To:	Clients of Eagle Point Capital
From:	Matt Franz and Dan Shuart, Principals
Subject:	Fall 2021 Portfolio Update
Date:	October 1, 2021

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric. … It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent. There must be some wisdom in the folk saying, `It's the strong swimmers who drown.'

— Charlie Munger, 1983 Letter To Wesco Shareholders

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In 1970 a statistician named Dr. Simon Ramo published a book titled *Extraordinary Tennis for the Ordinary Tennis Player*. The book divided the tennis world into two groups: professionals and amateurs.

Ramo made two distinctions between professionals and amateurs.

1. Professionals win points while amateurs lose them.
2. Amateurs sometimes mistake themselves for professionals, but professionals never mistake themselves for amateurs.

Though professional and amateur tennis use the same equipment and follow the same rules, they require different strategies. Professionals must play brilliantly to win. Amateurs win by making the fewest unforced errors. Professionals need to hit aces while amateurs need to avoid double faults. Ramo observed that in professional tennis, about 80% of points are won while in amateur tennis, 80% of points are lost.

If professional tennis is a "Winners Game" then amateur tennis is a "Losers Game." To win a Loser's Game, Ramo advises: "Give the other fellow as many opportunities as possible to make mistakes, and he will do so." Amateurs win by keeping the ball in play, avoiding unforced errors, and allowing their opponent to defeat themselves. In other words, amateurs win by not losing.

Tennis isn't the only game that can be played as a Winner's Game or Loser's Game. In *Strategy And Compromise* Admiral Samuel Morison wrote:

> *"In warfare, mistakes are inevitable. Military decisions are based on estimates of the enemy's strengths and intentions that are usually faulty, and on intelligence that is never complete and often misleading. Other things being equal, the side that makes the fewest strategic errors wins the war."*

General Patton put it more succinctly:

> *"Let the other poor dumb bastard lose his life for his country."*

Like warfare and amateur tennis, the stock market is best played as a Loser's Game. Since investing awards no points for difficulty, we prefer trying to avoid stupidity in a Loser's Game to seeking brilliance in a Winner's Game. If you want to beat Roger Federer, don't play him in tennis.

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Base rates are one tool we use to avoid stupidity. In statistics, a base rate is the prior occurrence of some event in a large population. For example, if we are told 10% of all cars in the U.S. are red, then the base rate of red cars is 10%. Knowing this, we'd forecast a 10% odds that the next car we see is red. The base rate forms the outside view, which is the forecast someone with no specific or special knowledge of the local situation would make.

The inside view is the forecast someone with specific, local knowledge would make. For example, if we were at a Ferrari race where 90% of the cars are red, we'd increase our forecast from 10% to 90%. The process of combining the outside view with the inside view is called Bayesian Updating.

In the book *What Works On Wall Street*, Jim O'Shaughnessy presents decades of stock market data that shows:

- The stock market tends to rise over time;
- Profitable companies tend to outperform unprofitable companies;
- Inexpensive companies tend to outperform expensive companies; and
- High return on capital businesses tend to outperform low return on capital businesses.

To avoid stupidity, we bet with these base rates instead of against them. We own simple, predictable, profitable businesses that earn above-average returns on capital and trade at below-average prices. We study businesses to hone our inside view so that we can identify whether a business's future is likely to resemble its past. We avoid investments that require a bold bet against the base rates to succeed. Instead of picking inflection points, we prefer to invest where the future is likely to resemble the past. This style of investing works best on businesses in "replication mode."

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A business's life cycle has three phases: startup, replication, and maturation. These phases are a continuum, not distinct buckets. Businesses transition between them over many years.

Startups are in the proof of concept phase. The business model hasn't yet proven profitable, which explains why investments in startups have such a wide range of outcomes. These outcomes tend to be explosive — to the upside and downside — and difficult to predict.

Startup investing is a Winner's Game. When Paul Graham ran Y Combinator (a startup incubator), he only expected 30% of his investments to succeed. That's not a great base rate, especially considering Paul Graham is one of the greatest venture capitalists of all time. Today there are lots of investors (most prominently on Reddit) who seem to have forgotten that they're amateurs, not professionals. They play the startup game with more panache than Paul Graham would himself. For every Google and Facebook that succeeded, there's a graveyard full of equally promising businesses run by talented founders that failed.

A startup graduates from proof of concept to replication mode when they demonstrate profitable and replicable unit economics. Investments in replication-mode have a narrower range of possible outcomes because they've already demonstrated a winning system. They merely need to continue doing more of what has already worked in the past. Replication-mode investing is a Loser's Game.

A business in replication mode matures when they've saturated their addressable market and run out of room to replicate. Unable to reinvest in their core business at high rates of return, they must either return profits to shareholders, pursue acquisitions, or incubate a new startup.

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Walmart has gone through each of the three phases. In 1945 Sam Walton bought a branch of the Ben Franklin stores from the Butler Brothers. He renamed it Walton's Five and Dime and began pursuing a high volume, low margin sales strategy. Walton's first years were rocky. He'd overpaid for the store and inherited an expensive rental agreement. Over time, he was able to lower his rent expense and find low-cost suppliers, which allowed him to undercut his competitor's prices while remaining profitable.

It's hard to pinpoint the exact moment when Walmart graduated from a proof of concept to replication mode, but it's safe to say the shift was complete by 1970. By the IPO, Walmart had proven that its stores were profitable despite offering lower prices than competitors. It had also proven that its managers knew how to open new stores to grow the chain. They operated 38 stores plus a distribution center.

With a large addressable market, Walmart had a long runway to replicate into. Walmart did just that, rapidly opening stores for the next thirty-five years. By 2005 there were 3,800 Walmarts in the U.S. and only a few small pockets of the country remained more than 60 miles from a store.

Since then, Walmart has matured and its growth has slowed. Over the last three years, Walmart earned $36 billion. Of that, it returned 95% ($34 billion) to shareholders via dividends and buybacks. Walmart only reinvested $2 billion into growth.

Walmart earns 20% on its equity. While it was in replication mode, it was reinvesting nearly 100% of earnings at 20% incremental rates of return, powering a near 20% earnings growth rate. Today, it can only reinvest 5% of its profits at that 20% rate, making for a 1% growth rate. The remaining 95% of profits get returned to shareholders as dividends and buybacks. Since Walmart trades at a 23x P/E, this amounts to a 4.1% yield. Combined, Walmart's growth and yield total 5.1%. Mature businesses are like bonds — they throw off steady cash flow, but lack growth.

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Warren Buffett has used replication-mode investing to become one of the wealthiest people in the world. In *The Snowball: Warren Buffett and the Business of Life* biographer Alice Schroeder recounts Buffett's investment in the Mid-Continent Tab Company.

In the early 1950s, computers read programs off tab cards. Programmers punched holes into the cards and fed them into computers where they were mechanically read.

IBM had a near-monopoly on the tab card business, and it was its most profitable division. Since the cost of tab cards was trivial relative to the price of IBM's mainframes, IBM could mark up tab cards 50% without customers blinking.

Two of Buffett's friends, Wayne Ace and Warren Cleary, decided to buy a Carroll Press to manufacture their own cards and compete with IBM. They reasoned that they could ship faster and provide better customer service from the midwest than the coast. They asked Buffett to invest in the startup, but Buffett declined.

Buffett reasoned that a startup going head to head against IBM would have little chance of success (i.e. a low base rate). Statistically speaking, the enterprise would likely be a total loss. Even though the business would be extraordinarily valuable if it succeeded, Buffett was wary that the investment could go to zero. **He passed because he focused on avoiding losses instead of making profits**. He knew that if he could stay invested while avoiding losses, the profits would take care of themselves.

Undeterred, Wayne Ace and Warren Cleary found the money elsewhere and started the company. Against the odds, they succeeded. Years later, business was so strong that they needed more money to buy more equipment to make more cards. So, they went to Buffett for a second time.

This time, they didn't just have a business plan to show Buffett. They had real profits. The Mid-Continent Tab Company was producing 35 million tab cards a month and earning 40% pre-tax margins and nearly 100% on its invested capital.

This time, Buffett saw the company was in replication mode and invested. They had proven that they could compete profitably and grow, and Buffett saw a clear path to making his desired 15% compound annual return. His investment compounded at 33% per year for the next 18 years before Dictograph bought the company in 1979.

What's notable is how Buffett waited for the business to enter replication mode before investing. He wasn't tempted by the extraordinary profit potential the first time, because it came with a reasonable chance of catastrophic risk. By waiting for the company to enter replication mode, Buffett was still able to enjoy substantial upside from the investment, but with a fraction of the downside of a startup.

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Berkshire's 2016 investment in Apple follows the same pattern. Apple released the first iPhone on June 29, 2007, but Berkshire didn't buy shares for another nine years, a few months after the iPhone 6S release.

It took Buffett nine years to see that the iPhone was in replication mode. Historically, consumer electronics were a bad business (i.e. low base rate of success). Competitors reverse engineered them and started a price war, putting prices in a perpetual tailspin. Apple was able to maintain iPhone prices because consumers wanted its software, not its hardware, which competitors couldn't replicate. Buffett developed an inside view over those nine years that eventually caused him to realize Apple wasn't a consumer electronics company so much as it was a software company. That signaled that Apple's profits were probably going to continue recurring and growing.

Even though Buffett waited nine years to invest, he still made a killing. Berkshire's $36 billion of Apple shares are worth $121 billion five years later. Replication-mode investing is still lucrative, despite carrying significantly less risk than investing in startups.

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Eagle Point Capital aims to own simple, predictable, and profitable businesses in replication mode. Businesses in replication mode don't require brilliant forecasts about the future to succeed. Instead, the future needs only to resemble the past. Investing is not about being brilliant. It's about being consistently not stupid.

This philosophy has kept us away from "story" stocks like Tesla, Uber, Peloton, and Carvana. We don't have anything against those companies and certainly wouldn't bet against them. Someday, if they enter replication mode, we might even own them. We were skeptical of Facebook when it IPO'd, but continued studying it and eventually bought it once it entered replication mode and traded at an attractive valuation.

Investors can and do succeed in investing in startups and mature businesses. Replication-mode investing isn't the only strategy that works. Paul Graham has made a killing despite his 30% success rate. EPC pursues replication-mode investing because it is the most aligned with our skills, temperament, and goals.

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Attached to this letter, we've written more about each of our businesses to explain why we own them, how they've performed, and our expectations for them. We also explain each of the recent changes to our portfolio.

But first, we'd be remiss if we did not **thank you for your continued support and trust.** Investment managers can only afford to be as patient as their clients allow. Your patience and trust contribute as much to our success as anything we do at Eagle Point Capital.

We are grateful to you for supporting EPC's long-term approach to investing. Our clients have proven themselves as exceptional and stoic investors, which provides us all with a significant competitive advantage. We are honored that you entrust us with your capital, and we are proud to be your investment partners.

Please contact us (**matt@eaglepointcap.com** or **dan@eaglepointcap.com**) with any questions about your account or your investments.

If you know any like-minded investors who would enjoy this letter, please forward this to them or put them in contact with us.

You can expect to hear from us again on or around April 1, 2022, with another portfolio update. In the meantime, you can read our previous letters and blog at www.eaglepointcap.com. We encourage new readers to join our mailing list to receive future updates.

Best,

Matt and Dan

The portfolio-specific portion of this letter is for clients only.