May 2, 2018

April 2018 - Performance Update

If you are an accredited investor, please contact us for performance information.

The old adage "sell in May and Go Away" is not something we ascribe to. We expect more short-term volatility from the markets. To that end, we are steadfast in execution and will always keep you apprised of the factors that may be solely a source of temporary portfolio agitation as well as those that may be real threats to performance.

Keeping our eye on the ball, brings me to a topic I feel deserves attention and some discussion:

The Death of Brands

Brands and branding are as old as civilization. However, modern branding began in earnest in the 1950's. As standardized manufacturing processes improved product quality, leveling the consumer product playing field, companies needed new ways to differentiate their offerings and induce consumers to pay a premium price for a product due to its perceived "qualitative superiority". In their heyday, brands carried a huge competitive advantage. If the cost of building the brand was less than the premium charged for the product, brands created durable competitive advantages, which generated great returns for shareholders.

However, not all brands are equal. They can be segmented into at least three categories:

1. Social consensus brands
2. Self-expression brands (luxury goods)
3. Search cost brands.

Some examples may illustrate and aid in understanding each group:

Social Consensus – The value of these brands depends on shared social acceptance. For example, Nielsen audience ratings are an accepted way of measuring the size of a market. While Nielsen may not be perfect, it is an accepted standard, making it hard for competitors to gain market share. Other examples include bond ratings from Moody's or S&P - these are worth a lot of money, while a rating from lesser known Eagan Jones is not.

Self-expression – Rolex does not tell time any better than Timex, but it is a powerful way of communicating "prestige". The popularity of Rolex makes communicating wealth and status easy, something that an equally expensive but lesser known brand cannot do. Other examples include Nike, and Under Armor.

Search Cost – McCormick spices, Colgate toothpaste and Kellogg's cereals are "search cost brands". Through years of marketing Proctor & Gamble (P&G) has convinced consumers that Tide washes clothes better than other detergents (it does not). While shopping at the supermarket consumers readily select these products, because they are easily available and can be certain of their quality. The overall prices of these items are so low that it is not worth the "search cost" to seek out alternatives.

This last category deserves specific focus. Today, brands that rely primarily on "**search costs"** are at great risk of disruption. Over the next few years, these brands and the companies that own them will experience severe stress because powerful retailers and technology (the internet) are reducing "search costs" on a global scale.

Costco, for example, has become a "trusted" intermediary between consumers and brands. Costco acted as "guarantor" of quality for lesser known brands sold at its stores and has aggressively promoted its own store brand, Kirkland. Amazon, is now doing the same thing but on a much larger scale. Consumers are now willing to try niche brands, as long as they have a lot of positive reviews and appear high in Amazon's search results.

With greater use of the Internet, the greater the amount of information about products, the more consumers rely on so-called "reputational" aspects to evaluate those products. What makes this paradoxical is that the vastly increased access to information consumers have today does not empower them or make them more cognitively autonomous. Rather, it renders them more dependent on other people's judgments and evaluations of the information with which they are presented.

In the information age, consumers are experiencing a fundamental paradigm shift in their relationship with products. From the "information age," we are moving towards the "reputation age," in which products attain value only if "endorsed" by "trusted" others. The paradigm shift from the age of information to the age of reputation must be taken into account when speaking of brands.

In the reputation age steeped in technology, critical appraisals or endorsement constitutes a sort of second-order epistemology, that prepares consumers to question and assess the reputation of products for purchase. This explains why Gillette, who spent years telling consumers that it was "The Best a Man Can Get" – could be undermined by Dollar Shave Club and a four-thousand-dollar YouTube video. Similarly, Yellow Cab spent years building a reputation for trust and reliability – until Uber changed everything.

The value of "**search cost** brands" is eroding rapidly, and power is shifting to retailers and consumers instead. If the value of the brand is not based on social consensus (Nielsen ratings), or self-expression (I'm an Under Armor / Nike guy), the brand is vulnerable to disruption. The top Amazon search result for "sugar free cereal" is a muesli from "Seven Sundays" – a company launched by a Minnesota couple in 2011. How durable is the competitive advantage of Tide? Or Energizer or Kellogg?

Warren Buffett has referred to many consumer brand companies as "The Inevitables" – given the changes in the economy, the "inevitability" of these companies such as Clorox, Kimberly-Clark, Kellogg, General Mills, Colgate-Palmolive, PepsiCo, Church & Dwight, Proctor & Gamble – may well be extinction. With little or no organic growth, stretched balance sheets and eroding moats, these companies face a difficult future.

At LRT, we believe that many "search cost brands" will begin missing earnings estimates in the years ahead and will be forced to cut dividends as they adapt to the brave new world around them. Investors in "**search cost** brands" are in for a rude awakening. At LRT, we steer clear of companies that rely on such brands.

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