CAPCO
ASSET MANAGEMENT

January 10, 2014

Dear Partners, Clients & Friends,

We closed last year's letter by saying:

"...Cash and bonds are positioned to provide their investors "return-free risk." The excesses in bond overvaluation today are as obvious as the stock over-valuations were in the technology bubble more than a decade ago. Sometimes it takes years for that kind of thing to unwind, but it is highly unlikely to be a great decade for fixed income investments. At the same time, equities are reasonably priced and offer the benefits of growth and inflation protection. It won't always be the case that the contrast in valuations is so dramatic and the conclusion so clear. The prospects and valuations of the kinds of companies we love are excellent. We are very optimistic about what the next decade should produce."

Not waiting for a decade to unfold, a year later, the S&P 500 stock index is up 32% and the Barclays US Aggregate Bond Index is down -2%, a meaningful step into our expectations for the decade. For the last five years, the investor who was waiting for a better outlook has paid a staggering opportunity cost.

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Capital Allocation

Capital allocation is perhaps *the* central investment topic. It is what you do when you invest with us, it is what we do when invest in specific companies, and it is what those companies do with their free cash flow.

Capital allocation covers the spectrum of virtually any source or use of capital: borrowing money or repaying debt; investing in one's own business or milking it for cash flow; buying assets or other companies (or selling them); even buying or selling the company's own stock. The greatest capital allocators tend to recognize and react to extremes in any of these areas in a clinical rather than emotional way. They may hold cash for long periods, but may deploy it aggressively when opportunity warrants.

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The public markets provide many examples of egregious capital allocation mistakes, many more where it is simply average, or an after-thought, but very few where it is simply outstanding. We consider capital allocation a distinct business discipline, but many businesses do not treat it as one. It is also a highly individual one, as the important decisions are made at the very top, by one or few people. The typical CEO rises through strong performance in sales, products or operations, usually by demonstrating skills in management and leadership. Rarely do those routes offer significant opportunities to allocate capital. Because we consider this skill so important, and because it is rare, we have a strong research discipline around it. As a result, our companies consistently demonstrate excellence in this area that far exceeds what is typical in American business.

Different companies in the same industry can have spectacularly different investment results due to capital allocation. Warren Buffett redirected the cash flows from Berkshire Hathaway's textile business into other, better, businesses: rival Burlington Industries re-invested in its textile business, and eventually went bankrupt. Ruger bought back huge amounts of its stock at low valuations, while rival Smith & Wesson made egregiously unrelated acquisitions at high prices, and then, facing disaster *during a boom*, sold its stock at low prices to raise cash. Energy producer Contango used the whole toolbox of capital allocation to enormous benefit, while rival Chesapeake Energy made wild use of the same toolbox to almost destroy itself.

We often reference their capital allocation when we discuss our companies, but detailed analysis of specific actions is often beyond the scope of our letters: the full picture is often complex, depending on many other considerations, and the results usually take years to unfold. But over a long enough period of time, capital allocation decisions may account for most or even all of an investment's value, and we have wanted for a while to include an illustration in a letter. The example that follows covers two similar companies making similar allocations for a very long time, with very different results.

In the freight transportation industry, Landstar (which we own) and Expeditors International (which we don't), are both asset light businesses, middlemen between shippers and carriers, with good operational management. Both are prodigious cash generators. For many years, both have allocated the bulk of their free cash flow to repurchasing their own stock.

In the last ten years, Landstar generated $1.2 billion in free cash flow. It spent about 70% of that on repurchasing its own shares. Because it was generally paying reasonable prices, its buybacks were highly effective and the share count declined by a very significant 30%, from 67 to 47 million shares. Longer term, since current management took over in 1989, the share count has shrunk a staggering 50%. The result is that each share owns twice as much of the company as it otherwise would. It is rare to find companies whose buyback programs have been this effective.[1]

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[1] When a company re-purchases its shares, it is in effect acting as an intermediary between its shareholders. Consider a company with a market value of $500 million and $200 million in cash (implying the operating business is worth $300 million). The shareholders collectively hold a "portfolio" of cash and a business. If the company then uses its cash to re-purchase 40% of its shares, the selling shareholders will now have only cash, and the remaining shareholders will own only the business. In effect, the remaining shareholders "bought" the rest of the operating business from the sellers. Whether this is a better idea for the seller or the buyer depends on the circumstances, including price. A company's annual profits will buy back 5% of its shares if it trades at 20x profits, but only 3% if it trades at 30x.

In the same period, Expeditors, has generated a cumulative $2.6 billion in free cash flow. It spent about 60% of that free cash flow on repurchasing its own shares. So far, it looks roughly similar. But Expeditors did two things very differently. First, its repurchases were made at consistently high prices (thus buying fewer shares relative to profits). Second, it issued numerous shares to its employees as compensation. Its repurchases reduced the share count by a nit, from 218 to 212 million, or less than 3%. To our eyes, Expeditors really produced only $1.1 billion in true free cash flow, because it paid out another $1.5 billion in employee compensation that traditional accounting does not capture in the income statement. We are strongly in favor of appropriate compensation for employees, and the point here is not whether this was appropriate. But *more than half* of conventionally calculated free cash flow did not actually belong to owners in this case, and it is something owners should take into account.

As this highlights, there is no silver bullet for capital allocation, no "one decision" that is always right, and no single number that provides a complete analysis. Our companies collectively use the full toolbox, and we examine each capital allocation decision on its merits, and give special attention to changes.

This is also true as we zoom out, to our own capital allocation decisions. The investor who chose the "safety" of bonds at the end of 2008 has earned a return of 24% (using the Barclays high quality bond index as a reference). Meanwhile, the S&P 500 soared 128%. At the end of 1999, a different time with very different valuations, the exact opposite decision was appropriate. In recent years, it was important for us to pick the right companies, but far more important was the decision to own equities at all.

One reason we pay less attention to relative performance is precisely this factor. When some asset's valuation is rising rapidly, a business or investment manager that has arranged its affairs and set expectations to "keep up" will tend to be forced into capital allocation errors. Our goal is not to keep up with anything in particular: it is to make intelligent capital allocations, adjusting to circumstances as they change, and being willing to trade off upside for safety (as well as the ability to invest aggressively when others are headed for the hills).

As we noted at the outset, you also make capital allocation decisions, including your allocation to Capco. Just as we strive to understand the thinking of the managers to whom we allocate, we try to provide you enough information to understand ours. The future is uncertain, but how we think about risks and opportunities, what we expect in good or bad scenarios, need not be.

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