would trim the position or sell it.

So it's a case-by-case basis, but certainly companies with the turns and invested capital tend to be. Overlooked by the market or undervalued we've we have a post on our website talking about how you could have paid 40 times earnings for Costco for, I think, over a decade. And it never, the PE never got even close to 40 times, and you could still earn it like a 9% return.

I think it was an eight or 9% return, and you could have paid a lot more for that business. And the market was even pricing in; it's just that the market had not fully appreciated Costco's economics.

[00:10:25] **Andrew:** Costco is a great example with moats to them. We talked about that recently with another guest. Maybe we can back up for investors who have no clue what return on invested capital is.

I know it's not the easiest topic to describe because there's more advanced accounting to go behind it, but could you give the gist of pretend. High schooler and you were trying to explain the return on invested capital. Let me how you would do that?

[00:10:53] **Todd:** Sure. So, my boss, the president CIO of Ensemble, Sean Stannard-Stockton, had probably the best explanation that I've ever heard.

And it's, at least to me, it was very simple to understand. And it imagines you have a printing machine and you fed a hundred dollar bills into the printing machine. And on the other, you turn the machine on the other side, came out 140 that's a really good business, right? And if you keep putting that 140 and in the machine, then you get 40% on that.

And that's basically the way I think about returns on invested capital is the company is putting in invested capital that's equity, debt capital, and it's getting a return on that. And so the higher, the more free cash the company is spinning off each year, the more valuable the company should be, all else equal.

And so I'll give you an example. Let's say you have two companies, both growing at 10% per year. They're in the same industry. Let's say one has a 20% return on invested capital. The other has a 10% return on invested capital. The 10% return on the invested capital company has to reinvest all of its money back in the business, just to maintain that 10% growth.

Whereas the company is generating 20% returns on invested capital only has to be in this. To keep up 10% growth. So that extra capital is then available to shareholders as dividends buybacks, or the company could do something else with it. And that company should all equal be more valuable from like a multiples basis or valuation, in general, should be more valuable to an investor because of that extra cash that's coming through and they're maintaining that growth rate. So that, to me, is the way that we think about returns on invested capital and why it's so valuable for investors to understand.

[00:12:41] **Andrew:** That's a brilliant explanation of that. Thanks for that.

[00:12:43] **Dave:** Yeah, it really is. So I guess going further, a step further on, on the ROIC path, the cost of capital is related to that. So can you maybe explain that a little bit as if I'm a high schooler as well?

[00:12:57] **Todd:** Yeah. Warren Buffett and Charlie Munger, I think it was Charlie. What sounds like a Charlie response, but he said at one of the meetings maybe five years ago that he's never heard an intelligent conversation about the cost of capital.

So we'll give it a go, though. And so I think the way that I think about it, the way we think about it is. That's the price of the capital that the company could get today if it went to market. And so let's say they wanted to the company wanted to issue debt right now for ten years.

What would the rate that they would get from the market be? So maybe let's say it's 4%, and that would be the cost of debt for that company. And then you would have, the cost of equity would be if you were paying or issuing stock at a fair price, And intrinsic value. And we'll talk about that perhaps in a minute, the intrinsic value of the principles behind it; what would be a fair return from that point?

Say the market average is 9%. If you bought a company at fair value and you would be comfortable with a growing about 9% a year, let's say the cost of equity is about 9%. And so those are the two factors that we think about. One of the things that we do internally with the cost of debt, I think we realized that current interest rates are abnormal.

And so what we do is we take a sort of a normalized quote, unquote 5% ten years is our starting point for thinking about the cost of debt, because. Yeah. Some of these companies, especially the companies like Costco, have AA ratings or AAA ratings; they're issuing ten-year debt of 0.8 3%.

And that's just, that's very, extremely low. And that's before the tax benefits right, of, of paying interest. Just basically free capital. And so how to do if you look at them, if you did a classic weighted average cost of capital on some of these companies, you're talking about three, 4% doesn't seem reasonable.

And so we, we think about it more from like a normalized cost of debt. And we think, look at the spreads on what depends on what the company's debt rating is if it was triple a, then the typical spread is about 1% over treasuries. And so we think about the costs of debt in that way. But yeah, it's so I think it's just a way of thinking about what's the company's opportunity costs, for its capital.

So that's just the way that's the most intelligent way I can explain the way we think about the cost of capital. It's something that, if you were taking the CFA exam or if you're in finance courses and university, you're going talking about quite a bit.

And it's really just thinking about companies being able to get over that hurdle. So if you're generating turns below your cost of capital, you shouldn't be investing the money. It should be going back to shareholders because they could theoretically take that money, put it in the S and P 500 index or something like that, and generate higher returns, and they could have got, had you put it back in your business. That's it's not the most intuitive thought process about the cost of capital, but it's a way of measuring it.

Is this company creating, or is it destroying value? And, from our standpoint, we would never touch a company that was even close to its cost of capital because it's just not, or at least I should say know there are companies that are currently generating cost of capital or below but are reinvesting at high rates.

So the increments return on invested capital is very high. So I look at companies like Netflix; they've been plowing capital into their business and, our expectation is that the return on that capital eventually will look very attractive. And so that's really where the disagreement is between market participants on Netflix is that people look at the low cost of capital, and they say they're just burning capital, buying all this content.

And we're saying, no, like they're going to be, they're gonna be leveraging that over time. They're going to get it; it's a fixed cost for them now.

Generally, each incremental subscriber that comes in or as they raise their subscription, that's all going to drop to the bottom line. And so that will generate that good returns on invested capital down the road, or at least that's our expectation as well.

[00:17:01] **Andrew:** So this kind of just popped into my head, but maybe with thinking of the cost of capital would be like the costs to keep the printer running. And then, the printer is going to give us this return. But if the costs to keep the printer running are so high that, let's say, we made $105 after putting in a hundred dollars, but if it costs us money to keep the printer on, then it's like destroying value as a.

[00:17:26] **Todd:** That's a good way of thinking about it. I think that's the first time I've heard that. It makes sense. So if it was a cost of $8, let's say to run the machine, and you're getting, putting a hundred dollars in the get a hundred five back it's you should have just kept the hundred. That, that makes, that makes sense to me. Yeah.

[00:17:41] **Dave:** All right. You, you brought up the I word intrinsic value. So maybe we could go down that path a little bit and tell us a little bit about how you guys think about it and maybe how people could help them think about it a little bit.

[00:17:54] **Todd:** Sure. So intrinsic value is a word that value investors, in particular, use a lot.

And it's the best way to describe it is if you were to have a transaction between. Two parties that were equitable to both sides. That would be what the intrinsic value theoretically should be. For the buyer, that would be, am I going to generate a reasonable return on this? So let's say it would be, let's say, 10%, like the buyer, would say I'm comfortable earning 10%.

Suppose I buy this at fair value. And then the seller is saying. That's that seems reasonable to me. I'm willing to, off, I think that's a fair value for my business. I think it sizes up the opportunity. It sizes up all the risks, and I'm going to take that capital and do something else with it, whether it retire or sell the business or whatever.

So I think that's the best way to describe it as just, what would be a reasonable transaction between two independent parties, what they call an arms-length transaction. There's no other incentive other than just making a fair trade; it's if you go to a flea market or something, and you shake hands with the seller, it's yo, that's a fair price to you and to me. And so that's how we think about it. And we also, I would say. A lot of times, you'll hear value investors say this company is worth exactly $83 and 23 cents. And while we have a target. So we have what we think is a fair value for the stock.

We also see it as more of a distribution. And so our, the way that we trade around fair value is it's not like if the stock gets to exactly our fair value that we're going to sell the whole position, it also depends on what else is going on in our portfolio. Do we have other stocks that are that we don't currently own that are, we think of better?

And so that's, I think that can be confusing to especially newer investors. Like, why wouldn't you sell, if you thought the stock was worth 80, a stock got the 80, why don't you sell out? And the reason is that what fair value, what intrinsic value says is that from that point, you expect the company.

If nothing, if your forecast that the business is exactly right, you should expect to earn the cost of equity for that business going forward. So if you have $80 stock and it's worth 80, from that point, it should, because of the time value of money as you roll, as you go forward each year, the company's value should increase by about 8% a year.

Now, sometimes if you're paying a little bit, so excuse me. So if you pay a little bit above the fair value, Your expected return might not be 8%, but maybe it's seven and a half. And maybe relative to other things in the available to you in the market, that's might still be a very good return. So I think the way investors talk about value investing or intrinsic value is deeply rooted in value investing.

So if you read Benjamin. Very much, it's a classic cigar butt scenario where I think a couple of puffs and you sell, and then you roll it in something else. But as investors in I would say, and we don't like to make too much of the growth investing versus value investing.

But when you're, when you have a business, that's compounding value each year as Buffett says, time is the friend of the wonderful business. And so, you don't necessarily have to be trading in and out of these great businesses. And when they close to fair value, because, that's what you're told by the *Intelligent Investor* or a *Security Analysis* from Benjamin Graham.

It's a different process. And if I were a deep value investor, I might have a different approach where, if I bought something that was; it was, I thought it was well below its book value. And I got the book value; maybe I exit, but, in terms of like dynamic businesses, I don't think you want to be trading in and out of them as you get really close to fair value,

[00:21:51] **Dave:** Yeah, that makes a lot of sense. So how do you guys think about something like a valuation? Is it, do you look at, there are lots of talks. Yeah. Media and Twitter and all those places about the differences between relative value and intrinsic value in such that people use the DCFs or those kinds of models or those kinds of things that you guys how do you guys think about that kind of calculations, I guess?

[00:22:17] **Todd:** I'm glad you brought that up. So I think a lot of beginning investors focus on me. I did. I'm sure everybody, a lot of people do too. Yeah. Multiples. So you look at what's the PE this PE is cheaper than that. So this one is cheaper than this, and that's, we see that as a shorthand for doing valuation work. So the way we approach it as we do DCFs discounted cashflow model.

So we look at the company's historical financials and then project into the future. And then, we can look at how much distributable cash we think the company is going to earn over the next ten years, and then we have a terminal value, and then we discount those cash flows to the present. And we think that's what fair value is.

The future cash flows of a business are discounted to the present at the reason at a reasonable rate; that's classic value investing. And w what a lot of people in the market do, and this is really common, especially in investment banking and sell-side research, is that you go off multiples.

And so you say the reason it's so prominent in the sell and the sell side, especially. And this is coming from someone who was on the sell-side; your job is to sell something, right? So you're selling your research to a buy-side person like myself now, where we're making the investment decisions. And we want your take on what the company is worth now.

And when you have, if you're doing discounted cash flow analysis on all of the companies on your coverage is a sell-side analyst. You might very reasonably conclude that all of my stocks are either fairly valued or overvalued. In which case, nobody wants to talk to you because you've got nothing to sell.

And so when you have relative, when you're doing relative valuation, you always have something to sell because something is always undervalued relative to other holdings. And so, let's say you're covering ten packaging companies. That was the space I happened to cover. You know if if you have, if you're comparing two companies and you're saying company A is trading for 30 times, company B is trading for 22 times earnings, whatever.

Company B is cheap relative to company A even, and so you always have something to overweight or underweight, or you can always message that. And so I think that's important to understand, especially if you're a newer investor and you see upgrades, downgrades, price, target changes. A lot of that is marketing.

And there are some great cell site analysts out there. I don't want to diminish that because they're their role in the market is to provide investors with insights about the company. They have industry expertise. When I was covering the packaging space, I would go to these conferences, and the other sell-side analysts from the other banks were.

It had 10, 20 years covering these companies. And so they knew everybody, they knew from the top to the middle management and they re they were thinking things like, okay this person is an up and comer. He's going to be the CEO in 10 years. And so they, they know a lot of things, some of these analysts.

So they're an extremely valuable resource to investors. I don't want to diminish the sell-side, but when it comes to the valuation work, we don't pay much attention to it because it's relative. Let me take another step back about that relative valuation is that I said earlier that it's a shortcut to intrinsic value because whether or not you're using relative valuation or you're using DCF, you're still making an assumption about future growth.

So embedded into the price to earnings is an assumption about how much the company is going to grow. What sort of cash flow is this going to do? And we find one of the values of doing a DCF is that you have an explicit forecast so that you can check as time goes on, is this company hitting these targets to justify its current valuation?

And if you're just going off of price to earnings or price to sales, you don't have that. So you're just following market trends, market momentum. There's no way for you to keep up with what's going on with the company and checking off whether or not they're following the path that you expected.

[00:26:30] **Dave:** Yeah, that makes a lot of sense. So when you listen to earnings calls, then the analysts that are interviewing or asking questions of the CEO and the CFO. Those are sell-side analysts, correct?

[00:26:40] **Todd:** Yes, I can't think of many companies that would let a buy-side investor on a lot. Sometimes it'll happen.

Sometimes a buy-side investor will sneak in. You've sometimes seen activist investors will sneak into calls, and it becomes a big controversy. But the companies are very careful about who they let. To calls and they will, I should say so when I worked at Morningstar; we were not one of us didn't have an investment bank arm, so the companies had no interest in doing business with us outside of the analyst work.

And so, I was always the last person to ask a question. And so, it was common for that to happen. It's just it's a game, right. Between the sell-side and the company and getting access and, so I think you really haven't taken. Th the sell-side ratings, with a grain of salt there's they provide a lot of value.

I encourage people to read the notes and the insights but also think about the game that they're playing. And not to say, this company downgraded my company; I need to sell like just take a step back and check-in and check your thesis and make sure.

And try to get access to the note, try to read it, try to find out what the analysts were saying. The rationale for the downgrade. Sometimes it's valid, but if you look at the percentage of buy ratings, holds ratings, and sell

ratings is it's massively buy and hold. Because if you have a sell rating on the company, you're basically shutting off your access to management.

It's really hard to cause them; they'll come down on you. They'll say, it's, I shouldn't say some of them. Companies will go; they care about that quite a bit. And they'll say, you gotta see, you gotta sell rating on us and why should we have you on the call or whatever?

So there's a game. And so, just as you're a newer investor, just be careful.

[00:28:27] **Dave:** Yeah, I like the calls because it does provide an interesting take on things that you may not think about. Just reading through the financials or just reading through the CFO or a CEO's, prepared remarks as they read them to some companies I've noticed have gone are starting to go away from that format a little bit.

What are your thoughts on that?

[00:28:48] **Todd:** Yeah, pet peeves a, as an investor is having half of the conference call, just being a regurgitated press release. And then they'd spend the last 20 minutes answering Q and A, and I see that as killing the clock; they just want to have a few questions and be challenged by analysts.

They don't want to; they want to avoid that as much as possible. So they keep talking about what's in the press release. And so I think companies that are opening it up saying, you've read the press. Ask, and I think that's a really good sign actually of companies that are willing to be open and transparent with the analyst community investor community.

And, the sell analysts ask great questions. And the most part. Yeah. They have the sort of cliche, like great quarter guys, when you provide us,

if it's theirs again, as part of the Kabuki dance, that's part of the show. And you kinda have to look past that, but I would say analysts do touch on real compliance. And in most of the questions that we would ask would, are generally being asked on the call,

[00:29:55] **Dave:** Yeah, that's awesome. So I'd like to pivot a little bit and talk about something that I know is near and dear to your heart. So you write, you wrote this great article on your website about how to buy and sell, buy the buy and hold has gone away. And maybe you could talk a little bit about that, and maybe we could dive into management and leadership and culture and some of those ideas.

[00:30:17] **Todd:** Yeah. So the title of my article was provocative; some intentionality it was then, there was no such thing as buying and hold, and there was there's a nuance there. So what I was getting at in the article was that you can't buy and passively hold equity. Like you could use static assets like gold or a painting because the underlying business is changing dramatically.

A few bought Amazon in 1997; what you bought was an online book retailer. And if you buried your stock certificate in the backyard and dug it up today, what you own is not an online, just an online book retailer; that's probably less than 1% of the business.

And there, the point was that even management changes, so Bezos was the CEO then, not now. And there are just so many changes happening, companies that they are, they are complex. They are organisms

responding to internal and external changes. And no, our concern is really with people who were just buying something.

And just saying, I can forget about this because that's not the right way to think about owning equity is the business changes. So, therefore, you have to stay on top of what's going on with the business. Now, I think one of the reasons that sort of the quote-unquote coffee can approach to buy and hold is attractive, and it has had some good statistical results.

Are that investors, when you say you need to stay on top of this company, they do it too much. They get too nervous, and they get too involved, and they get too emotionally tied to the business, and they'll buy and sell in and out of business at the wrong time. But we think you can go in again, thinking about milestones and thinking about how the company is progressing.

Is the company making the right decisions right now. Management, or are they sticking with the strategy? They said that they were going to do it three, five years ago. Do we think that they are positioning the business the right way? And if so, continue to hold. And what I should have said added in the article was that we have multiple holdings that we've held for over ten years in a portfolio.

So it's not like we're against buying and hold. It's just that we're calling out why you need to be careful with passive buy and hold that you have to understand that businesses are dynamic, not static assets. And it's important to be aware of that and not kinda stick your head in the sand because people we will hear a lot is, someone will say I've owned Disney stock for the past 40 years.

My grandfather had it and his lockbox. And, you'll hear stories about that, but you never hear stories about grandpa's stock certificate for United States Leather Corporation or something that you're a railroad that is gone, so I think theres survivorship bias in those stories.

And so, it's important for investors to realize that not every company is worth holding. In fact, we would say you would really want to only hold great businesses types that we're after, sort of companies that are middling returns on invested capital. We aren't creating a lot of value that we would not suggest holding those passively at all.

We would suggest if you were going to invest in those types of businesses that you're looking for a catalyst in that you're trying to get out as soon as the catalyst happens. And that's a different approach we have.

[00:33:32] **Andrew:** I think it's key to focus on the fact that you said check-in after three to five years, you then say three to five months where there's no way you can make a decent guesstimate on how things have changed if at all.

Cause there's so much noise in the short term. And you touched on the idea management will change. We say we see a transition from Bezos to the next CEO. So how do you think about just management and leadership in general, and how does that factor into a buy and hold or sell kind of a decision?

[00:34:07] **Todd:** Yeah, so we have three core principles of companies that we own, and we, they have to have all three things. Otherwise, they're ineligible for a portfolio. And so we have to have a moat. And we have to have a great management team, and the business has to be forecastable; there are businesses out there that are super complex and hard to understand, and that's just not really what we're after, but going to management is very key to our process.

In fact, I think we have, we score each company on seven attributes, and management sort of is three of them. So it's, I would say it's a very important part of our process. And so management, we of the same thing, not managing. There are really two types of managed personnel man personalities. So we see there are visionaries, and there are optimizers.

That's the framework that we use. And so, a classic visionary example is Steve Jobs. He there's no blueprint for success at the business. And visionaries are often the best CEOs for those situations. They are creating value in ways that no one else understands because it's not yet in the rules.

They're breaking all the rules, and then you have optimizers. I don't know if you've read the book, the Outsiders CEOs; yeah, those are classic optimizers CEOs. So there's a blueprint for success like a John Malone type, here's what you do. Like you, you've structured the business this way, and you'll create more value.

Those are classic outsider CEOs, optimizer CEOs, and there's a blueprint for success, and they're just executing on that blueprint extremely well. And so we think there's value in both. I think value investors, in particular, tend to focus on these optimizers. Whereas we see value is also visionary.

So these are guys who are creating great businesses, creating products and services that no one else has considered, and both can add a lot of value to shareholders. So we focus a lot on those two frameworks. We haven't owned anything. Super dynamic and the new innovation curve with like electric vehicles or anything like that.

We don't own any companies in that space; Reed Hastings at Netflix as a com is as a leader. We would suggest that he is a classic visionary. He went from mailing DVDs by mail to streaming to creating content. There was no blueprint for success, and now everyone was trying to catch up.

And so they went from rule breaker to rule maker. And so there's this transition, and now they have, they're changing leadership a bit, and now they're moving more I would suggest to more of an optimizer type of approach where they are now we have the blueprint for success.

Now we just execute, we have this lead, we have the dominance, now we transition. And so we think about CEOs that way. I think about two different types of personality. And there can be a mix too. So you might have someone like Mark Zuckerberg who at Facebook, then he has Sheryl Sandberg, who's his optimizer.

And like you think about the balances between different personalities of management teams, and that can change over time. So you might have a company that has been run by an optimizer for a long time but then needs a visionary to come in and revitalize the business.

So over time, that changes. But management is key because they are there, the torchbearer, so to say of the moat. And they have to make sure that there's no moat erosion happening behind the castle walls is; another article that I've written is about how moat version often doesn't come from external sources. It's not like a competitor shows up one day and starts invading the castle while it's strong.

Typically what happens is the castle gets weak first. And then the competition comes in. And so management teams who don't keep their foot on the gas and keep the company moving forward. Once they start settling into a routine, things start to happen because bureaucratic and that's; I think what Bezos is after what, his day, one and day two philosophy, it, Amazon needs to stay on day one, and we don't own Amazon for disclosure.

I'm just familiar with the business. So I think that's what he's after is he doesn't want the company to get. Complacent. Complacent. Yes. Thank you. And I think that's how moat erosion begins. And so, management sets the culture for the business. The rest of the business looks to the CEO, the CFO, to set an example, and some of the best companies that we follow are ones where there's what we call a founder's pedigree.

So even though the founder may not still be there, the co they've set a tone at the company for the success of generations to follow. And that's, those are great situations where it's just this is the way we do things. We do it this way.

We'll always do it then. And that's a great sort of sign as you're looking through companies that if they've had like strong family ownership over the years or a dynamic CEO at some point who set the tone for the rest of the business.

That's one thing we own a company called Masimo, which creates primarily tellerless non-invasive pulse-ox imagery meters. So if you go to the hospital, for example, you'll get one of those glowing red things on your finger that keeps track of your pulse socks. And so they make most of those in the US they pretty much have a dominant share in the ICU and operating parts of the hospital.

But they have a founder, Joe Kiani, who, when we visited the company of their investor day. And I think it was 2019; the whole COVID quarantine has worked. I'm trying to remember the team; that was one thing would be, we picked up from talking with other people at the business was not all of them were there for a paycheck.

They were there to solve big problems. They wanted to make healthcare more efficient and more affordable. And that those are things that just get us excited about a business is when people have this intrinsic motivation, and they're not worried as much about, what's my pay going to be this month, they're there for a purpose, and that's something we really like to see.

[00:40:24] **Dave:** Yeah, that's awesome. So I guess that kind of how has outside investors, can we move past some of the fancy jargon and pretty words that people will say as the culture? And I can say this from experience cause I worked for Wells Fargo for five years, and this was right as all the scandals started to hit.

So I was in, I saw the evolution of, you got to sell. Two. Okay. Maybe we don't need to do this, and maybe we actually need to take care of our customers. So I saw them trying to change the culture, but, so how has an outside investor, how can we look through, look past some of that stuff.

[00:41:02] **Todd:** It's a really good question. I think if I recall correctly, Enron was like one of the best places to work in 1999 or something. And so you always have to be cognizant of that. And a lot of times, there is almost, it's not my favorite word, but like a cult around, around the company. It's an us versus them the type of mentality.

And that can be healthy, for sure. If you look at companies, if they have a name for the employees like Googlers, or when I worked at Vanguard, and we were the crew, it's there's a certain culture. That's what creates this dynamic of, we have shared values, and we want to defend those values and what you'll often see if you go to Glassdoor and start researching the company, look for how the company's employees are talking about it.

And if they're saying like a good paycheck, the time I get enough time on the clock or whatever. That's okay, but what you really want to see is a real fierce debate, and the debate is key. If everyone's just super positive about it, it's probably not durable, but if you're, if you have people on there who said, I joined, I didn't get it.

Things weren't working out. I just, it, wasn't a great fit. That's actually interesting when that happens because that tells you that there is a clear culture where some people don't fit with that culture. And then we think the companies that are in that dynamic do really well, especially when challenged.

So when I worked at the Motley Fool, I was there during the financial crisis, and it was a great experience for a 27-year-old at the time because I got to see firsthand what a great culture could do in a crisis. We went, did a lot of the other corporate stuff. I think some are benefits where we're temporarily put on hold or whatever, but we all knew that this was a huge opportunity for us to provide tremendous value to our subscribers and how the, and we stayed focused on making sure that we provided that value and on came out stronger on the other end.

And so I think that's a sign of a great culture when you can rally everyone to a cause, especially when challenged, because I worked at a bank before and I know that when a challenge comes, the employees might go, gosh, this is just not really what I want to do today. So with that attitude is very different from a dynamic company that's servicing customers and cares a lot about how the customer is getting value, how their suppliers are getting value.

We talk a lot about it, Sean written a lot about this for our blog about stakeholders taking. Every stakeholder, not just shareholders, not just employees, but customers, suppliers, the community, is considered when the company is making decisions.

So I think there's one thing you can do to make sure that the company is not just talking the talk is going to YouTube we'll go through videos, see if there are people talking about the business, read local business journals. A lot of times, companies have really good corporate cultures.

It may not get written about in the Wall Street Journal, but it might be in the local business paper. People saying, a top place to work in Kansas City or Cincinnati Ryan, that's a good sign that there's something happening there that people are enthusiastic about working there.

Also, look at the track record, too, companies like Costco or Starbucks, which we also own. They're their focus on taking care of stakeholders for 20 years, and you've seen it play year in and year out. And so you can give that validation, but if a company, all of a sudden, it's just Hey, we're going to treat everybody nice.

Now that might be a red flag that maybe let's just give it a couple of years at least, and see if they're serious about this.

[00:44:51] **Dave:** Yeah. I think that those are great insights, and you could probably argue very easily that the more successful the culture is, the more successful the business is going to be over the long term, and that's going to help the stakeholders or shareholders in a longterm.

[00:45:05] **Todd:** That's right. We think that's a very important thing to understand about businesses. Try to understand the culture before making an investment, and that's not always easy to do, as you said, unless you're. As outside investors, we see maybe 10% of it goes on into business, right?

We just get quarterly updates, but we don't know what's happening politically and internally; we've all worked at companies and seeing what goes on behind, behind the scenes. And so it's important as

shareholders too, the more we can understand the culture, the more we can be comfortable in our assumption.

About how this company is going to do over the long term. Suppose we have no idea. And we don't know if the CEO is going to leave tomorrow or whatever it's going to be. We've got a culture we can understand. The CEO might leave, but the CEO will probably have enough respect for the institution to do it properly and take their time in the transition.

Th those are the things that we think are very important, and it's something that value investors. I keep, I want to come off as me, like bashing value investors. I think we, Sean, Arif, another colleague, and myself all came up as value investors. But, My perception has changed a bit to become more business-focused, understanding what's going on at the business, the qualitative aspects of things.

And so, the more quantitatively minded analysts, the more value-oriented analysts may not spend as much time looking at culture. And so I think that's something that if you are more of a qualitative thinker like I am, I was a liberal art major in college. I was not a finance major coming, trying to focus on these sorts of big ideas; these big concepts can be very valuable.

[00:46:40] **Dave:** Yeah, I think that's, I think that's a great idea that you, I think the importance of what you're talking about, you can see, you're starting to see this in companies like Walmart and Amazon who have not had great reputations in the public eye for how they've treated employees in the past.

And they have, they're working hard to try to, rehabilitate their image because they understand, I think now that this, that impacts their business.

[00:47:05] **Todd:** Yes. And that's something I think is very interesting is how ESG impacts corporate decisions. And w we're still coming up with our own take on how to think about this.

But and you'll see people be cynical about ESG saying, wow, it's just marketing or whatever, but it's really not., these co corporate boards, they have lobbying groups, they have special interest groups coming to them saying Hey if you want to hit your targets, you've got to change your power sources.

You've got to change the way you're generating electricity or whatever it might be. There, there are things that are being talked about at the board level. For helping the country, helping the world hit climate change targets and things like that, and improving labor relations and all these things matter.

And that's why we take a lot of focus on stakeholders. As we think that all else equal companies that have for a long time cared about stakeholders will be in a great position because they don't have to radically change their cultures to accommodate, a company like, like Starbucks, for example, as long been talking about sustainable sourcing of products and we also own Chipolte and they've been very forthcoming about freshly prepared foods and sustainably sourced, meat and vegetables.

And they're in the driver's seat right now because they are already; they've already made those changes is already part of their corporate culture. But if you've, if you now have to change, that's going to be costly. It's going to take time.

It might change your culture. It might impact your business.

[00:48:41] **Dave:** Yeah, those are great insights. And I, that across the board, a company like Culver's here in the Midwest. They, they were one of the first fast food places to really embrace that whole idea of fresh meat

and locally sourced kind of things to really enhance the reputation as well as the product itself, so yeah, I like that.

[00:48:59] **Todd:** Yeah.

[00:49:00] **Dave:** Obviously, Todd, we greatly appreciate your time with us today, and we love all the great insights and all your explanations.

And thank you for taking the time to explain everything like we're high-schooler. Cause that helps a lot. W where can people find more about you and what you guys are doing at Ensemble capital?

[00:49:14] **Todd:** Sure. So Ensemble Capital's blog is intrinsicinv.com, and you can find us on Twitter at intrinsic inv, and we on there quite a bit; Sean and I both tweet from there. And so if you would like to reach us, you certainly can. And we're out, out in the social media world, so we should be easily found. If you want to email us directly, it's info@ensemble.com.

[00:49:42] **Dave:** Okay. Awesome. Again, thank you so much for your time and for your knowledge, and for sharing all that with us.

It was amazing. I really enjoyed the conversation.

[00:49:50] **Todd:** It was a pleasure; thanks so much for having me.

[00:49:52] **Dave:** You're welcome. Thank you, Todd. Thanks.