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‘Death of the Brand’ or dearth of thought?

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"A part of good science is to see what everyone else can see, but to think what no one else has ever said."

AMOS TVERSKY

Some ten years ago, in the cavernous QEII Conference Centre in front of a 600-person audience, a precocious 37-year-old version of your author stood up and risked career-level embarrassment. I gave a speech titled *"The Death of the Brand: a cognitive bubble in quality compounders"*. It was an attempt to take on the near-religious dogma of the brand-as-moat, 'quality compounder' narrative. The central argument was that a cognitive bubble had formed around the durability of returns for many franchise stocks. Big Brand Inc type companies, egged on by their investors, were the epicentre of this trend. US packaged goods corporations such as Kraft Heinz, Anheuser-Busch, and Clorox stood out as the most egregious examples. But staid, supposedly long-term European peers such as Diageo, Unilever and Nestle were also caught up in this fever of margin fanaticism.

This stance was against the consensus. Big name investors argued that investing in compounding quality franchises had a "unique advantage".[1] By quirk of scheduling, this contrarian speech followed immediately after that of a famous buy-and-hold, 'quality' investor. This experienced and famous UK fund manager, with an enviable multi-decade track record, argued the exact reverse of my position. His big idea was that "arrows", representing the extrapolation of long-term trends, are key to long-term stock picking. And that by focussing on "wheels", an analogy for cycles, value-type investors lose out over the long term.[2]

[1] FT article by Terry Smith 20 April 2017, where he talks about $1of retained earnings being valued at 4-5x by Mr Market https://www.fundsmith.co.uk/news/2017/2073-financial-times-the-unique-advantage-of-equity-investment/.
[2] Indeed, this investor's biggest disagreement in investment philosophy was with Howard Marks' assertion that *"Ignoring cycles and extrapolating trends is one of the most dangerous things an investor can do"*.

The cure for high returns *is* high returns

It won't surprise readers that we disagree. Both returns on capital and, crucially, investor expectations of these returns, over-shoot. This is the Capital Cycle at work. High profitability gets capitalised at high multiples and vice versa. One of your author's main career learnings is that stock market valuations of profits *in-and-of-themselves* act as a catalyst for agent behaviour. Quality companies are not immune to these Capital Cycle "wheels", which can set the stage for multi-decade underperformance.[3]

Compounders?

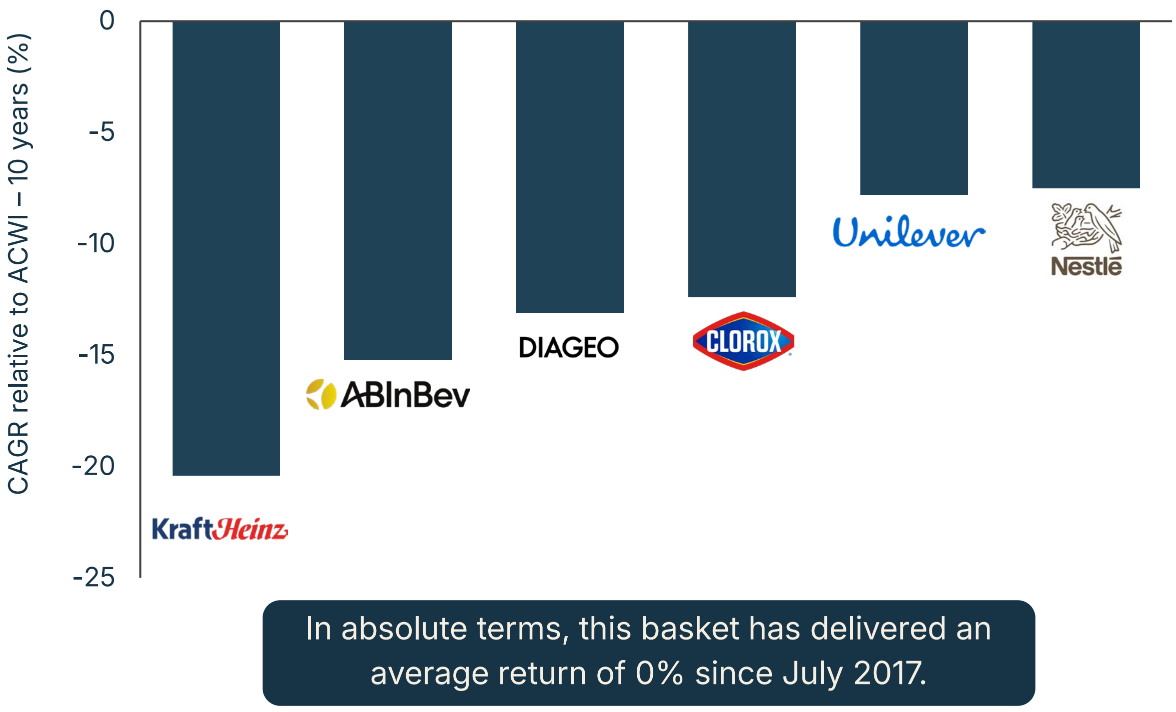

Chart data. [4]

What did the quality compounder cult miss?

Investors who extolled the virtues of branded moat investing faltered in three areas – analytical, behavioural and, perhaps, commercial. On the first of these, monopolising TV advertising for c70 years provided a huge tailwind for branded

[3] Coca-Cola stock, the ultimate 'inevitable', was essentially flat for two decades from 1998, when it peaked at over 40x PE, underperforming by S&P500 by over 3% per year for 18 years. Source: *FT*
[4] Source: FactSet. Period 31 Jul 2017 to 31 Aug 2026. This does not represent all the securities purchased or sold. Further details of the calculation methodology and a list showing every holding's contribution to overall performance during the period is available upon request. https://commons.wikimedia.org/wiki/File:KraftHeinz.svg , https://commons.wikimedia.org/wiki/File:Anheuser-Busch_InBev_-_logo_(Belgium,_2022-).svg, https://www.thecloroxcompany.com/newsroom/media-resources/logo-gallery/. https://commons.wikimedia.org/wiki/File:Diageo_Plc_Logo.svg, https://www.nestle.com/media/images-video, https://www.unilever.com/news/press-and-media/media-assets/

consumer goods companies. This ended with the advent of social media.[5] Big Brand executives grew fat and happy, dominating the traditional media air waves to push consumers into products, ultimately over-reaching by raising product prices too high. This gave an even bigger price umbrella for lower-return retailers to promote private-label and own-brand – where margins are 1.0-2.5x higher than selling branded goods.[6] The underlying customer of ketchup, beer, soap, and so on is, after all, not that interested in sustaining a 15% EPS CAGR for so-called quality investors!

The second misstep was behavioural. Part of the investment thinking around quality compounders has been outsourced. In my 2017 speech, I quoted psychologist Daniel Kahneman, *"For some of our most important beliefs we have no evidence at all, except that people we love and trust hold those beliefs."* And who better to take investment beliefs from than Warren Buffett? Of whom FT journalist Lucy Kellaway observed, *"I can think of no business leader who has been so worshipped for quite so long, ever, anywhere"*. The world in which Buffett was making exceptional branded goods investments is unlikely to repeat, as my colleague Omar Malik detailed in a speech, fittingly enough, in Omaha last year. And the spectacular disaster that was the Kraft Heinz merger, currently being unwound after accounting scandals and $15bn+ write downs, is a reminder that even a Buffett halo does not guarantee investment success.

The third reason is, perhaps, the least forgivable: a marketing imperative. The quality compounder thesis offers a simple and repeatable (read: commercial) story. Combined with 'high conviction', concentrated portfolios, it offered a seductively simple antidote to passive investing: Buy good companies and let the EPS algorithm do its thing. But every investment approach needs to be constantly challenging itself. As per Charlie Munger, "Any year that passes in which you don't destroy one of your best-loved ideas is a wasted year."

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[5] Seth Cohen, P&G's chief information officer, has said the company previously was able to update its TV ads 1-4x per year. Now it needs to generate 10-200 times that number of social media updates. Source: *Bernstein Research*
[6] Over the two decades preceding the publication of our piece, the share of profit captured by branded manufacturers, relative to the retailers and distributors, ballooned from 2.5:1 to 10:1. More recently Big Brands have started to cede profitability to retailers, but this pool reversion arguably has further to run.

We shape our buildings, and our buildings shape us

Our insights into the Big Brand cognitive bubble were, in hindsight, simple. They were not the result of complex industry analysis or expert network calls. Our analysis, focused on enterprise value versus sales, demonstrated an obvious bubble in valuation relative to profitability. Anheuser-Busch and Kraft Heinz both peaked at above 7.0x LTM EV/Sales in July 2017,[7] implying margins more akin to software than beer and cheese. This was not sustainable. We instead bought a basket of retailers – Costco, Kroger, Walmart and Tesco – where margins and returns were lower and where the customer was getting a better 'deal' via lower cost private label goods which were as good or in some cases better than the branded alternative. The earnings cycle was in our favour. And the enterprise valuations relative to sales were approximately one-tenth that of the Big Brand companies at c0.5-0.8x EV/sales. Since July 2017, our basket of retailers has risen 245% vs. a 0% average return for a basket of Nestle, Unilever, Diageo, Kraft Heinz, Anheuser-Busch and Clorox.

Like much of our investment work, this was simple and contrarian. However, this kind of thinking can only be put into practice in an environment that actively encourages such anti-consensus ideas. What we have built at Hosking Partners over the past 15 years is a supportive architecture for contrarian, long-term investing – something we think is going to be increasingly valuable given the decline of active management and the treadmill toward increasing specialisation.

This building permits our generalist multi-counsellors an unconstrained mandate, allowing us to invest where we see upside and avoid highly valued 'momentum' areas of the market – whether that be in Big Brand companies ten years ago or, say, US technology shares today. We do not need to change our investment approach to fit the latest fad, as our diversification allows us exposure to multiple idiosyncratic investment ideas at one time. Of course, a large number of shares is highly *un*fashionable. This presents a challenge to our marketing colleagues but represents a real competitive advantage for the investment team and for our

[7] At the same point Alphabet was valued at 5.5x EV/Sales.

clients. Having outperformed our MSCI ACWI benchmark for one, three, five and ten years, we can evidence that by building something different, we are building something enduring. And as with most businesses, if it is hard to build, it is hard to replicate.

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