# INTERVIEW WITH PAT DORSEY

## INVESTOR AND AUTHOR

YOUNG INVESTORS SOCIETY

## WELCOME!

Pat Dorsey on YIS Live

**James:** We are so grateful to have investor and author Pat Dorsey joining us today. Welcome and thank you! Pat, I'm going to kick it off to you. Maybe just a start can you give an introduction of yourself: how you got where you are? And can you look back on the lessons that you had over last years as an investor. What are the key lessons that you learned?

**Pat:** Well, I'm a proof that if I can succeed in this business, anyone can. I've never had finance accounting course. Or, an MBA. I sort of figure out on my own. So, for those of you who are learning about investing are high school students or taking finance lessons in college. You're way ahead I was at that point of my life.

In terms of lessons, I think the biggest single one is that the scarcest resource is not financial capital. It's human capital. Right? Each of you, there's 24 hours in a day. When I think of the time with the research squad I have here, there are four of us so there's 200 hours a week. Each of those hours is so precious. And how you spend them is really precious. And so, you always think about – it's like radioactivity. The half-life of what information I'm getting and the half-life from somebody's opinion about what the federal do is about 20 nano seconds. It's the halfway of what my employment be in the next quarter. It's about 10 nano seconds. But the half-life of reading a report, we learn something about a business that you can apply to the next business you learn. That's going to have more shelf life too. It's hard to block out all the CNBC and stuff that always bombarding you all the time, just think about how useful that information to be to me next week or next month. If it's not, it's not worth spending a lot of time on. It took me a lot of time to figure that one out. I think it's worth remembering. Because at the end of the day, what makes investors great is not just discipline and patience and all that yabi-yaba but it's knowing a lot of businesses. It's being able to say "Okay. This one looks kind of that one when I looked at that one last year. So, I can start to think about what's important."

**James:** Alright. Thank you, Pat. With that, why don't we kick off

Pat Dorsey, founder of Dorsey Asset Management

Author of the books, *The Five Rules for Successful Stock Investing, and The Little Book that Builds Wealth*

From 2000 to 2011, Pat was Director of Equity Research for Morningstar. Pat was instrumental in the development of Morningstar's economic moat ratings, as well as the methodology behind Morningstar's framework for analyzing competitive advantage. He is a CFA charter holder.

some question from Sussex Tech? What question do you have for Pat Dorsey?

**William:** I split them into groups and develop some questions and topics to discuss with you, Mr. Dorsey.

## Snapchat & IPOs

**Trevor:** What are you expectations for company that are starting up or having an IPO, for example Snapchat? What do you expect from them?

**Pat:** That's actually an interesting question. Not just Snapchat because I think it's really a smoking hole in the ground, for reasons that we can go into. IPOs, in general, it's interesting thing because it's very easy. And, I remember Warren Buffet many years ago saying "Why in the world would buy an asset at the time the price the sellers choose it?" Which is an IPO really is. I said "Oh my god! I should never look at an IPO." But that's actually not the case. Because companies go public for some different reasons. Think of when Google and Facebook went public. Neither of them went public to raise money. They went public just to give liquidity for internal option holders. When Mastercard when public, it was because it was owned by big consortium banks that didn't want to own it anymore. When Chicago Mercantile Exchange went public, it was because the seed holders wanted to become a public company. All of those businesses were insanely mispriced when they went public. And I think many businesses that go public are still oftentimes mispriced because we have limited historical financial information, and people are naturally cautious about a business that only has three or four years of data, right. It hasn't been around for a long time.

But don't just ignore an IPO just because it's newly public. The same way you wouldn't buy it just because Jim Cramer's flagging all the time. I mean, treat it just like any other businesses. Snapchat, in particular, the one thing that I would recommend that you to pay attention to for Snapchat is what happened to their growth rate to the fourth quarter of last year when Facebook essentially copied their Stories feature. The user growth rate rolled over pretty fast. I don't know that Snapchat has a path to monetization yet. They might figure one out, but I'm not going there.

> "I THINK SNAPCHAT MIGHT VERY WELL BE A SMOKING HOLE IN THE GROUND."
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**William:** Which might be a good segway into a question perhaps, when we are waiting for SNAP to see whether or not they're going to monetize or should we open up a short position on SNAP? Your thoughts on short positions, Mr. Dorsey?

**Pat:** Sure. The thing about shorting is that you can only make 100% and you can lose an infinite amount of money. Which is, last time I checked not the world's greatest risk reward. Shorting is tough, generally, because time is not on your side. If you own a business, even if you wind up overpaying someone for it but the business has a management team that doesn't allocate cash stupidly and has good competitive and it's growing, time is your friend. With short position, time is your enemy. Because you're paying for the short position; you're paying to borrow. Regarding shorting Snapchat: given that Snapchat over the next year or two is going to be trade more on headlines than any kind of actual financial results. Without guessing those headlines, I would say you would be taking on one heck a lot of risk. Short selling is incredibly hard. The few good short sellers I've met never ever short because of valuation. They short because either 1) the business fraudulent or 2) fundamentally flawed. I.e. the business will never make money. If you think Snapchat is a fraud, more power to you. If you think the business model is fundamentally flawed, either there's no way to monetize it; you probably will do okay the long run. The trick is can you make margin calls in the short run.

**William:** Dean, do you have the next question?

**Dean:** There is the company in mind that I was researching and I wanted to get your thoughts about companies that do reverse stock splits?

**Pat:** What's the company called?

**William:** I guess we have to tell you the name of the company.

**Pat:** I'm sorry, I didn't' hear the question?

**William:** Dean wanted to know about what's your take when company institutes reverses stock splits.

**Pat:** Well, something's probably gone pretty wrong if the stock is so low that you have to a reverse split. But frankly, it doesn't one difference one way or the other. It's like a little bit the question Yogi Berra once asked which is "How would you like pizza cut, Mr. Berra?" He would say "Cut it in small pieces. I am not that hungry." Well, it doesn't make the pizza a different pizza whether eight pieces or four pieces. But I would commend you to look at businesses that don't split their stock. It's actually a very interesting thing to run a screen for businesses with share prices over $150. Just picked a random number.

You see this more now than you did 10 years ago. Google has a very high share price. There's Amazon with over 200-dollar share price now. But companies that don't split their stock are implicitly saying "We don't want to cater to investors who are stupid enough to think that 15-dollar stock is cheaper than a 100-dollar stock." Because anyone who is looking at stocks for more than 20 minutes knows that it's about per share value. And so, it's interesting screen to run. Run a screen sometimes on companies that have share prices in the triple digits. It's a smaller list than you think. You will find businesses there that you've never seen before are actually pretty darn good.

"RUN A SCREEN SOMETIMES ON COMPANIES THAT HAVE SHARE PRICES IN THE TRIPLE DIGITS. IT'S A SMALLER LIST THAN YOU THINK. YOU WILL FIND BUSINESSES THERE THAT YOU'VE NEVER SEEN BEFORE ARE ACTUALLY PRETTY DARN GOOD."

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## Dry Ships: An Example

**Dean:** Yeah. Because the company I was looking at they are called Dry Ships. They have had many reverse stock splits.

**Pat:** Dry Ships? Oh my god. I would say, investing in Dry Ships is kind of like playing poker with Kim Jung Il. I think it's a dangerous preposition. Unless you are the guy with the weapon. Seriously, Dry Ships is the purest commodity player ever. The operating leverage in a bulk carrier is just insane, and so is the operating Deleverage.

To your point, why it's done a bunch of reverse stock splits? It is because they had to do them. The share price would be so small. You would need to go over to your high school's electron microscope to find it.

**William:** The only reason we are asking is one to get your take on when companies do reverses, is that if there is something amiss with that firm, that would give us the opportunity perhaps then to open up short position because in various competitions that we're in, we don't have to pay the excessive margin cost that you would have to in real life to open up short positions against Dry Ships. In which case, we've done really well. The fact of that matter that they're going to pay their shareholders a dividend; I'm dumbfounded. That they're able to pay their shareholders at 6 cents a share.

**Pat:** That seems odd to me. Actually here this could be an indicator to looking for short candidates, very successful short sellers look for any business that both sells equity, raises capital via equity sells and also pays big dividends. There is something horrible in there. Just think about it, why on God's green earth would a company raise capital at 10% cost of equity and pay out the other end as dividend? Unless, as management, you wanted to convert that into cash in your pocket. So in Dry Ships case, there's probably something fishy going on.

## Marijuana stocks

**William:** Alright. Dean has to go on that note. I put Dean on the spot on that one.

Scott has to go to work but Scott has been with me for last couple of years with various investment competitions. He's very excited about the YIS Stock Pitch competition; he's going to do this year. Scott is very humble and he wouldn't like be tooting his horn but Scott got accepted at Steven's Institute of Technology. He'll be majoring in Computer Science and Quantitative Finance.

**Scott:** In this day and age, marijuana is becoming bigger and bigger. How do you feel about investing into marijuana stocks?

**Pat:** I've got nothing for you, boss. I'm sorry. I've never looked at it – I'm sure there's something just because they are more acceptable socially than it was 20 years ago and it's legal in Colorado and other places. Scotts Miracle Grow, which is a good damn business regardless of marijuana, because they essentially own the US market for turf care. If you've a golf course or a guy that maintains lawn, pretty much there is nobody else to deal with other than Scotts. But I think it's re-rated quite a bit on this whole marijuana thing because of the hydroponic angle. It's a great business. It's worth to learning about it. If the marijuana air comes out of it, you are still left with a very good business. But in terms of direct marijuana stocks, I've got nothing for you. I'm sorry.

> "SCOTTS MIRACLE GROW: IF THE MARIJUANA AIR COMES OUT OF IT, YOU ARE STILL LEFT WITH A VERY GOOD BUSINESS."
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**Scott:** I mean, personally, more and more states are legalizing. It's going to happen. I don't, personally, smoke the marijuana but it's going to happen. My dad is actually invested in one stock. He bought at $150 and it went to $340. I just think that more and more states are legalizing the industry for marijuana. I think maybe hemp as well. There's so many uses for hemp. I think the general industries for marijuana: medical, recreation and I think it's just growing.

**Pat:** It's a very reasonable proposition. I just don't know any way to capitalize on it and monetize the insight. I would look at Scotts. I mean, it's damn good business. Marijuana or no marijuana. It's obviously it's like the number of golf course is growing 3% a year. It's pretty mature business for quite a while. If they don't get extra few points of growth per year from hydroponic equipment that could be kind of interesting. But other than Scotts, I've got nothing for you.

But it's reasonable. You actually highlight pretty interesting point which is: In investing, half the trick is what might the world could look like in three to five years? Then, in your case, more states will legalize marijuana that kind of thinking. That seems reasonable. But then the other half, how can I make money on it? That's often get trickier and trickier. Anyone who figured out and said 20 years ago "Wow! PCs are going to be the hot thing!" The problem is I can't think of a PC manufacturer that would make money for the past 20 years. Most of them went bankrupt. Simply because while the benefit was to you and I as consumers, you know with more processing in smaller space, was actually horrible from a manufacturing stand point. I think the trick is to find a business which is going to make money from marijuana sales but also, have some kind of competitive advantage. Right? It's going to be around in five years. It's going to be able to protect its business even with others flooding in for competition for it.

## Preparing for a Stock Pitch is Different than Investing

**James:** I would love it if you could walk us through one or two examples of how you think about a stock whether Facebook or just walk us through the due diligence process and investment thesis. We have hundreds of kids preparing right now for their stock pitch competition in May. I think your expertise on how you look at stock will help them a lot.

**Pat:** Okay. Just to bear in mind is that there's, I think, a difference between investing in real life and stock pitch. I say this because their goal right now is to win the stock pitch. I think about this because the guys comment about Dry Ships. I vividly remember being in stock pitch, in an MBA stock pitch program and Dry Ships was pitched. The trick is that basically the 'pitcher' left out the single most important point. It was at the top of the commodity cycle. You have a ton of oil tankers being converted into bulk carriers. There's ton of supply just about to come out of the market at crater prices. But, the person who was pitching didn't mention this or didn't know this, and none of the judges asked her that. But because she gave a convincing presentation and ended up winning the competition. I would also say as advice that you may be a loser in the stock pitch but it's not always the best pitch that wins. It's the one that sounded the best. It's not that you go back later and see which one made the most money. When you're thinking about your pitch in terms of doing one, make sure it's the business you can understand, but *don't ignore non-consumer businesses.* I think stock pitches, especially those in high school, often default to things that people have personal experience with. Which is okay, but just because I visited two Under Armor retailers, doesn't mean I know a lot about Under Armor. Whereas, if you talk to five mechanical engineers about AutoDesk, odds going to be that you know a good deal about AutoDesk because they have only got a couple of competitors, the space is usually more concentrated. That would be number one.

> "DO A LITTLE BIT OF WORK ON MANAGEMENT; KNOW THE TRACK RECORD AND COMPENSATION; DO A LITTLE BIT OF PRIMARY RESEARCH; AND FIND A BUSINESS YOU CAN UNDERSTAND."
>
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*Second, Don't ignore management*. I think that's a flaw of many stock pitches, to assume that management knows what they're doing. If you spend a little time looking at their track record on their acquisitions and if they bought back stock at the wrong time. That will make you stand out relative to your peers. Even the tiniest amount of primary research, will help you stand out. Don't just rely on couple of reports you can cobble together. Get out there! Let's say you are pitching McDonald's, for example. Go and talk to a couple of store managers. You know, ask about what it's like being a store manager. What's your relationship like with the franchise owner? It will set you apart in a big big way. I was on the board for University of Texas in their MBA fund for a number of years. I still remember one team pitching Buffalo Wild Wings. We asked the team "Have you talked to franchise owners of Buffalo Wild Wings? This is Austin, Texas. I am positive there is one here." They hadn't looked. In a large college town? There's got to be one here. They hadn't looked. It was like "We didn't ask you to fly to Japan and go to robotics factory. We asked you to have a beer somewhere and talk to the store manager." It wasn't that hard.

Do a little bit of work on management; know the track record and compensation; do a little bit of primary research; and find a business you can understand. You know usually you do this in teams I guess. People usually do this in groups. Get one member of your pair to take the other side. What kind of hard questions that am I going to get from the judge? If I am the PM that you are pitching this to and I was really skeptical what would I be pushing back to you on? In that way, you will (A) tighten your pitch and (B) you'll be prepared for the inevitable zinger and you won't have to go "Oh, I haven't thought of that."

## Investment Case: Facebook

**James:** Do you have an investment idea that you have invested in the past or that you are invested in currently? Would you walk us through why you invested in it?

**Pat:** Sure. I can talk about Facebook, one that you are probably familiar with. It seems it's too obvious but here's a business of $20 billion dollar plus top line and it's still growing over 50%. You don't see that very much. Moreover, the global advertising market is roughly $600 – 650 billion dollars give and take. But it's big. Whether it's $600 or $650 that's a lot bigger than $20 which is Facebook. Advertising grows a little faster than global GDP. It's 4.4% a year. As you imagine, digital advertising grows significantly faster than that. Printers decline pretty quickly and the amount of time we spend on mobile devices, tablets and what not, is increasing. Advertising follows eyeballs. Right? Or ears. Back in the radio days. Originally, advertising was a sign painted at the side of the barn because that's the only place you can put it. And then we have newspapers. And you have ads there. And then radio. You have ads there. And then you have TV. You have ads there. Now, we have PCs. We have ads there. And then, God forbid, we have mobile phones. And there are ads in the feeds. Right? You see the pattern here which is simply that advertisers follow attention. Wherever people are, that is where the advertisers need to be.

We have only a finite amount of attention, there's 24 hours a day, people sleep 6 – 8 hours a day, so there's let's call it 18 hours of attention per day. That isn't growing, right? The number of hours in a day isn't growing. So, there's a finite amount of attention per day and this attention is spending a growing amount of time on digital devices. Within that, two companies get the incremental ad dollars, and that's Facebook and Google. Right now, Google has about 8% share of total advertising. That's 3x the revenue of Facebook, give or take. That's really interesting because there's certainly a lot of things Facebook does that Google cannot do. Right? Google only knows things about you because of where you visit. Cookies on websites, right? If you said "I'm looking for a good lawyer. Or, I'm looking for… believe it or not, the highest keyword on Google right now is DUI Dallas. This is a request, right? If I am a lawyer in Dallas, I want to get that keyword. Think about it if you are Nike. It doesn't matter if you are Nike or Under Armor, you want to elicit an emotion from someone. You want them to buy this specific thing. You want them to have a good impression of Under Armor or Nike. How do you serve information to someone who might not be searching for a Nike product but who's in your demographic? Google has the harder time with that because it's mainly what is called a direct response. Whereas on Facebook, you can push an ad based on your characteristics. Maybe you didn't actually buy athletic apparel online but you are connected to a lot of people on Facebook who had. Or, you follow famous runners. That's really valuable information for me if I were Under Armor or Nike. That is something Google is having a harder time to do. Google is also have harder time with rich media. Because if you're going to view Google on via Chrome, Safari, Firefox, on different websites. It is harder for the advertisers to control the user experience via Google. Whereas via Facebook, the advertisers know exactly what you are going to see, what you are going to experience. In terms of a metric that's really appealing to an advertiser.

Given all those facts, why shouldn't Facebook be the size of Google in terms of advertising? The thesis is a little bit more complicated than that but that is it boiled down. We can't figure out why they shouldn't be at that same size. Especially if you're Facebook, you don't need to pay the traffic acquisition cost on Google. Which is one reason why Facebook runs at high 40s margin and I think Google runs at mid-20s margin. The flying cars and the drones are another reason that Google as lower margins.

That's Facebook. Basically, I was pretty skeptical at Facebook when I started looking at it. Okay, 20-something billionaire. He's just going to waste his capital. He's going to buy stupid stuff. And then we looked at Instagram, and Instagram was basically 12 people when he bought it. Why the heck look at Instagram? Seven years later, that's a pretty smart acquisition. You know Don Graham of Washington Post. He's also one of the early board members at Facebook. That's something interesting for a 20 something billionaire to have intellectual maturity to invite a non-tech guy but who has a pretty good track records and put him on their board. I thought hmm maybe there's something going on here.

**James:** Pat, I think you painted beautifully the history of how advertising follows the eyeballs. And that pie is much bigger than we expect or give them credit for. But I guess the follow up question on Facebook is: How do we know the eyeballs will stay on Facebook? How do we know that five or ten years from now that eyeballs won't move somewhere else? We have a lot of teenagers watching that would say "Hey, I don't use Facebook, I use Snapchat or something else!" How do you look at it in 5 - 10 years?

**Pat:** Totally fair question. If you told me you can make one big investment and lock it in the closet and come back in 10 years, it probably won't be Facebook because the landscape is moving too fast. This is not a Coca-Cola. But so far, Facebook has responded just like what we talked about few minutes ago. Facebook saw basically that young people were debating whether to post their picture on Instagram because it stays up there forever. People like the familiarity of Snapchat. Facebook said "Well, imitation is the most serious form of flattery. Let's do the same thing." Which they did! And that feature of Snapchat, I think it's called Stories, has become massively popular. And it actually rolled over the Snapchat's growth. Which is interesting, it shows not just the willingness to innovate, but to learn. I think a lot of companies as dominant as Facebook just say "oh the way we do it must be great. What they're doing must be stupid." In this case, no. Snapchat was actually served the needs of that demographic. That's an interesting competitive response.

> "I THINK FACEBOOK IS HYPER AWARE OF THE RISK OF USER ENGAGEMENT. THEY ARE QUICK TO INNOVATE AND ADAPT AT A VERY RAPID PACE."
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You also saw about six months ago, Facebook de-prioritized sponsored posts. They saw a decline in the user engagement and they changed their algorithms so that posts from your network is going to push higher to the feed that sponsors first. Think of it, from the point of view from their customers or advertisers, that's bad. Right? Facebook basically said "Hey, guys who are paying us lots of money, we are doing something that disadvantages you in a short run. Your ads are not going to be pushed high. But it builds business in the long run because it keeps your engagement high." As you pointed out, without user engagement, there's no net. It killed Myspace, right? In Myspace, plenty of classified ads, horrible user experience, and people left for Facebook. Our view, I think Facebook is hyper aware of the risk of the user engagement. There's couple of examples, they are quick to innovate and they're quick to adapt when people are looking for something better like Snapchat, they copied it. Things like Facebook Live. They are innovating at a very rapid pace.

So yeah, the risk is there. You're 16 years old and on the same social network as mom and dad. Okay. So, 16-year-olds becomes 26, 10 years from now. Will Facebook be as dominant as it is today? I don't know. It's the position that we have. Probably one we watch more closely. We go to a lot of digital advertising conferences. We talked to people who are directing the dollars, to understand what kind of value they are getting, what kind of ROI Facebook is giving. Ten years from now, I think it's still pretty dominant. But I don't know. This is the stock that we are happy to have and continue to work on.

The key thing is that the current valuation does not assume dominance 10 years from now. Facebook is currently trading at 16 times P/E. Probably it pushes at 17 or 18 now. But I mean, think about it, 18 times P/E. For the business growing over 50% and posting 10% operating margin growth over last year.

**James:** That has a little capital expenditure and high returns on capital.

**Pat:** Yeah. I think one of the reasons why the stock is reasonably priced. You know you have to ask something what I am missing. Sandbag might be too harsh a word but I mean last year, they thought they would spend like 2 billion dollars in CAPEX. They wound up spending a lot lower than that. They've been telling the street "Hey, the rollout will take time. Just take it slow." They've been saying that for six or seven quarters. From their perspective it is very obvious, I think that so many of their engineers are paid in stock comp right? If you're people are paid in stock comp, what you want is a very slowly appreciating stock. If the stock is doing this all the time, you could have a group of people who join the company and get their stock at high level just because randomly people got excited about Facebook that month. Then two years later, your stock is in under water. Whereas if you just have this gradually appreciating stock, everybody wins.

I think that's the reason why they've been so cautious. I mean their tone. They are not hyping it at all. We'll see. We think that we do well. But we're also always being cautious and looking at what we may miss.

## Mistakes and Lessons Learned

**James:** Tell me about that, Pat.  We had Guy Spier on a couple months ago and he talked about building an investment checklist which is basically rounding up all of your investment mistakes that you've made over your career and coming up with the checklist of how to avoid those mistakes. Maybe, tell us about a mistake that you've made, and what you've learned from it. I think that can be valuable for these young investors starting out.

**Pat:** I'm just going to go through my list and see which is the most valuable to share. I think the single biggest lesson is to avoid downward spirals. Just because I own this or have owned it that its special. I should trust the management more, because I own it. If something surprises you, if the management unable to answer a question you think should be reasonable and if that undermines your confidence or their ability to manage the business, then you don't need to own it.

The thing that I would keep coming back to is simply that you can never set too high a bar, either on management or business. As an investor, you don't need a hundred stocks. You are not running a large mutual fund. You need to own ten personal account or if it's relatively high concentrated portfolio, maybe 30 right? So you can throw out lots of things if it doesn't meet the bar. Like, if I think the guy pays himself too much. Don't be afraid to say no. Definitely, I've got into trouble when I was not willing to say no. I thought "Investors that have a different style of investing than I do and they own the business." Well, they might know a lot, but they're playing tennis and I'm playing football. You've got to know what game you're playing.  There's actually a sticky note on my computer, it says "No FOMO". No Fear of missing out. You see somebody else making money off something; but we all

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have different standards. It was like “Wow! There must be something I don’t know.” Well, no. Maybe they’re playing different game than you are.

I think my biggest mistake definitely come when I’ve not kept the bar as high as it should be in terms of management or business because that’s what I’m doing. I stink at deep value. There are just some things that I cannot do. I shouldn’t go there.

> “THERE’S ACTUALLY A STICKY NOTE ON MY COMPUTER, IT SAYS “NO FOMO”. NO FEAR OF MISSING OUT.”
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## When is the Time to Buy?

**James:** It’s tough to know because there’s always a bit of uncertainty and even the best and cleanest investment ideas, there’s always something that irks you. How do you know that irk is significant? Or, how do you know when that is just the buying opportunity and the market is missing this long term opportunity from the short term noise in front of them? There’s never full comfort. Because if it appears too good to be true then it often is to be too good to be true.

**Pat:** It’s a good point. If you’re continuously looking for perfection, frankly, you’ll sit on a lot of cash for the rest of your life. There will be no perfect investment. There is no investment that has an amazing moat and long road to grow, run by an angel with no imperfections.  It’s not going to happen.

You’re totally right but what you need to decide, is that flaw fundamental to the thesis or not? There’s a couple of examples. There was phenomenal software company we looked at a couple years ago. It was just an utterly dominant. But they screwed up their US business. In Europe, businesses tended to pay by subscriptions. US enterprise, they tend to buy a license upfront and pay lower maintenance fees. That’s the model they prefer. They had just never offered that payment scheme in the US. That’s the main reason why they hadn’t been able to sell software. It was just kind of like “Duh!” You know, I mean, it’s like opening up an Italian restaurant and not offering pasta.

We met their director of sales and it was okay, but not great. He was touted like he was like this great white savior of that piece of the business. But we spent all of our time worrying about that and not paying attention to the 95% valuable portion of the business sitting in Europe. It’s was just stupid. It was a flaw of the business but not a fundamental flaw. Sometimes great businesses get mispriced because everyone is focused on the small piece underperforming while the rest is just doing fine.

Whereas, there’s another business that we looked at that was a massive turnaround story. Prior management had basically done a huge roll up for 15 years. Eventually, things fell apart. They got indicted for defrauding the UK government. The entire C-Suite left and most of the country managers got booted. Most of the board got booted. It’s the biggest house cleaning you’ve ever seen. A lot of low hanging fruit. This business was the world’s third or fourth largest global private employer. I think they didn’t have one global telecoms contract. They called up Vodafone they saved 6 million pounds worth of phone call. It’s the thing you can centralize your business. No. But at the end of the day, it was a business that was like 5.5 out of ten. It’s above average but it’s not by a whole lot. I think I’m above average height of the American but I am not a tall guy. That’s so what I mean not keeping the bar high. It was a turnaround story. And then business it was a better than an average business but not a hell of whole lot.

I think to your point, you are right you have to withstand some pain in the business. But you still need to set the bar high enough.

There’s another one. There is wonderful little in the UK conglomerate. Bought and capitalized small businesses and fixed them up. You know they paid up to 40% of earnings as dividend. And I was like ‘Why?’

You guys have generated high return on capital. Just keep the money and reinvest it. "Well, our shareholders kind of expected. They always want the dividend." No, that's not perfect or optimal, but do you really want to kill thesis because of that? That's again my point. It does not destroy it because the company is imperfect. Just because it's imperfect doesn't mean that I shouldn't go there. I don't know if it's a good answer.

## "Too hard"pile

**James:** It's like Buffet's "too hard" pile.

**Pat:** Well, I won't even go there, I don't actually like the "too hard" phrase. There is too hard. Like you're not a biotech expert, for god's sake, don't compete with biotech investors. Right? You've got hedge funds; they've got PhD's on their staffs. That's too hard right? But there's also it just "doesn't suit me". It doesn't suit my style of investing. It doesn't suit who I am, right. You know, I shouldn't go to the beach in Speedo. I refuse to. It doesn't suit me. It's just that it's not something that I am very good at. The 'too hard' Buffet is fine but people think like "Oh this business is understandable." They get it or not. But does it fit your personality? Does it fit what you are trying to do as an investor. I think that's what you see frequently when investors get in trouble. When they get out of their wheel house right? They're trying to be activists when they're not activists. Or the value guy trying to own Amazon. But there's also that doesn't suit what I do.

## Economic Moats

**James:** One last question before we let you go. In your book, *The Little Book that Builds Wealth*, you talk the different moats that you look for in businesses and we teach these students about these moats. Warren Buffet coined the term economic moat, and we have our kids learn about network effect, we talked about Facebook earlier and they would have a network effect moat, and then others route density, low cost advantage, brands. There's different competitive advantages that we can look for companies. I'm just curious in your portfolio when you invest, are certain moats stronger than others? Do you tend to favor certain type of business? Or do you invest in whichever one has the best price for the return potential?

> "THE REAL MONEY FOR REALLY COMPOUNDING CAPITAL OVER TIME, IS NOT IN THE BUSINESS THAT HAS BUILT THE MOAT, IT'S IN THE BUSINESS THAT IS BUILDING THE MOAT."
>
> PAT DORSEY

**Pat:** A lot of it would come back to what are you trying to do as an investor. And how much capital you are working with. Berkshire Hathaway tends to have a lot of big branded companies in his portfolio because he has a lot of capital he is working with and branded companies tend to be big businesses.

You know at this point, we are working with a relatively small pool of capital. And we we want to keep it small. As such, we are unlikely, frankly, to ever own a big FMCG company; absent a huge dislocation in price. Simply, because we will probably find better returns elsewhere. And because those businesses don't tend to have a lot of reinvestment opportunity. And I said we want to find companies that can reinvest to maximize the value for the shareholder. So, it depends on what you are looking for as an investor. What's your capital base? What you're trying to do?

There's something probably I didn't focus on in that book, which at the time, at Morningstar our equity coverage was mega cap skewed right? So we focus on the business that are established like the Costco, the Coca-Cola, the Unilever, you know. But the real money, if you're thinking about the really compounding capital overtime, is not the business that has built the moat, it's the business that is building the moat. That's probably a business that's younger. It's got a runway ahead of it and where each dollar of incremental cash flow is being invested at a progressively higher incremental return on capital as the business that is gaining scale and the moat is growing stronger. That's where the Mongarian lalapalooza returns comes from.

I think if you go down the path of thinking yourself as a quality investor, you are investing in strong moats and blah blah you tend to skew towards the inevitable. And again if what's you're doing, is managing a don't-get-me-killed portfolio for a bunch of retired families, great! That's probably, that's what you should do. But if you are working on a longer time horizon, a little bit more a relatively higher tolerance and a smaller pool of capital, the businesses that are building those moats – the moat isn't there yet, but the management is doing or taking the right steps to each year to widened that competitive advantage, those returns are probably going to be superior.

**James:** Yup! Sounds like another book.

**Pat:** Thanks. Let me get this business off the ground first.

This business is about learning and you know I think 15 years ago, what are the most stable moats in the world? That would be the big consumer branded companies. Well, let's look at what happen at Dollar Shave, Unilever and P&G right? I mean, Dollar Shave did not exit six years ago, seven years ago whatever the number is. The only reason it can exist today and couldn't 14 years ago, is because they can get that message out and market to people in a vastly cheaper way that it couldn't 14 years ago. 14 years ago, you had to buy an ad on CBS or QVC or whatever. Now, you post an awesome Youtube video for five hundred bucks or whatever.

I think of the moats of the big CVG companies, are not as big as they once were. Granted, I'm not going to go shorting P&G tomorrow. But the barriers to reach the market in a critical mass of potential customers is vastly lower today than it was ten years ago. When you think about it, what's the barrier to building a brand? Reaching people. Fifteen or 20 years ago, that channel was three networks in the US and some cable networks. It's vastly more fragmented today. The ability to take a niche brand and hit critical mass is an enormous change. I mean look at Greek Yogurt company. You know that company in Upstate New York (Chobani). Anyway, it just came in from nowhere. That wouldn't have happened 20 years ago.

> "THE BARRIERS TO ENTRY TO BUILDING A BRAND IS MUCH LESS TODAY THAN IT WAS BEFORE."
>
> PAT DORSEY

**James:** That's a really very good point. The barriers to entry to building a brand is much less than it was 10 years ago.

**Pat:** Yeah, it's still not easy. I think it just shows how little you can take for granted in this business. I mean like you know Nokia. Right before the smart phone. I mean they had like 45% global market share, a crazy number like that. How do you overcome that scale advantage? There's no way you can overcome that, until you do. Until you miss the boat on the smart phone. Remember that old James Bond movie when he's sitting on his back driving a convertible car and writing on Nokia phone. Remember that? Anyway, we can't take anything for granted.

**James:** I think as much as us investors, especially high quality investors, are trying to say we are building a moat around our companies, investing for the long run and having a sleep-well-at-night portfolio, the reality is we always have to be learning. We always have to be analyzing its trends. Llike Buffet says it's learn, learn, learn. You're always reading and you're always learning.

**Pat:** Yeah. I mean, we are doing a lot of research on company called Dollar General right now. Wal-Mart has been losing share in the dollar channel to Dollar General and Family Dollar for several years now. It's because Dollar General figured out that it's frankly pain in the butt to get it in and out of Wal-Mart. I mean come on a thousand square feet and a massive parking lot and all you need is look at eggs, no I'm not going to bother. But If you have a footprint as about the same size of a drugstore but you're pricing things at the same level as Wal-Mart, and a small basket, the value proposition to the consumers is pretty crazy. It's like Wal-Mart figured out how to win against small town merchants like Kroger and Winn Dixie but the scale that allowed them to win, that scale itself opens them up to competition. It's convenience, right? So now you're seeing in rural America a lot of people are kind of doing a weekly or monthly trip to Wal-Mart to fill up on things but then you see them go once or twice a week to a dollar store when they ran out of shampoo and there they get a soda and they get higher margin products.

**James:** Alright, Pat this has been a tremendous pleasure!  Thank you so much for your advice and your wisdom.