Portfolio Activity Q3 2021

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BUYS

Autodesk, Inc. (ADSK)

Autodesk sells mission-critical software for 3D design, manufacturing, architecture, engineering, and construction. Its legacy product, AutoCAD, was first released almost 40 years ago. Since then, the company has shrewdly leveraged this product's dominance to expand into adjacent verticals. It continues to do so through cross-selling and M&A, leading to impressive intrinsic value growth year after year.

When we initiated our position in ADSK in 2019, the company was transitioning from a perpetual license model to a cloud-based SaaS model. This temporarily impacted earnings, which put the stock out of favor. Confident in the long-term vision of management, we made an investment as we felt the stock presented an attractive value. The company has since completed its business model transition and is now generating ample free cash flow. It has streamlined its focus of offering integrated product packages for various industry applications, while moving up and down the value chain in these industries.

During the quarter, management lowered free cash flow guidance. We felt the stock over-corrected in response to this action, giving us an opportunity to purchase more shares of ADSK for client accounts. The lower expected free cash flow is largely a result of the timing of billings and the company's tinkering with pricing strategies. In our view, management is focused on maximizing customer lifetime value rather than hitting short-term targets, just as they were when they transitioned to a SaaS model. We like this trait in management teams, as it gives us confidence that our capital is being invested with long-term returns in mind. (Louis Foxwell, CFA)

CoStar Group, Inc. (CSGP)

CoStar is an information, analytics, and online marketplace provider to the commercial real estate (CRE) industry. Most CRE transactions in the U.S. involve a CoStar subscriber, as adoption of its offerings has become table stakes for industry participation.

CoStar owns the most robust CRE database in the U.S., which it monetizes through its crown jewel asset, CoStar Suite. This offering combines property data with analytical tools and professional research, which brokers, property owners, and investors use to make decisions. Due to the fragmentation and fluidity of CRE data, an accurate and complete database is difficult to create and maintain. CoStar's first mover and scale advantages have placed it years ahead of competition; therefore, we think it is highly unlikely that a disruptor will displace CoStar as the leading information services provider in the CRE industry.

CoStar also operates online marketplaces and listing services, notably Apartments.com and LoopNet. These are high-growth businesses that offer internal reinvestment opportunities in the form of marketing spend. We think these investments, which are currently depressing earnings, will yield high returns in the long run. Once these marketplaces reach maturity, we believe margins will expand significantly as customer acquisition costs decline and operating leverage kicks into gear. CoStar has an impressive acquisition history in the marketplace business, having re-accelerated the growth of many acquired assets over the last decade. It recently acquired Ten-X – a commercial real estate auction platform – which we think will see a similar acceleration of revenue growth.

We initiated a position in CoStar after our research uncovered some potential sources of hidden value related to product pricing, long-term margin realization, and opportunities in residential real estate. We think this is one of the highest-quality stocks in our investable universe, and we determined that shares traded at an attractive price given the long runway for potential value creation. (Louis Foxwell, CFA)

Fair Isaac Corporation (FICO)

Fair Isaac is the data analytics company behind the FICO Score. This proprietary score summarizes a consumer's propensity to repay debt and is used in most consumer credit decisions in the United States. FICO licenses its scoring algorithms to the credit bureaus, who distribute the scores to banks, mortgage lenders, credit card companies, and auto loan originators. The company makes money every time the score is used in a credit decision, and it costs FICO almost nothing to license each additional score. The result is a scalable business with high incremental margins that requires very little tangible capital to operate.

Market sentiment has turned negative on FICO in recent months. Investors have become concerned about emerging fintech companies which may disrupt the traditional lending model with AI and alternative credit data. In our opinion, these concerns reflect a misinterpretation of the true value proposition of the FICO Score. The FICO Score acts as a common language (i.e., benchmark) for risk assessment in the lending ecosystem. Its role in the industry is to *standardize* the risk management process with a cost-effective methodology, not to meticulously analyze each individual borrower. Institutions need real-time risk assessment that is easily digestible and communicable between parties. For example, when a bank securitizes loans and sells them to investors, the investors need a way to analyze the aggregate risk of those securities. They can look at the average FICO Score in this case without analyzing each individual loan, saving a lot of time and resources in the process. Ultimately, we view the FICO Score as a building block for decision making that can co-exist with other lending platforms. Additionally, given the high switching costs for lenders, investors, and regulators to adopt a new standardized scoring system, we think FICO will have long-term staying power in the industry.

FICO continues to invest in its software business as a key growth area – specifically the decision-management platform. We believe this is depressing near-term earnings which is making the stock look expensive on the surface. Management is also using excess cash flow from the scores business to repurchase shares on the open market, which we view as a prudent use of capital at current market prices. We purchased more shares for client accounts during the quarter as they traded below our estimate of intrinsic value. (Louis Foxwell, CFA)

Take-Two Interactive Software, Inc. (TTWO)

Take-Two creates and publishes interactive entertainment. It owns an attractive portfolio of IP that includes *Grand Theft Auto (GTA)*, *NBA 2K*, *Red Dead*, *Max Payne*, *Civilization*, and *BioShock.*

We think the *GTA* property provides a lot of optionality for long-term shareholders, and we expect it to experience a step-function increase in earning power upon the release of *GTA VI*. Even with the current iteration of the franchise, *GTA Online* enjoys network effects and switching costs as players grow their in-game digital identities and assets. Take-Two primarily benefits from this by selling digital currency, but we think it will expand to other monetization models like in-game advertising and subscriptions. In summary, we think *GTA Online* is in the early stages of development as a social platform and virtual playground.

NBA 2K, which drives a significant portion of earnings, is akin to a growing annuity. Our analysis leads us to believe that the NBA will have difficulty finding another publisher who can monetize its brand as effectively as Take-Two in the video game medium. The 2K brand is also primed for further reach into other sports, which is evidenced by the company's recent push into golf.

Shares of TTWO have been hit recently for several reasons: (1) China has cracked down on gaming for its younger population, (2) engagement has pulled back as people are leaving their homes more, and (3) the company has delayed multiple titles in recent months. With regards to China, we would point to the fact that many of the company's games are already banned in the country. Take-Two generates a very small percentage of its revenue in China, so we do not see the recent regulatory actions as having a material impact on earning power. The concern around short-term engagement is valid; however, engagement is still above pre-pandemic levels after the pullback. We think consumer behavior has permanently changed in favor of Take-Two as players are more engaged and open to purchasing digital goods. Lastly, the delay of titles makes sense to us given console shortages and supply constraints. Once the supply of consoles hits a critical mass, we expect Take-Two to release multiple games from existing and new IP. (Louis Foxwell, CFA)

SELLS

(The positions below were reduced or eliminated in most accounts. In some cases, positions were kept in selected client accounts for tax purposes.)

Activision Blizzard (ATVI)

Activision has been under pressure the past quarter for a few primary reasons. First, the video game companies benefitted greatly from the ancillary effects of the pandemic, with people sheltered at home looking for new forms of entertainment. The markets have been rotating out of these "pandemic winners" in 2021. Second, China placed restrictions on its young population, limiting them to only three hours per week. Third, widespread supply chain issues have delayed the long-awaited console releases from the last holiday season. Lastly, Activision faced an investigation and received lawsuits related to its workplace culture, specifically in its Blizzard division. As expected, the fallout has included top executives stepping down and the departure of a few key developers. So far, one of the lawsuits has been settled, but the company has more work to do to navigate this issue.

Our take on this is that we want to wait for more information before making any wholesale decisions. The market rotation and supply chain issues are likely transitory. The China restrictions are unfortunate to see given that this was a significant growth runway for some of Activision's franchises, specifically, Call of Duty. However, this is ultimately a small portion of its current revenue base and is unlikely to impact the company materially. The workplace culture issues are harder to unpack, and we want to see how the company responds. Our initial thesis is still intact and likely unaffected by this news long-term, and this could be a short-term issue that creates an opportunity. However, this could take time to resolve, and the stock price could stagnate until more clarity emerges. Therefore, we swapped positions in client accounts that did not own some of our newer ideas. We will continue monitoring the situation and may potentially resume purchasing if and when we feel comfortable with the near-term headwinds. (Matt Holman, CFA)

Berkshire Hathaway, Inc. (BRK/B)

Our thesis on Berkshire remains the same as it was the past few quarters. We still have growing concerns about the company's ability to generate market-beating returns over the long term. To reiterate our updated thesis, our concerns center around a few key thoughts:

1. Berkshire has underperformed the market for years. That said, it is outperforming year-to-date due to a rotation into value-based industries. We feel this is a temporary rotation, and returns will continue to be more attractive in these newer businesses long term. Therefore, we are taking advantage of this recent outperformance to sell at higher prices.

2. This underperformance is partly due to its reluctance to purchase these modern companies with more structurally advantaged business models. Buffett famously said they missed on Google and Amazon at a recent annual investor meeting. He says they did not understand or appreciate the value proposition and did not see how they could outperform over the long term.

3. We are concerned about Berkshire's size and ability to make investments that will lead to material growth. Berkshire has outperformed for decades by purchasing smaller businesses and rolling them into the portfolio as wholly owned subsidiaries. As a $600+ billion company, those investments no longer generate the same growth rates as they would for a $50 billion company. Berkshire must wait for larger-scale opportunities, which are harder to acquire at discounted prices. This is why Berkshire has built such a significant position in Apple. It has also led to idle cash accumulating on the balance sheet earning minimal returns with treasury rates still near historic lows.

4. We are starting to get some clarity on the succession plan. Buffett will pass the CEO reigns to Vice Chairman Greg Abel when he steps down. Abel currently runs all the noninsurance operations at Berkshire. Buffett said Abel will continue the decentralized structure and culture that made Berkshire what it is today. We still don't know how Abel's investment and capital allocation strategies will look compared to Buffett's, though.

In summary, we feel this is not the Berkshire of old and could look even more different after the management transition. Therefore, we are re-deploying the capital into what we believe are more attractive opportunities with fewer question marks. We plan to continue swapping into our newer ideas as they become attractively valued, with the longer-term goal of fully exiting the position. (Matt Holman, CFA)

Hilton Worldwide (HLT)

Like many companies hit hardest by the pandemic, Hilton's shares have rebounded, and its investment performance reflects that of late. Hilton's shares have overcorrected based on our research and expectations, and the valuation has risen beyond our fair value estimate. At the current price, we feel the valuation is pricing in lofty growth expectations which may be difficult to realize given our outlook on the travel industry. This company still meets our quality criteria, but the margin of safety is no longer there. Therefore, in qualifying accounts, we swapped out of HLT and into our newer ideas, which we feel are more attractively priced. (Matt Holman, CFA)

TJX Industries (TJX)

The pandemic has hit the brick-and-mortar retailers hard, and TJX is no exception. TJX has had to battle store closures, traffic reductions, merchandising accommodations, and supply chain constraints over the past year and a half. While TJX stores have recovered to their pre-pandemic levels, the investment performance is still lagging. Our take on this is that the market is more interested in names with less pandemic-related exposure. The main question now is whether TJX is just a good business amongst great ones or if it can evolve with its ecommerce peers while maintaining its unique shopping experience. For now, the former is looking more likely, so we are swapping capital into our newer ideas as they become available. (Matt Holman, CFA)

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