The following is an excerpt from our letter for the 1st quarter of 2006:

**On Being a Good Partner**

Competitive advantages come in an almost infinite variety, and their analysis is perhaps the single most difficult and time consuming aspect of our research process. But however great or small a company’s advantages, *it is our observation that their durability is usually directly related to how good a partner the company is to those with whom it does business.* This is so simple and trite as to be corny, but it is hard to overstate its importance.

It is not nearly enough for a company to just say the right things, because most do. The evidence of this attitude of partnership is in the business model and its execution. There is a long list of great businesses that squandered their position by trying to squeeze out the last penny of profit. At the same time, many businesses with more fragile characteristics have built great positions by ensuring that their customers or suppliers wanted to see them endure, rather than looking for some way to replace them.

For example, Jim Sinegal, Costco’s CEO, has a viewpoint that we embrace and look for in other companies: his iron rule is “no easy hits on the customer.” Costco sells with famously low mark-ups, and it could often sell the same volume at a little higher price. With its slim margins, the short term result of slightly higher prices would be a massive increase in profitability (and presumably stock price). Instead, Costco builds a rare level of customer loyalty and trust. Similarly, its employees receive the best pay in retail. And while no one would argue that Costco goes easy on its suppliers, it sells a relatively small number of items and thus provides vendors the opportunity to sell exceptionally high volume.

Landstar is another example. Its trucking loads are originated by independent agents, who receive a percentage of the revenue. Many businesses might cap these payments at some level (many of the agents make extremely good money), and others might choose to serve large accounts directly, to save the commission. But Landstar, as a partner to its agents, refrains from such internal competition and disincentives. As a result, they build a stronger, more durable business every day, as the agents gladly embed their business into Landstar’s model. The result is exceptionally productive, profitable and stable agents. The same concept and result applies to the truckers driving the loads.

At Carmax, the business model is also based on operating as a fair partner to their customers, but we relate one example that concerns us as a way of distinguishing our investment thinking. Carmax offers to buy any car offered at a “no haggle” price, regardless of whether it makes a related sale. As a result, it buys many cars not suitable for its own lots, which it sells through its own auctions. In recent periods, Carmax has shown increasing profitability on these
sales. A natural reaction might be to rejoice at these additional (and significant) profits – clearly
the stock market has signaled its approval. However, we view it with some concern. There are
several things driving this result, many of which are good – they have a superior “unreserved”
auction model that results in higher wholesale prices and they work to offset temporary pricing
conditions between retail and wholesale to ensure a competitive retail offer. But to the extent
they offer lower appraisal values than necessary, we are concerned that they may be violating the
“no easy hits” rule. We have had substantial discussions with the company and its CEO about
our concerns, in which we conveyed our view that it may not be obvious in any single
transaction, but eventually, consumers figure it out. Despite this concern, Carmax’s
responsiveness to us on this issue is a good example of why we like to partner with high quality
managers. Stay tuned.

There are many instances where a company has done well for many years despite
frustrating its customers, who are temporarily unable to do anything about it. Consider the soft
drink industry, which for many years has been a wonderful business for the makers of the
flavored syrup, like Coca-Cola and Cadbury-Schweppes. These companies have reaped most of
the profits to be made from selling soft drinks, leaving inadequate returns for their customers, the
bottling plant owners that buy syrup and sell finished drinks to retailers. As the bottlers struggle
to earn a decent return on their plants, they have turned to alternatives, drinks they could produce
in low volume but high margin. It is the syrup makers’ partners, these bottlers, who breathed the
life into drinks that are now eroding public consumption of soft drinks, the syrup makers’
livelihood. Had the bottlers been able to earn a better return, they might have had a vested
interest in defending the soft drink industry, rather than throwing their powerful distribution
systems behind the competition.

Something similar could be said of the auto unions. As the monopolistic supplier of labor
to Detroit, they were able to extract enormous compensation, and have taken, by far, the greatest
proportion of Detroit’s profits. By taking maximum advantage of its “customers”, labor has
jeopardized Detroit’s long term prospects, and thus labor’s own employment.

How Capco Strives to be a Good Partner

In addition to influencing our investment decisions, this viewpoint is also the basis for
our relations with our partners. We have strived to structure the business as a good partner to all
involved. Compared to the substantially more aggressive fee structure of hedge funds, we have
offered our limited partners a choice that is unique to the best of our knowledge, of either a base
fee or a share of the profits. Similarly, we use “tax lot layering” to ensure the fairest possible tax
experience for our partners, a method that is far superior to the pro-rating used by mutual funds
and the aggregation and stuffing method used by most hedge funds. This requires us to invest in
expensive software that would otherwise be unnecessary (which we do at our expense). We have
eschewed “soft dollars”, which some managers use to pay their overhead expenses by accepting
rebates on commissions paid by their clients. And we take pride in the way that we report to you
about what you own, which we are confident compares favorably with virtually any manager. In
short, we make decisions with a focus on behaving as your partner.