Why Bottom-Up Value Investors Need Systems Thinking

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systems thinking: an approach to problem solving taking into account the interactions between a system and its component parts, designed to better reflect second-order, reflexive, and unintended consequences. [1]

Stop me if you've heard this one before: an NFL team is building *state-of-the-art* new digs, outclassing the other 31 with bold architecture and whiz-bang digital scoreboards massive enough to render the actual playing field into a distracting sideshow. The team solicits taxpayer funding by projecting how the venue will reinvigorate the local economy. How could you say no? It's a matter of local pride to be the biggest and best; now it's apparently profitable to boot.

Except by the time the project's shovel-ready, the stadium's already been eclipsed by another two in the works - one by a bitter division rival, no less. Fast-forward a decade or three, and all of a sudden home field is looking pretty sad and worn down. The team freshens up its now-vintage pitchbook and sticks out an oversized mascot paw for more bond money…

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I'm the sort of investor who isn't terribly popular at dinner parties, on the rare occasion I end up at them, because everyone's first question is *"oh, where do you think the market's going*?" Naturally, I reply with the standard bottom-up value-oriented line: *"you know, I really don't have any useful thoughts on the market, but I could tell you about this awesome new product from my favorite corporate training company that totally changes how Chief Learning Officers create impact journeys for…"* Lo and behold, I look up, and they've abandoned me for the lobster samosas, leaving me to drown my unfinished sentence in a cold Coca-Cola.

Nonetheless, while I focus on picking strong swimmers rather than predicting the tide, one potential mistake that can be made when deeply analyzing individual opportunities (in addition to over-reliance on exhaustive data collection rather than thoughtful decision making) is to get so wrapped up in company-specific details that you overlook the broader systemic context - the "and then what?" analytical step out of the reductionistically precise comfort of a spreadsheet into the messy, complex real world.

Here's a quick example of how you could be lulled into a false sense of bottom-up security that conflicts with fairly obvious system-level issues. This time last year, for reasons I can't quite remember, I actually spent a little bit of time working on brick-and-mortar retailers. (I know, I know - not one of my better time allocation decisions.) The first one I looked at had an interesting story: for what management assured investors were fully controllable reasons around product assortment, the comp stack didn't look super, but they had a magic plan: *investing in e-commerce, reducing time-to-market to emulate fast-fashion peers, and implementing new real-time data systems to target customers and "chase" hot products flying off the shelves.*

[1] Paraphrased from various sources incl. Wikipedia, this, and Seeking Wisdom (referenced later).

Oh cool - that seems like a reasonable strategy. Or at least it did, until I looked at retailers #2, 3, and 4… and discovered that, whether due to social proof or some other factor, they were all taking pretty much the same approach.

My mind automatically jumped to the system level - unit-wise, the apparel TAM is more or less a zero-sum pie, insofar as anyone not named "Dez Bryant" [2] or "your wife" [3] is only going to buy *so many* pairs of shoes between now and next Christmas. (*So,* so many.) Quips aside, retail's obviously a mature market where achieving robust growth necessitates either differentiated product to the extent of pricing power, or stealing volume from competitors. Mathematically, share gains by LULU/Gildan/etc necessitate commensurate share losses by Levi's/Hanes/etc. Implementing real-time sales tracking, a more robust e-commerce platform, and a supply chain with shorter lead times certainly seems like a valid competitive strategy with a reasonable shot at success… until you figure out all your competitors are pursuing the same approach, which means, on net, any one player will achieve zero incremental competitive advantage.

With another year in the books, my suspicions were confirmed - new data systems couldn't salvage comps for any of those sad-sack retailers. Admittedly you can't blame retail executives for trying; after all, if they didn't make those moves, they might be holding their next earnings call on their way up the steps of bankruptcy court. However, investors blinded by "cheap" valuation metrics, hoping for improving comps and margins, should've known better. Value trap 101.

Of course, I'm not breaking any new intellectual ground here - this is exactly why Buffett stopped buying cigar butts with no competitive advantage. Keeping with the apparel theme, here is a pithy explanation from Charlie Munger:

> *"[in a commodity industry], all the advantages from great improvements [will] flow through to the customers. The people who sell the machinery - and by and large, even the internal bureaucrats urging you to buy the equipment - show you projections with the amount you'll save at current prices with the new technology. However, they don't do the second step of the analysis - which is to determine how much [will] stay home and how much [will] just flow through to the customer.*
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> *I've never seen a single projection incorporating that second step in my life. And I see [such projections] all the time. Rather, they always read: "This capital outlay will save you so much money that it will pay for itself in three years." So you keep buying things that will pay for themselves in three years. And after 20 years of doing it, somehow you've earned a return of only about 4% per annum. That's the textile business."* [4]

[2] http://www.star-telegram.com/sports/nfl/dallas-cowboys/cowboys-corner-blog/article112413027.html
(Knowing Dez Bryant owns 3,000+ Jordans makes me marginally less ashamed of my seven-color collection of hightop Chucks.)

[3] Statistically speaking, I am writing to an overwhelmingly male audience, so you're more likely to find this amusing than offensive. If you are the exception, please accept my apologies, enjoy this study about how women are better investors than men, and note that I am an equal-opportunity humorist who also made a self-deprecating joke about my own frivolous rack of shoes. =)

[4] Via pages 228-229 of Peter Bevelin's excellent *Seeking Wisdom*. An awesome book that you should go read.

A third and final example, coincidentally also retail-related, is the bull thesis on Seritage Growth Properties (SRG) - i.e. slicing up and redeveloping erstwhile Sears boxes at substantially higher rental rates. [5] I've seen multiple detailed writeups, none of which addressed my basic system-level question: *which tenants can generate sustainable profits in B/C space?* Fellow big-box anchor J.C. Penney has issues, the venerable Macy's is slashing jobs, and I don't think new Barnes and Nobles are in the cards. The long list of smaller-format retailers that have gone from "hot" to "not" includes, but is not "Limited" to: Hot Topic, Quiksilver, Aeropostale, J. Crew, Express, and essentially all of Ascena's brands. Even cleats and clubs aren't safe: Sports Authority went so bankrupt that creditors chose to liquidate. [6] And it's not as if these stores are closing into a supply-constrained market - Jones Lang LaSalle notes the U.S. has as much retail space per capita as "*France, Denmark, Finland, Portugal, Spain, Italy, and Germany combined.*" [7]

None of this is to say that Seritage couldn't work. But imaginably, the counterparty (Simon?) to those other downsizing retailers' leases probably also wants to redevelop space… implying what for pricing and utilization in an oversupplied market with shrinking demand? This system-level view raises critical questions I consider "too hard" - i.e. unknowable and/or unpredictable. So I passed Seritage by in favor of a much more clearly underpriced REIT I actually had an angle on. (A small position and not my favorite idea, but in an expensive market, I'll take value where I can find it.)

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Most of the time, systems thinking helps you avoid dangerous pitfalls - take the standard B-school example of terminal growth rates - if you assume a business will grow at 20% forever, *you're gonna have a bad time*, because SnackApp can't be bigger than global GDP in 2035, it just can't, I don't *care* how many selfies your cousin's cat is sharing on it. [8] Math says no. At a more sophisticated level, incorporating systems thinking can help bottom-up value investors mesh deep business understanding with the broader industry and customer context to obtain a more reasonable, realistic set of expectations for how business performance will evolve over time.

That said, sharp thinkers reading between the lines of my first two examples might also spot a categorically attractive fishing pond for potential ideas. I came close with one line on the second page, but didn't explicitly spell it out, because where would be the fun in that? **If you're up for the challenge, email me with your thoughts.** If you make a valiant attempt, I'll share my hypothesis… and if you mention that you tweeted/LinkedIn-ed/emailed/otherwise shared this paper, I may even throw in an actionable small-cap investment idea related to my premise. :)

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[5] Example: https://www.valueinvestorsclub.com/idea/SERITAGE_GROWTH_PROPERTIES/137107

[6] I am taking some editorial license here (and throughout) and you could quibble with the way I'm describing some/all of these situations. I do not claim to be an expert on any of them. The point is basically that despite widespread agreement for half a decade that Amazon is eating bricks and mortar retail, investors are somehow perpetually surprised that it *keeps happening*.

[7] http://www.us.jll.com/united-states/en-us/news/3775/life-liberty-and-the-pursuit-of-retail-space

[8] #teamdogpeople