Cliff Sosin

(Continued from page 1)

Cliff Sosin

earned both a B.S. in Engineering (High Honors) and a B.A, in Economics from Swarthmore College.

Graham & Doddsville (G&D): Cliff, can you tell us about your background, and how that led to CAS Investment Partners?

Clifford Sosin (CS): I went to Swarthmore College and studied Engineering and Economics. I worked for two years at Houlihan Lokey focusing on restructuring. I wanted to be on the buy side because I didn't like being an advisor. I preferred seeking truth as opposed to seeking an argument. I went to a place called Silver Point, which is a distressed lending business. I was in a private lending part of the business, but negotiating private loans didn't suit my temperament. Part of it was environmental. It was 2006, so there wasn't a spread that was too thin or a company too risky. I found doing these private sales very frustrating. It wasn't a good fit.

A year later, I started to look for another job and found my way to UBS. There were 35 people in the group, mostly split into industry groups. My job was to look at high yield and distressed, but I also got to spend time looking at generalist stocks. Fast forward a year and a half and the group shrank from 35 to nine. I was fortunate to keep my seat. We also stopped investing in high yield and distressed so I focused on stocks. That's where I started thinking full-time about stocks and began, from 2008-2012, developing my investment philosophy.

I learned a lot at UBS, met some great people and really matured. I also was fortunate to have some very good investing results. At a certain point though it became clear that at a more traditional long-short business such as UBS I wouldn't be able to invest the way I want to; however, I was trapped at UBS because of my deferred compensation.

Eventually, the Volker rule required the bank to get rid of its proprietary investing business. They transferred us to UBS O'Connor. That created an opportunity for me to leave and continue getting my deferred comp based on the vesting schedule. I wasn't rich, but I wasn't poor, so I had space to start a business and know that if I didn't attract much in the way of assets, I could still eat.

I left UBS in July of 2012 and started CAS Investment Partners the week of October 9th. People ask, "Why the ninth?" The eighth was Columbus Day; we were aiming for the first, but we missed. We started with a very small amount of capital and have been fortunate to get bigger since then.

G&D: Could you walk us through the CAS philosophy and strategy in more detail?

CS: It's simple in concept. We try to invest in businesses that we can understand and that we can get for less than they're worth. We're not going to find a lot of them because we're not that clever. We find a few from time to time. Right now, we have five positions of size. Of those five, three of them date to the inception of CAS.

The key is finding businesses we understand, buying them for less than they're worth, and hopefully holding for a long time. We try to marry that long-term outlook with a degree of accountability. We try to identify why a business is going to be successful and try to formulate that idea into a clear hypothesis, enumerate the predictions of that hypothesis, and then we look for disconfirming evidence to kill the hypothesis.

To understand our approach, you must appreciate that in this framework a stock price going down never constitutes disconfirming evidence. We spend no time worrying about stock prices bobbing up and down in the short to medium term. We are indifferent to stock price volatility.

G&D: You have five positions. Is that the level of concentration you want going forward?

CS: There is no ideal. That's probably towards the higher end of concentration. I think about it in two ways. First, if you think about concentration in terms of how big a loss would you be able to withstand and not interrupt some decade-long performance, you can come up with a third or a quarter of your money, which is a lot. That puts an upper bound on individual position sizes if you recognize that no matter how much you think you know, there's always some probability of something you never imagined that causes that position to be a zero.

You can also analyze the problem empirically. I don't

(Continued on page 15)

Cliff Sosin

think that managing volatility is a worthwhile thing, but let's use this lens for a second. The idiosyncratic mark-to-market volatility declines proportionate to the square root of the number of positions you have. If you have four, you get half the benefit of having infinity. To get 90% of the benefit of infinite diversification, you need 100 positions. You get 50 points for the first four positions and it takes you another 96 positions to get another 40 points. It's just not worth it. A handful of positions is enough. It forces you to think hard about the trade-offs you're making and allows you to take advantage of the handful of truly good ideas you have.

G&D: How do you think about exiting a position and entering a new one?

CS: I consider opportunity cost. You want to own a position for the next five-to-ten years. What's a reasonable range of outcomes for both investments? Is it similar? If yes, then more diversification is better. If it's worse, then no. Why sell the good for the new? The basic idea is you think about how much money you make and how sure you are over a long span of time. You try to figure out the best portfolio. Easier said than done.

G&D: Is your approach different on the short side?

CS: The benefit of shorting is that the capital opportunity cost is very low. What I mean by this is that when we buy something, we need to sell something to make room so the wealth gains over time are limited to the excess performance of the new idea over the old idea. There is opportunity cost.

Conversely, if we short something, we don't have to sell something so there isn't much opportunity cost. It's a very small opportunity cost from the balance-sheet perspective. To the extent that we can find things to short that go down, we stand to make money. The question is whether finding shorts is worth it from a time perspective. The jury is still out.

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Our shorting is different because we're not doing it to hedge. We don't have to do it; it is intended to make money. Also, I think over time we have a pretty good shot at decent returns from the long side alone so I tend to be quite risk averse with regards to shorting because I don't want to muck up what should be good long-term performance on the long side.

We have a narrow window of things we want to short. We won't short dreams or pyramid schemes, nor highly shorted stocks. We're looking for some sleepy company that's going to get hit by a truck. Something bond-like… or better yet a bond. The problem is that is really hard, so we don't find many. There's a certain amount of looking and not a lot of finding. To make matters worse, the positions we find tend to be small since you can only reasonably be short a small percentage of a company's shares without taking too much squeeze risk. We've made a little bit of money over time but it's certainly not been worth the time to date.

So why do we do it? The theory is that every decade or two, you might come up with a great short, a la the subprime short or something else with a skewed risk-reward. If you're not looking, you probably won't find it. If you can maybe make a percent every year or two nibbling on berries and then occasionally, come across an elk, it's worth it. Honestly, I don't know whether we'll get it right. We've never taken down an elk. I'm not wired to like shorts. It's hard for me to see them.

G&D: How do you think about risk and how do you try to get comfortable with a long time-horizon given your large exposure with each investment?

CS: Let's think about risk in two different ways. The risk I think you're thinking about is path dependency risk. It's this idea that, sure, the business flourished, but along the way you went broke. I am fairly averse to any significant degree of path dependency risk. It's not to say that we cannot have some investment in the portfolio that's over levered,

(Continued on page 16)

Cliff Sosin

provided it has the right risk-reward. You just can't have five of them. You certainly can't have a lot of portfolio leverage. You've got to make sure the investments you're making are resilient and your structure is resilient. If you think about our business, the whole business is predicated on the idea of finding investors who are looking for long-term compounding. They're willing to have volatility and not going to call me every day if we're down 20% in a month. You've got to attract the right investors and build the right economic model. We can't have an economic model where I'm struggling to keep the lights on if assets are down 30% or 40%. We've got to have an economic model that works in the worst of times. We've got to be flexible. Inevitably, there will be bumps in the road.

The second way to think about risk is the risk that the investment thesis was wrong. We try to be careful about that. We try to lay out our hypothesis in an unvalidatable form, outline what would constitute disconfirming evidence, look for that disconfirming evidence, enumerate, question and stress our assumptions. Pre-mortems are a good idea; writing down and revisiting any evidence that doesn't fit with your hypothesis is a good idea too. You also have to watch out for all the usual cognitive and decision-making biases. When you only have five positions and you're in them for a long time especially, all these biases come into play.

In the end you are going to make mistakes and you are going to get unlucky. Margin of safety is key. Investing is hard. As it should be.

G&D: Holding positions over the long-term, how do you protect against thesis drift?

CS: It's a risk. You should update, refine and improve your thesis with time but you probably shouldn't allow yourself to come up with an ever-increasing litany of excuses for a business where your understanding is clearly not as good as you thought.

You can't judge the probabilities of something unless you can understand the underlying mechanism. You have to form a view of what would change your mind on the mechanism upfront and you look for that. If you find it, you shouldn't own that asset. But it is okay to refine and enhance your understanding of the mechanism and it is certainly okay to update your understanding as the business evolves.

G&D: Given your concentration, how much adjusting of positions do you do, particularly if things run or struggle?

CS: We reallocate capital so we have more invested in positions we think have a higher rate of return. Our margin of error is broad enough that 20% up or down doesn't matter here or there. If one stock goes up 30% and the other goes down 30%, there probably is something to do. We adjust for large movements, but not for small ones.

G&D: When you're looking at a new position, how much do you want to know about the company before it even enters the portfolio?

CS: There's no sense in putting on a starter position.

I've been impressed over the years how I think I understand something well and then I learned something I never knew. But before we buy a single share I want to have a hypothesis I've exhaustively attempted to invalidate, and if our hypothesis is right, it's probable that the returns will be high enough to justify the opportunity cost of whatever we sell. I've found that with investing, there's one thing that must be true and everything else is just noise. There's one thing that matters. Once you nailed that, you can still learn a lot more.

G&D: Are there industries that you avoid or ones that your team focuses on?

CS: We try to think about mental models. Investing is the applied social science. We try to develop these tools to break down how complex social organizations perform and behave in our market-driven economy. We'll look at anything where we can use these tools but not at things where we cannot. The classic example of something we won't look at is biotech. The ability of some new compounds to cure cancer is just not something to which we bring any particular expertise. Whereas, an understanding of "loyalty effect economics" applies to a broad range of different industries, from wealth management to insurance brokerage to subprime lending. If you were

(Continued on page 17)

Cliff Sosin

to think about a circle of competency, if our tools explain it, then it's in our circle of competency.

I don't have a tool for making a lot of useful predictions about the future development of technologies. As far as I'm concerned, technological innovation is drawn out of a hat. My ability to forecast that is very limited, and so if your business is one predicated on how the web architecture works, it's improbable that we're going to figure it out. If on the other hand, your business works because people love coming to your meetings and being part of the organization socially, that's something that we can figure out.

G&D: We saw, in prior letters, that Herbalife is one of your biggest long positions. Can you walk us through the research process with that idea?

CS: It was always on my radar. If you did a "Magic Formula" screen, it always showed up cheap. It was this company that always grew and had great economics, but I had never bothered to grab the 10-K. I knew the name [Herbalife], and watched the Ackman presentation a week or two after it had been done for roughly the same reason people stop to stare at car accidents. I originally thought the Ackman presentation was great and I even wrote to one of my friends that I thought Herbalife was a pyramid scheme but a very profitable pyramid scheme.

However, there was something that bothered me. Ackman spent a lot of time talking about the product and the $100 MSRP. He showed that on eBay, the same product trades for 65% of MSRP. That sounds bad. He used that to show how there's no significant retail profits. The weird thing is that if you're a distributor and you have any volume, you buy at 50% of MSRP. So that seemed to imply that distributors were making money even selling on eBay.

"I knew the name [Herbalife], and watched the Ackman presentation a week or two after it had been done for roughly the same reason people stop to stare at car accidents."

If I told you that there was a loan and nobody wanted it and it was worth virtually nothing, what would the market clearing price be? The answer isn't 65 cents on the dollar. The answer is closer to two cents on the dollar. In the case of Herbalife, you can compare it to furniture. Used furniture trades at a much bigger discount at MSRP than Herbalife product. Herbalife's a food. When you're buying food on eBay, it's a little weird. There probably should be some discount. This bugged me. It was inconsistent.

You can't have a situation where large numbers of people are buying the product they don't want because they want to participate in a money transfer scheme. It doesn't work if people try to sell, can't sell, become stuck with product and then eventually throw it in the garbage when, at the same time, there is a secondary market where the stuff trades above the wholesale price. People are not that ignorant. It's not like one dollar of the stuff trades on eBay; millions of dollars' worth is traded on eBay. Herbalife sells billions so it's this teeny little piece, but it's millions of dollars in a secondary market.

That was the string in the sweater that I started pulling at so to speak. I was also fortunate to have a friend who had done some work on it and believed it to be a good business, so he steered me the right direction. John Hempton also put out his somewhat famous blog post. He wrote about going to an Herbalife club and guess what? It was filled with customers. They're drinking shakes. I started to put it together.

I spoke to people who are experts in the space (lawyers and such) who say Herbalife's not just a legitimate company, it's the white gleaming example of multilevel marketers in the industry. They call it the gold standard. Herbalife's turnover is the lowest in the industry. People love it. It's been around forever. I started noticing all these things.

Finally, I sat down and revisited the section of Pershing Square's presentation where they were quoting this paper from the SEC's former economic consultant. I read the paper. The legal precedent from the Koscot case for multilevel marketers is that the

(Continued on page 18)

Cliff Sosin

companies must sell to ultimate users.

Dr. Peter Vander Nat tried to put some math to the legal standard. It's a very sensible paper. He says, let's imagine that we consolidated the economics of the distributors with the multilevel marketer. There'd be a certain amount of gross profit, there'd be a certain amount of overhead, and then there'd be a certain amount of sales and recruiting commissions. If the gross profits less overhead cover the sales commissions then the organization is clearly not a pyramid scheme – after all, it could work as a consolidated entity. Conversely, he posits that if the gross profits don't even cover the overheads then all the commissions paid are essentially wealth transfer among the sales people so it is a pyramid scheme. Somewhere in between, there'd be some percentage of the amount paid out to distributors that comes from gross profit and some percentage that comes from new distributors coming in and going out. He said 50% would be an interesting tipping point.

This is the way that Dr. Vander Nat tried to put some math to the legal standard, and there is an equation that falls out. In Shane Dineen's part of the Pershing Square presentation, he tries to fit Herbalife into this equation. Ackman's team used a bunch of assumptions and shows Herbalife's a negative number, ergo a pyramid scheme.

The problem is that the original paper starts with a bunch of implicit assumptions. Among the implicit assumptions is that the product is either sold at the retail price or not sold at all. The problem is, we know for Herbalife that anyone can sell it on eBay for 65 cents on the dollar. That is different than the embedded assumptions in the model. If you were to just make that change you can't come up with any way that Herbalife is a pyramid scheme in the Vander Nat model.

Also, let's look at this in a Bayesian sense. Just ignore everything you know about Herbalife. Imagine some company that's lasted for 37 years, is publicly traded, exists in 90 countries, and has been in regulated markets all around the world. Is it or is it not a fraud? The answer is it may be a fraud but the prior probability that it's a fraud is quite low.

When I finished going through the Vander Nat paper, I added that to the mosaic of things and decided I was reasonably confident that it wasn't a pyramid scheme. I essentially looked at it in a Bayesian sense. The prior probability is low. Ackman presents evidence it is a pyramid scheme but we have determined that much of that analysis is faulty (and there were a lot of other issues beside the ones I mentioned). Then you layer the availability of returns, the high price on eBay and the perception of this as a class act among industry veterans, and you come away thinking it is vanishingly likely that Ackman is right.

At the time, I definitely did not understand why it was a good business, but I was willing to take the trend of 30 years of performance at face value. It was also very, very cheap so there was enormous margin of safety, and conversely we were being paid very well for the risk.

G&D: If multi-level marketing is successful and legitimate, why do so few brands choose to operate this way?

CS: I spent a lot of time trying to understand why this business works. We are going to venture out on the bleeding edge of what I think I know. We are going to enter the realm of more conjecture where I have much less evidence. If you look at the sphere of human activity, there are some activities, such as buying a jet engine, that are very rational. There are other activities, such as participating in your local church, that economists would say should not exist.

I might argue that members of successful long-term multi-level marketing organizations are participating in a social group. They're identifying themselves as good people through the participation in a social group. They are doing it for other people and they are doing it for themselves. Volunteer fire departments, church organizations, and civic organizations are all organizations where people participate, but not in a strictly economic sense. What makes Herbalife special, and what makes a great multilevel marketer special, is that you build a belief system around these products.

Herbalife is not a purveyor of protein powder. Herbalife is an organization that people participate in because they

(Continued on page 19)

Cliff Sosin

view themselves as healthy, active people. They want to lose weight, be healthy and active, and share their experience, the lifestyle, and its benefits with other people. Think of it as analogous to a religious movement or to a political movement. It's very hard to build these things. In the early days, they die like fruit flies. Once they grow up, they last forever; but it takes a lot to get one up and running and you can't just start one… at least not easily.

"What makes Herbalife special, and what makes a great multilevel marketer special, is that you build a belief system around these products."

We came to appreciate that, within Herbalife, while there's an economic incentive engine that motivates some, that only explains part of the phenomenon. If you think about Daniel Pink's work on what motivates people, it is purpose, independence, and mastery. In Herbalife, you give people a huge purpose. If you sign up for Herbalife and you help one person lose 50 pounds, the odds are good that you want to keep participating. You want to find the next person. That would be a big thrill.

If you think about it, social organizations are all over the place. It's only natural that through natural selection, companies would realize that these mental pathways exist and you can use them. Group identification is fundamental to people. There's social cohesion.

Of course, there are varying levels of passion. On the lowest level, you've got people who don't know anything about the mission and lifestyle. They bought Herbalife products once and they used them. You've got a whole lot of people who make a little bit of money and spend some time doing it because they enjoy it. They like the people involved, they think it's important. Then there are the real money makers. For them, it's a job and a mission. It's like being the priest.

G&D: People don't just join Herbalife to try to make money?

CS: I think people join for a lot of reasons. The vast majority of members are really just discount customers. They join so they can buy the products at a discount. Some join because they like the social aspects, the fit camps, the nutrition clubs, the other members to support and reinforce their nutrition goals, etc. Some join with modest income aspirations in addition to their health and weight-loss aspirations, selling a bit to friends and family. Some join with the goal of building a big business. Some of them succeed and some of them, just like any other business, don't. Undoubtedly some people try to make a business out of Herbalife and fail, so some of them lose money but usually not very much. It helps a lot for those who are trying to build a business to also love the mission. It is hard to build a Herbalife business. There are setbacks. If you focus on the good you are doing it helps a lot in terms of working through the setbacks.

The most common failure mode within Herbalife is for a happy consumer to try his or her hand at selling only to learn that it isn't for them. So, they stop selling and simply consume the inventory they might have purchased and go back to being a happy customer. It's like me buying five boxes of Cheerios because I thought I was going to sell Cheerios. Then I decided that selling Cheerios is not for me. I'll just eat the Cheerios.

Keep in mind Herbalife has a return policy. If you were truly duped in this manner—you bought $5,000 worth of inventory, tried to sell it, and you couldn't—you could return it to the company. This is a big problem with the bear argument. It's like if a bank robber left a business card, "Please call if you want your money back." Many hedge funds have bought Herbalife products and returned them. This has been well-tested.

G&D: Does the stigma of multi-level marketing deter investors?

CS: There are multi-level marketing scams that promise the world and die quickly. A new multi-level marketer is a risky proposition for an investor. What makes Herbalife interesting is that it has very low attrition, compared to other such firms, and it's been around a long time. Herbalife's results are going to be volatile, particularly in small, new markets. It can have attributes that look like

(Continued on page 20)

Cliff Sosin

Antonio Lequerica '18 speaking at the Pershing Square Challenge

the ice bucket challenge, where it takes off and then it collapses.

Let's say you and I both go into business. You decide that you're going to go on a diet and challenge your friends on Facebook to do the same diet. Let's say you have a virality coefficient of greater than one because you've got some hip twist on this idea. You're going to see this exponential growth. But then you're going to see this exponential decline. You stop your diet and run out of friends, then they stop and so forth. It's this flash in the pan business.

Let's say my business is to organize walks near where I live in Westport. I'm going to spend time every day inviting people to these walks, on social media but also any other way I can, especially in person. "We're meeting at 9am on Sundays and we're going to go for a two-mile walk." Then after the walk, which, say, costs $5, I find a comfortable place and serve shakes. We're going to have a talk about nutrition and health. I'm going to have people who lost weight tell how they lost weight using the product. You can see how that is much more durable. People make friends with each other, come back week after week and do the walks. They buy product for home use. They lose weight and tell their friends. Eventually, I'll get the people who were doing my 9am walks to organize another one at 1pm because I can't make it. One of them starts walks in a neighboring town and so forth. So the model duplicates. You can see the difference between a durable strategy and a flash in the pan.

You've got people who have been doing it for ten, twenty years. They have built real organizations with real customers that have real durability to them.

G&D: If someone in your family thought joining a multi-level marketer was a great business idea, what would you tell them?

CS: They should go for it. The only catch is, like any business: it is not easy. If you watch any Herbalife video, often the first thing they say is, "It's not easy. You've got to work really hard at this." I'd also encourage them to start slow. Make sure they like it and can do it before signing a lease on a nutrition club for example. That's just common sense but sometimes people can overcommit. That is the only way you can actually lose any real money in Herbalife. You quit your job, lease a nutrition club, then discover that you can't sell any. Not wise.

If you look at Herbalife people, they often start out selling to someone like their brothers-in-law. That's very common. If you look at Herbalife's four million members, three million basically just buy it for themselves. Of the remaining million, half or more basically just sell to people in their social circle.

The big step you make in Herbalife is talking to strangers. You need to talk to 40 people a day. Ask 40 people a day, strangers, of whom at least 39 are going to say, "No." If you do that every day, you could build a nice Herbalife business over the span of ten years. You have to like it. You have to work at it.

A common Herbalife success story goes something like: "Hey, I started with Herbalife ten years ago because my friend had just lost 30 pounds on it and I knew I needed to lose weight. I lost 20 pounds and my wife lost 40 pounds.

Then I got into the business. I didn't think I could, but Joe told me that I could. I started talking to people. It was hard at first, but I learned how to do it and that I didn't have to be afraid. There were times I didn't think I could ever get there but eventually I did. Now I work full time at Herbalife, I have a big organization and make a great living. Last month my check was $7,568."

That's not impactful when one person does it. But if you get a lot of people coming up it's very motivational.

There's a woman I met in Los Angeles. She was the sort of attractive, personable woman that everyone wants to be friends with. She knew the school bus schedule. She would go ahead of the school buses and chat up all the moms. Women would come back to her club and they would have a shake and gossip. A lot of the women wanted to lose some weight and would buy the product for home use. She would motivate and coach them. Some of these women needed extra money around the holidays so she was able to say, "Why don't you go and hit these bus stops. I can't do all of them." You can see how it turns into a nice business. You end up with this amazing group

(Continued on page 21)

Cliff Sosin

of dedicated, talented, gritty, sales people or entrepreneurs.

I think some of people's discomfort is a lack of familiarity. It wouldn't be uncommon for a Herbalife member to want to make an extra $300 around the holidays selling retail to people they know.

G&D: What about the rest of your portfolio?

CS: Herbalife is our biggest position. Everything else is roughly equal. We own Cimpress N.V. (CMPR), Credit Acceptance Corp. (CACC), World Acceptance Corp. (WRLD), and two rental companies, predominantly Ashtead Group (AHT.L), which owns Sunbelt rentals.

G&D: Could you walk us through the WRLD thesis?

CS: WRLD gets a bad rap. Subprime lending, in general, gets a bad rap. I think that people tend to confuse their desire not to have a society with any desperate people with the fact that once people are desperate, WRLD is a "lender of last resort." I think the role of "lender of last resort" is extremely important. It gives people with nowhere else to turn an opportunity to borrow money to solve urgent needs. In performing on those loans, individuals can improve their credit scores, which will ultimately improve creditworthiness in the future.

It's an incredibly difficult, risky, and thankless business, but providing this ladder, from the very bottom to a notch or two above the very bottom, is incredibly important for social mobility. Compare the role of these lenders in society to the importance of chewing gum manufacturers—I think subprime lending is a far more important business.

"It's an incredibly difficult, risky, and thankless business, but providing this ladder, from the very bottom to a notch or two above the very bottom, is incredibly important for social mobility."

Some people don't like the industry because the interest rates are high. But as an industry, there are not reams of profits to be made. If you look at a typical installment lender, they are not making money hand-over-fist. The prices are covering their costs and their losses and create a modest profit. These loans are expensive to originate and service, and they have a lot of embedded loss due to the risk. They're also small and have short duration. To make a reasonable dollar profit, you need to have a high implied rate.

Another way to think about WRLD is to consider 200 people, all of whom have large problems. They need to repair their water heater, or fix their car or, less practical but emotionally important, they can't buy Christmas gifts or travel to a friend's funeral, etc. All come to WRLD's office and WRLD sends half of them packing. Those are the people who really suffer; nobody lends to them.

Then, WRLD makes a loan to the remaining 100 of them. Those people get money and solve their problem. Sure, they pay for it with an interest rate of 60% on average. But that is a lot better than the alternative of not having a car to go to work. Over time, some people will renew that loan. The average person renews twice and is in debt for 24 months. Almost 80% of them will eventually exit the repayment door as opposed to the charge-off door and their credit is improved.

Who are the victims here? When the customer repays, WRLD makes a healthy profit but the customer got the cash he or she needed and his or her credit improved. Tough to argue that those borrowers are victims.

When customers default, they experience the discomfort of having debt collectors call them and further degradation to their credit score. But otherwise, they are better off. WRLD gave them more money than WRLD received back. This is different than many payday transactions where the lender can often profit even when the borrower defaults. It's hard to argue that the borrowers were victimized. And even if you could, you can't make the other 80 loans without experiencing the twenty who don't repay although they sure do try.

I'll add one more piece. WRLD is an installment lender, which is fundamentally different than a payday lender. Payday

(Continued on page 22)

Cliff Sosin

lenders charge very high interest rates, typically 400%, for very short-term loans, two weeks on average. Payday lenders have an ability to reach into someone's bank account and pull money out. With these two features, payday lenders can and often do make money on loans where the borrower defaults. WRLD is an installment lender. They give people longer-term loans with fixed payments. A typical loan might be $900 payable in twelve $100 installments. WRLD has no ability to enforce repayment if the person doesn't voluntarily repay.

G&D: How does WRLD collect from customers?

CS: The most common method is paying in cash in person. WRLD has expanded the payment options, and there are people who pay with check. The customers are not all under-banked. There are people who pay by phone. There's debit card. But WRLD has no ability to take money out of people's accounts.

In the vast majority of charge-offs, WRLD loses money. The incentives are well aligned. WRLD wants to make loans that people can repay. The only way WRLD can get people to repay them is if the borrower's income less expenses is enough to service the debt.

G&D: How long are the loans on average?

CS: The average loans are twelve-month, but they're monthly installments. The average duration of a twelve-month loan is six months. The average duration of a portfolio of twelve-month, linear amortized loans is three months.

G&D: What do you think about increased political scrutiny and regulation of the industry?

CS: A variety of politicians will paint these guys as evil. It's not hard to find someone who had some really bad experience. Yet WRLD's net promoter score is 68%, which is amazing. WRLD is very popular with its customers.

The academic work on payday loans is mixed. There is a wonderful piece by John Caskey that summarized all the academic work and makes this point nicely.

On the negative side, there is work that shows that the career performance of Air Force members stationed at places with access to payday loans is worse than ones without access. Of course, that's bad. There is also evidence that different disclosures about sustained use of loans by borrowers can importantly reduce their propensity to borrow. So those would indicate that perhaps payday loans are bad.

But there is also research that shows that counties in California with access to payday lending have reduced rates of suicide and robbery after earthquakes than other counties which have banned the product. Similarly, when Oregon put in place a ban on payday loans, economists used the occasion to study how the change impacted people right on the border of Oregon and Washington. They found that indicators of financial suffering, including phone disconnections and job loss, were higher after payday and installment lending were removed on the Oregon side of the border than just a few miles away on the Washington side of the border where payday loans were available. So these studies support the idea that payday loans are good for society.

Evidence supports both sides. What I think is clear from the research is that whether payday lending is good or bad, it is not very good or very bad. Economists have studied this too closely and had too many conflicting findings for the impact to be very strong one way or another.

Installment lending is far more user-friendly than payday lending. So if payday lending is at worst a little bad for social welfare, I think it's highly probable that installment lending is very good for society. All those people who need cash are served by these businesses.

Still, obviously, despite the logic and evidence this is an industry that is under a lot of scrutiny. The CFPB is clearly of the view that high-cost short-term consumer loans are probably bad for consumers. There is a very lengthy legal discussion we could have about all this but it is too involved for this interview. I think though it would leave you thinking the risk isn't as big as it might seem. But it is a big risk.

G&D: What evidence would indicate that your investment is wrong?

(Continued on page 23)

Cliff Sosin

CS: Not an easy answer. Let's start with what the economic mechanism is.

Our hypothesis is that the business has what we call "loyalty effect economics." It's an economic phenomenon in *The Loyalty Effect* by Fred Reichheld. It describes how in some industries a business in the upper-right of a 2x2 matrix of customer retention and employee retention is the most lucrative. If you can establish an organization with long-tenured employees and long-standing customers, you will be much more profitable than your competitors.

"Installment lending is far more user-friendly than payday lending. So if payday lending is at worst a little bad for social welfare, I think it's highly probable that installment lending is very good for society. "

Now let's look at the installment lenders. WRLD has been very successful at this. WRLD's average branch employee has five years' experience. This is tremendous. Way higher than most other front-line employees in most companies or industries. These aren't big communities. They know who is who in town. They know your mother. They go to church with you. People come in and if they're good at it, WRLD's people have some reasonable ability to underwrite your loan and avoid getting ripped off.

The managers are also likable people because they treat you well. If you are in a Walmart break room and someone says they have a problem, someone else in the Walmart break room might say, "You should go to WRLD. They treat you well. They're friendly. They treat you with respect."

When customers have trouble paying, WRLD managers treat them well. WRLD runs on kindness. The way they collect is to call repeatedly until they get the client on the phone. Eventually, they'll get through and say, "Come in. That's all I ask." You'll come in and they'll say, "Tell me about what happened," and you tell your story.

Depending on the circumstances, they can often say, "I'm looking at your file and because you've made three payments you have some equity in your loan. If you renew today, you'll be current with us, you can walk out of here with $50 and you won't have any negative impact on your credit score."

They don't force anyone to take out a new loan, but it sounds like a pretty good option for many. The whole business works on friendliness. The branch manager has been there a long time and knows the community. People trust you as someone to borrow from because they know that if something goes wrong you will be reasonable. You get this whole base of former borrowers who are your referral sources. They also come back because they might have some sort of cash flow issue two years later. Half of their new customers are former borrowers who return. The largest source of first-time customers is referrals.

The key to making the business work is having this branch manager who's ensconced in the community and can underwrite carefully. Knowing the community is a big advantage because you know who to avoid. You also have this big base of former borrowers who are both your best customers when they have a need and a great source of referrals. It sounds so simple but these are the "loyalty effect economics." WRLD's financial performance over the past 30 years is unbelievable.

So, how would we know that this thesis is wrong? Well, when we first postulated it, we didn't have all the facts I shared above, but I learned about the importance of manager tenure and of referrals and so forth when we looked for these attributes as part of attempting to invalidate our hypothesis. At this point, I can't think of any more ways to test the hypothesis. So if we are wrong or things change, we'll probably first detect it if the financial performance got worse. A decline in repeat business or an increase in employee turnover would be concerns. Most likely though, to the extent that the economics break down, we would see it in the financial performance.

G&D: In terms of performance, WRLD's traffic is declining. How much of this is related to competition, especially online?

(Continued on page 24)

Cliff Sosin

The winning team, Windsor Cristobal '18, Anji Lin '18, and Isabella Lin '18, pitching Yum China at the Pershing Square Challenge

CS: Declining traffic is a problem. There are two key risks with WRLD. One is the regulatory risk. We talked about that a bit. The other is declining new customers per branch. If you look at number of new customers per branch, it declined from 2011 to 2015 although it has recently been increasing. There are two possible arguments for the cause of the decline.

One is that instant-decision online lending is winning in the marketplace and store-based lending is losing. This would be a secular disintermediation. The other argument is that WRLD hasn't been run very well and thus is underperforming.

Two and half years ago, the company didn't have a website. It had an IR site, but that was because the SEC required it. If you were a retail customer who wanted to find a branch and went to the Internet, that information wasn't there.

The lack of a website was just the tip of the iceberg. The business was undermanaged for years. It was basically running in 2015 exactly the same way it was run in the 1990s. In some sense, its success without evolving at all for two decades is a testament to the quality of the business. But it started to catch up with WRLD, and starting a few years ago, new customers per branch began to fall.

Importantly, we think that returning customers, referrals and quality underwriting and collections by seasoned employees in the branches, the economic engine, continued to be a source of strength, the issue was primarily attracting new customers who had never done business with WRLD before.

Now there is a new CEO who is making a lot of progress turning things around. The first initiative was building a website as a driver of branch traffic. Half of customers at some competitors find the company through the web, fill out an application online, and finish the transaction in the store.

So WRLD put up a website and it helped. Month over month, it gets better, but it hasn't been a panacea.

Then management evaluated direct-mail, historically WRLD's only form of advertising. Management experimented and found that shutting off the direct mail in certain geographies had no impact on new customer applications. That's how bad it was.

How could this be? Well, it turns out that the direct-mail program was completely outdated. I won't bore you with the details, but WRLD was sending the wrong letters to the wrong people at the wrong time of the month. Management revamped all of WRLD's direct marketing, and it helped a lot.

Now between the web and enhanced direct mail, it looks like WRLD has turned the corner. It looks like it is bringing in more customers than it is losing so it should be returning to growth. But we will see. The good news is there are a whole host of other initiatives that it is in the middle of which should also help to drive a lot of volume. They haven't been tested yet, but there are a lot of shots on goal so to speak, a number of which have been meaningful for competitors. I am optimistic that WRLD can return to some of the robust growth of their past. It looks like by modernizing its operations, WRLD has been able to restore volume, so this is inconsistent with the secular disruption concern.

WRLD is the only industry participant I am aware of with volume problems. Everyone else is doing fine. This is consistent with the theory that it is not an industry problem but a WRLD problem.

Also, I think it is likely that online underwriting is still a lot worse than in-store underwriting. If you look at any online subprime lender, the rates they charge are far higher and their charge-offs are far higher. The Internet has some speed and convenience benefits, but as of now I don't think it is nearly as good at underwriting or collecting.

All of this is evidence that's inconsistent with the thesis that the Internet's killing the business. At least today.

G&D: How sensitive is the WRLD business to macroeconomic changes?

CS: We think about economic sensitivity with everything. People think a lot about economic sensitivity when they think about credit. Let's start with that mental model for credit. You start out with everyone. You use reputation data to get two thirds of people that are prime credit.

(Continued on page 25)

Cliff Sosin

What does it mean to be prime credit? What it means to be prime credit is your probability of defaulting is almost entirely a function of whether you get sick, divorced, or lose your job.

Sickness and divorce occur steadily. Losing your job is cyclical. As a consequence, lending to the two thirds of people with good credit, is effectively an actuarial exercise. It's like insurance. Companies compete price down as low as possible, make a modest spread. Whether prime lenders make or lose money on the vintage is largely driven by whether there is something that causes the job-loss expectations for that pool to be meaningfully different. Namely a recession. It's pretty analogous to P&C insurance and catastrophe risk.

The subprime population is, by definition, hard to underwrite. So you can create loans with substantial margin of safety if you do a good job underwriting. Also the loans are short in duration so you replenish the portfolio with new loans fairly quickly if your original assumptions prove faulty. So the net of this is that when unemployment rises, WRLD's credit worsens but the impact is small compared to its overall economics.

Interestingly, a shared common factor for WRLD and its customers are the prices of food and energy. WRLD's borrowers are on the haggard edge and that's the whole reason why they're coming to the company. Adding $50 a month to their expenses from rising gas and food prices impacts all of them. That can increase charge-offs across-the-board and is probably a bigger risk than changes in employment.

G&D: Can WRLD potentially benefit in a downturn, especially in increased loan volumes?

CS: Potentially. If I were to give you WRLD's earnings-per-share growth numbers through 2012 but scramble the order, you would not be able to detect the financial crisis. There was some harm from rising fuel and energy prices in 2008, but there was good volume.

All told, it was a non-event. In fact, if I gave you quarterly year-over-year EPS growth from the IPO in the early 1990s through 2012 you wouldn't be able to pick out any macroeconomic events. Normally, the business is very under-levered and right now they're profoundly under-levered. WRLD normally runs with three dollars of assets and one dollar of equity. At present, they're running with three dollars of assets and two dollars of equity because they haven't bought as much stock as they usually would.

G&D: How do you assess management? When you're looking at ideas, how important is the management team?

CS: I'm not very good at judging people. I haven't thought much about management, historically. I've watched a lot of investors come to very strong opinions about management teams. I've never understood how they had such conviction and I've seen mixed performance from this.

For a long time, that governed my thinking. On average, teams are average, but certainly don't invest in crooks. I thought about the business first, price second, and then management a distant third. That is changing a little bit. Through experience, I discovered that it matters more than I appreciated.

"I thought about the business first, price second, and then management a distant third. That is changing a little bit. Through experience, I discovered that it matters more than I appreciated."

If you read Daniel Kahneman's book, *Thinking, Fast and Slow*, he explains why you can better judge people, in fact any complex issue, by subdividing it into smaller pieces. The Israeli military subdivides personal performance into smaller bits in order to find officer candidates and that works a lot better than making overall assessments, in fact making overall assessments doesn't work at all.

I've tried to use this approach in assessing managers. I want managers who are smart, energetic, honest, humble, and good capital allocators. Those are the five sub-attributes of a good manager that I want. So I try to assess them along each

(Continued on page 26)

Cliff Sosin

dimension. The resulting assessment is becoming more of an important factor. I put more weight on it now than I used to because I've watched good investments do worse than I hoped because bad decisions were made. But I am still a business- and price-first investor.

I should add, that I have increasingly focused on overall culture within a firm. By that I mean the combination of organizational habits, social norms and incentives that dominate day to day life and decision-making within an organization. Senior management influences culture but is also an expression of culture. So you have to assess them as guiding the system but also a product of the system.

You want an organization that prizes frugality, where individuals feel safe sharing their views and making mistakes—called psychological safety—and where people freely help and support each other. You also want to know what a firm is optimizing. Sometimes great things emerge when an organization centers itself entirely around optimizing one thing.

G&D: Any advice for students or other young people trying to build careers in investment management?

CS: If you really, really like it and you're nuts, you can get into this business. I, for one, enjoy it despite its difficulty, but it's really a waste of your talents. This is the Charlie Munger view on this. He's right. He's so frustratingly right. Every time I think I've thought of something brilliant, it turns out he said it 40 years ago.

It's brutally hard to come in every day, do a lot of work and then throw it out. You can make money investing because it doesn't suit people's temperament. It's not natural. If people really want to do it and they recognize how difficult it is to do, then God bless them, but it isn't for most people and I have no useful advice if you want to do it.

But, if I were to allocate the resources of society, we'd have way fewer people doing what I do. We'd have lots more people doing useful things. It's a huge waste. The fundamental issue is this: there are limits to the amount you can forecast the future. Nonlinear dynamic systems are subject to inherent forecasting limitations. Think of weather forecasting, because it is nonlinear you just can't forecast accurately more than a few days in advance even as the amount of computing power and the data quality explodes. The economy and businesses are even worse because they are under-specified nonlinear dynamics systems. It's totally impossible to refine your predictions past a certain pretty rough point.

If you have a million, brilliant people trying to predict the future of a nonlinear dynamic system using all kinds of computers the outcome you get won't be much better than if you just had a few thousand. For the purpose of capital allocation, connecting savers to investments, we only need a few thousand. But we have tons more. We have armies of our best and brightest wasting their time in what is basically a giant game where they are just betting against one another.

Nor does it do anything for social welfare to connect Chicago and New York with a perfectly straight fiber line, like Michael Lewis describes in *Flash Boys*. My advice, which I give to everyone and nobody listens, is don't do what I'm doing. Go do something really useful for the world.

"We have armies of our best and brightest wasting their time in what is basically a giant game where they are just betting against one another."

There's a great book you can read about entrepreneurship through acquisition called *HBR Guide to Buying a Small Business* by Ruback and Yudkoff. For a young person coming out of business school, that's just a brilliant idea. I think it's perfectly reasonable not to want to work in a big corporation. I can also understand why people don't want to go work for some new startup. It's too uncertain. But you can raise some money to buy a small robust company and then create value by using your immense talents to run it better. One of the best examples in this book is the acquisition of the leading fire-hose testing company. Using your brilliance to figure out how to do a better job testing firehoses helps society use fewer resources and is an incredibly important and essential task. If you are

(Continued on page 27)

Cliff Sosin

successful, of course you can expand the business and bring your talents to making society more efficient in even broader ways.

You guys could be very competent at almost whatever it is you choose. If you choose a small enough niche, you could be the best in the world. My point is that if you pick a small niche and bring your talents to it, you can do well and make the world a better place. You can earn a fantastic living and hop, skip, and jump to work every day.

G&D: Great. Thank you so much for the time.