To the Partners of BlackBird Financial LP:

I recently purchased a used vehicle off an auction site. The process was simple: I reviewed the cars currently on auction, identified the few that looked like good deals to me, and then found the one that best suits my needs. My friend takes a different approach. He finds a car that he really wants and calls all the dealers in town, offering them a really low price. He tells them that if they ever really need to move inventory and are willing to accept his offer, they should give him a call and he'll come by the dealership, cash in hand.

This difference in approach is akin to the different methods of finding attractive investments. Most people look around the stock or bond markets to find what seems to be most attractive, while a smart minority first finds a group of wonderful businesses, and then wait patiently until they can buy them at a bargain price. This brings us to the question at the heart of this article and possibly the industry as a whole: **what defines a great company?**

Very simply put, a good company is one that can earn a high return on capital employed. Let's review an example: If I started a restaurant chain which went on to earn $100 million per annum, is this a success? It really depends on how much capital was needed to start and operate the business. If we used $10 billion, it would equate to a meager 1% return, but if the business only used $250 million, we'd be earning a fantastic 40% return on our investment. Essentially, a profit of $100 million can only be said to be good or bad in light of how much capital the business uses.

Competitive Forces

Let's take a minute to analyze the latter scenario. Mr. Retail invested $250 million to start Food Forest, Inc., a chain of restaurants catering to underserved neighborhoods in a number of major cities. Within the year, Food Forest, Inc. is achieving a 40% return ($100M/$250M). Here's the catch: It won't be long until his fellow capitalists notice this favorable outcome and seize on Mr. Retail's success by opening restaurants of their own. As they encroach on his market, Food Forest will need to compete to maintain their market share. This may mean lowering prices (which'll hurt diminish their net income) or updating their restaurants so they have more pizzazz (increasing invested capital). Before long, the return on invested capital will take a hit, and Mr. Retails's results won't be so attractive anymore.

So then, how does a company remain attractive for an extended period of time? By possessing a **sustainable competitive advantage**, or moat, as Buffett would call it. This may materialize in several different forms, including brand names (think Coke), patents (drug companies), and network effects (Facebook and Google).

In Practice

Let's take Google as our example: over the last decade they've earned a return on capital in the high teens (and a near identical sum on equity, because they have had a minuscule amount of debt during most of this period). Because they have more searches performed than competing search engines (with a 92.71% market share according to statcounter.com), their algorithms are able to endlessly improve more quickly than a smaller competitor, thereby cementing Google as the best search engine. In fact, American Customer Satisfaction Index gave Google the highest score amongst their competitors for User Satisfaction. Of course, the best search engine is likely to gain new users, thereby keeping the cycle in motion. A business would need to be a fool to skimp and advertise with Microsoft's Bing with only a fraction of the audience (2.73% market share). This is what enables Google to fend off intruders and continually earn healthy returns. How has this worked out, you ask? Well, over the last decade their income has increased more than four-fold (pre-tax income of nearly $40 billion in 2019) and their investors have been immensely rewarded with a 330% return, outperforming the rise in the Nasdaq or the S&P 500.

Contrast the economics of Google with Posco, the third largest steel producer in the world, headquartered in South Korea. With little differentiation between producers, steel is generally a commodity type business. As a result, Posco has earned roughly a 5% return on invested capital over the past decade. Their business demands enormous capital investments to maintain the plant and equipment necessary to remain competitive, but will provide only meager returns on said investment. This is an example mediocrity, if not worse. How did their investors do? Sales have gone nowhere, profits have decreased in the decade since 2010, and as a result, shareholders have seen a decrease in the price of their holdings.

A word of caution is in order: Even the best company will not justify an infinite price. McDonald's has a long history of earning excellent returns on invested capital due to their brand name and scale, which provides them enormous leverage with their suppliers. During the early 1970's, the market recognized much of the potential in the company and bid up its share price. At the height of the Nifty Fifty (of which the company was a member) in January of 1973, McDonald's sold for 86 times earnings, at about $0.96 per share adjusted for splits. As investors came to their senses, the price plummeted 68% to just $0.30 in 1974. It took until mid-1982 to break the high price set in '73. That's more than 9 years! No matter how wonderful a company is, paying too high a price is never a good idea.

This brings me to our conclusion and a lesson; we aught to invest like my friend buys his cars; find wonderful businesses that we'd love to own, then patiently wait until, thanks to the stupidity of Wall Street, someone will sell us their stake at a fantastic price.

Your fiduciary,

Judah Spinner
Chief Investment Officer