



## Holland Macro Views

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# Raining Gold + Unpeeling Amazon

What follows is a few new reflections on markets, sustainable competitive advantage in an inflationary environment and Amazon. As markets remain volatile, we are reminded of a Buffett quote that, in times like these, it is good to keep in mind:

*“...you make most of your money in the bear markets, it just does not feel that way at the time”* **Warren Buffett**

As each bear market of an investors' career unfolds (maybe this in my tenth, but I am not counting!) they feel quite different. In your first one maybe you think your world will end as you see colleagues fired or your savings plummet in value. In bear markets 2-4 you watch all your clever and precise forecasts of many a company's future go up in smoke. After a while (5+ bear markets ..?) you start to see them for what they are – i.e. just market cycles. Like the ones that Howard Marks' so brilliantly writes about. Finally you see them as unique opportunities to invest long term capital, albeit carefully. The following Peter Lynch quote speaks to arriving at that point of view:

*“As soon as you start to realise that you can afford to wait out any correction, the calamity also becomes an opportunity to pick up bargains”* **Peter Lynch**

For anyone wanting to understand falling markets better we strongly recommend *Anatomy of Bear* by Russell Napier. Its a few years since we read it, but it's a great book. Hopefully pretty much all of our readers are now wired closer to Peter Lynch's thinking above. That does not mean we did not make mistakes when markets were ebullient, or indeed do not still have some trepidation in our veins as we invest today. It just means we understand that today is an opportunity, and if we think we see gold raining down on us, we will reach for a bucket.

The curse of diligent investors in bull markets is often felt when having analysed a company correctly/carefully, they then watch its share price spiral higher before getting a chance to invest. At such moments we longed for stable or falling prices to complete our work. Today that is exactly what we have, both in the companies we analysed in the past and those we are looking at afresh today. This is good news and we must remind ourselves of this fact! The corollary is now also true. I.e. if we are analysing a company today and its shares keep falling, such falls do not make our analysis any more wrong or right. If we let market swings dictate our attitude towards a company then our supposedly independent analysis is anything but.

*“It is not that we enjoy falling markets, but we do enjoy the lower prices they bring”* **Warren Buffett**

### [A target rich environment](#)

We have spent years looking to understand businesses with Sustainable Competitive Advantages (SCA). Moats and brands are the well-known ones, but we have looked deeper into companies

with a strong focus on efficiency and an intent to pass that efficiency on to customers. Such businesses do not scream pricing power to investors in an inflationary environment. Indeed how can they when their DNA is for lower consumer prices not higher ones? Quietly however they have great pricing power, even if they choose not to use it. Competitors with high cost bases and high margins to protect are upping pricing and/or cutting the costs that produce service. Our companies will raise prices the bare minimum they have to. They do this to try to help customers. Such actions do not win analyst hearts or result in higher short term profits, but they do help customers. And customers a) don't forget and b) can smell value a mile away.

*“consumer will drive to the next state to buy gas or toilet roll five cents cheaper, but will not buy stocks when they are marked down” Warren Buffett*

Successful scale economy businesses do not surprise with short term boosts to profits, or a bump-up in margins. They surprise in their longevity. Today most such businesses are doing what they can to help customers (or indeed staff) in a rising cost of living environment. Their efficiency focus however will ensure their products will remain as appealing in an inflationary environment as it was in a deflationary one. Their appeal was always relative to higher priced peers. Such appeal and price/service gaps with competitors have not gone away just because industry wide costs are rising. Indeed, likely competitor pricing gaps have increased further. These gaps are the long term moats. Today consumers may have to live within their means, but they still have to live. As such eating out, flying and shopping are all things consumers still wish to do today or tomorrow. They just want to do them at a lower price. The businesses we favour enable them to do this. Today's investors may not see this, but tomorrows customers do.

*“Skate to where the puck is going, not where it has been.” Walter Gretzky*

**We share an observation from a recent JDW analyst call.** The company pointed out that it had pretty good control of cost inflation. This was by owning its pubs freehold, not underpaying its staff in the past and having long term beverage supply contracts. It even hedged its utility costs a year out. A question followed. Q) “When those utility bill hedges run out how much will your costs rise?” Management answered it would be c.£60-70m pa. The stock started falling the minute that answer sunk in. Why? Because £70m is roughly equal to a years' profits for JDW (in a good year!). What was not asked however was an important follow up. Q) “If you need to pass on this cost to customers how much would you have to put up prices and how does this rise compare with the price action your competitors have already been making?” The answers to these questions are a) c.3% (i.e. £65m cost headwind vs £2bn turnover) and b) competitors have already put prices up way more than JDW meaning the pricing gap with its peers has never been so large.

We are not saying JDW does not have any cost inflation, Only, that in its past consumers have sought out its low prices relative to competitors, thus meaning short term cost headwinds have been overcome. A non-full recovery in volumes we accept could hurt trade in all pubs, including JDW. However, our thesis remains one that admires JDW's scale economy model. We also ultimately expect a reversion in consumer behaviour to that which existed pre Covid.

## The secret sauce we seek

In most of our new company ideas in the last year we hope readers might have seen a slight difference in our approach. We still like owner-managed companies and proven compounding of course. Also our Operate, Generate and Allocate hurdles we hope are now ingrained in our approach. Many investors we have studied go on a journey that often starts with looking for cheap companies and performing analysis of tangible assets. They then move towards valuing intangible factors and the importance of company culture and ethos in determining long term growth in intrinsic value. It seems we are no different.

Two companies we have studied in the past twelve months helped our approach evolve in this way. **Amazon** and **Ryman Healthcare**. Each are very different, but what struck us as we studied both in more detail was their clarity of purpose and how remarkably aligned they were with their customers as a result. Indeed rather than looking for reasons why these companies might succeed in the future, we found ourselves wondering how they could possibly fail when their approach was so inventive and customer aligned. Customers would be lost without them.

In our recent Floor and Decor piece we wrote about ‘fade’ and how a fade in growth is implied in almost all company valuations. Brands, toll roads and the like tend to fade slowly, and Mr Market realises this. Scale Economy Shared businesses fade slowly too we have learnt, but Mr Market’s recognition of this fact is patchy at best.

Great company cultures with clear missions towards constant innovation and customer obsession are truly rare. So if we really think we have found such a company then we need to acknowledge this fact and pitch its fade rate alongside the very small number of businesses with similar cultures. Clearly this list is very short, but might include Berkshire, Costco or McDonalds. Notably, outside early fast growth rate years, such companies have experienced hardly any fade at all. However, many an observer assessing these businesses when they were 10, 20 or even 30 years old would have found reasons to doubt future growth. Indeed at points they might have looked like they had saturated a market or geography (Berkshire in insurance or McDonalds in US market). What enabled them to keep growing decades after such moments was the culture and orientation towards growth, innovation and often a single minded focus on what was best for their customer. This is a very unusual combination and it is what we found when we started unpeeling the Amazon onion earlier this year.

NB: The “through the customer eyes” culture is something we also saw clearly when we first looked at Schwab. Indeed, this ethos is the main reason for our long term bullish view on it. When we heard the Schwab team articulate this point we knew it had great power and told us why Schwab’s growth had not faded in the last 20 years.

## **Amazon – The more we dig, the more we like**

Our Amazon piece from the Spring is attached – we feel it still encapsulates the view we retain today. We make a few additional points:

- We remain of the view that subscription and advertising will be key lines going forward to watch for indications of Amazon’s earnings power (of course in addition to AWS)
- We think one point we made in the note bears repeating. Indeed the more we have reflected on it since the more important we think it is. This being that AWS has done two remarkable things for Amazon:
  1. As AWS looks after the very backbone/heart of every customer (i.e. its data) Amazon has earned a huge amount of unspoken trust in the corporate world (B2B). This trust has already existed between Amazon and consumers for years having been built on

solving hard problems (last mile logistics) and by delivering on its promises. Now it also exists between Amazon and the very largest organisations on earth. This is important and we suspect has long term yet-unseen positive implications.

2. By sharing its' efficiency with customers by reducing prices AWS has brought the Scale Economy Shared business model that has proven so powerful with consumers into the world of corporate buying. With perhaps TSMC as the only exception we cannot think of another company globally that is doing this. Again the implications of this could be very significant.
  - As such this feels a lots like “Day 1” for Amazon’s relationship with corporates going forward.

We note the company’s recent efforts to expand in healthcare and see this as another desire of Amazon to try to tackle complex problems in markets that may have large future potential.

At the time of writing, our note we praised [Amazon Unbound](#) by Brad Stone for the insights it provided to us in helping to understand the important culture of this company. Over the summer we have also read both [Invent and Wander](#) by Jeff Bezos and [Working backwards](#) by Colin Bryar and Bill Carr. Both are truly excellent books that provide great insight into this company’s culture and execution. We simply cannot recommend them enough.

### [A Perfect Match](#)

*Invent and Wander* is a collection of Bezos’ writings, which in truth we see as almost as timeless as Buffett’s letters. As we turned each page, we were kicking ourselves for having not given more time to the company earlier in our careers when Bezos was so clearly laying out the message for us (over 10 years ago). Perhaps at this point it is important for us to reassure readers we are talking about our investment process and what now reads to be an excellent match in the culture of Amazon for it. We are not just embracing Bezos/Amazon’s words because the shares have been a successful investment to date. Indeed those that know the author of this note well, know he can be sometimes a little too contrarian for his own good. Often, he is loathed to buy into many a success story that he sees as unsustainable or fully priced.

What is so appealing to us about Bezos writings and the approach that is now more evident to us at Amazon with every page we turn is the super close match with what we have been seeking in our investments in these last c.10 years. We have studied Ryanair/JDW/Southwest etc. to find value in the scale economy model we admire. We also then found Phil Fisher’s innovation used to stimulate growth inside a company like Next. We have also found a few companies (but not many) that fulfil the criteria laid out in [Good to Great](#) by Jim Collins (See discussion of this in our Floor & Decor piece). In short Amazon looks to be excelling in all these areas as we articulated this Spring. Further reading seems only to support this view in more depth.

### [Amazonian = Kaizen](#)

In much of the analysis we undertake more work does not always yield more insights. It more often than not either leads to more unanswered questions, or it just reveals more of the same. Just re-enforcing a little of what our early work suggested. Our work on Amazon has been different in that every page we have turned has been a treasure trove of findings. We find many past stories of how products and service came about due to the innovation culture. Or we find from books like ‘*Working backwards*’ how ingrained Amazon’s culture now is in its work force.

Such learned nuances are hard to summarise in a note like this. Investors must read them for themselves. We simply cannot recommend the two new books highly enough for giving us greater

depth and perspective into Amazon's culture and ethos. We conclude that it is both impressive, highly unusual and important. We think it will be long lasting.

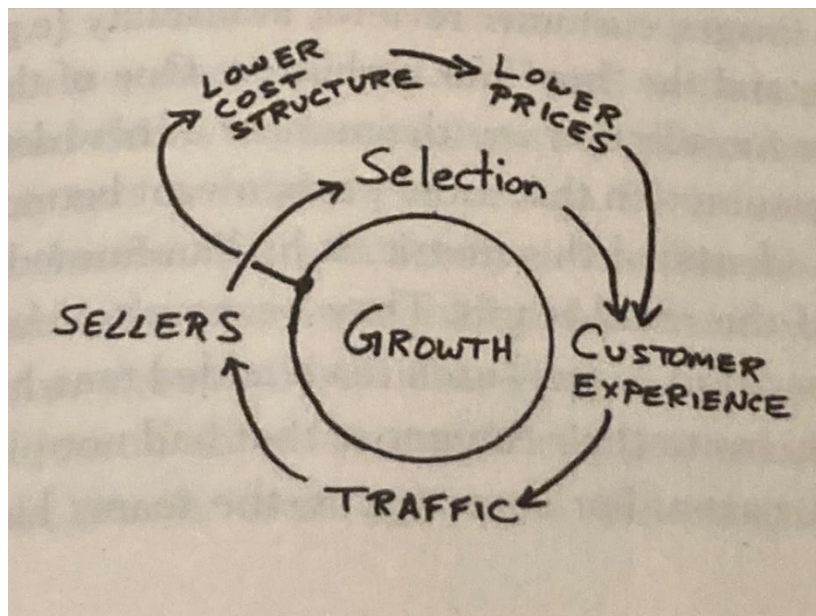
*"I don't understand how Amazon does it. They are able to build and win in so many different businesses, from retail, to AWS and digital media. Meanwhile we have been at this for 30 years and still have not mastered our core business."* **Fortune 100 CEO. Extracted from 'Working backwards' by Colin Bryar/Bill Carr**

Having read a great deal about the Amazonian way of doing business, we are minded to the [Kaizen business approach](#) that a few highly successful US companies adopted in the last twenty years. Those that fully implemented such an approach have seen multi-decades of success. Investors in companies such as Danaher shared in this success with c.20% pa returns for almost twenty years. This is despite the fact that their methods were clearly visible for all competitors to potentially copy.

All of this leads us to one simple conclusion. This being that the more we study it the more we conclude that Amazon will not fade like a normal company does. For years if not decades to come it will find new products, services and markets to use its unique approach in. In just the same way that the Kaizen method for lean production was able to be deployed across so many different industries.

As a teaser to read *'Working backwards'* we show a picture its authors said Bezos drew on a napkin in 2001 to explain to staff the business model. When we talk of a 'perfect match' above between our approach and Amazon hopefully you are starting to see why!

Fig.1: Bezos scribbles a re-investment wheel - in 2001!



Source: Working backwards by Colin Bryar/Bill Carr

### The signs were there!

Long serving clients will have seen us present many versions of this reinvestment wheel from our Unilever piece in 2011 onwards. Clearly, we knew Amazon was a company employing such a model, we just did not know it was being communicated so well.

Or... more importantly executed so brilliantly that the shares were not 'expensive' as maybe we concluded from just a glance at the company, but in fact cheap! For those inclined to forgive this oversight we feel we must confess other errors of omission in the case of Amazon first:

- In 2011 your author reversed a previously bullish view of Tesco. Doing so on the back of realising they could no longer compete in many non-food categories with Amazon selling so successfully online. Thus realising that Tesco's asset/turns would deteriorate.
- In c.2012 your author listened to Charlie Munger talk about how many companies around the world underestimated the damage Amazon could do to them
- In researching IBM in 2015 we found in our due diligence that IBM had lost out in winning a crucial multi-decade CIA data contract to... you guessed it Amazon. We even found a quote from the CIA extolling the virtues of the Amazon offering!

... and yet still we did not look properly at the company

So, we have had our chances to assess this company better in the past, but steep share price rises and high headline multiples kept us away. We just needed to have done some proper reading/research (is it not always the way!).

Faced with uncovering Amazon better as we think we are today, but seeing its past growth we could easily once gain assume we are too late to invest. In fact we are concluding the opposite. The comments above we made in comparing this company to a very short list of others that have not faded we think is a crucial comparison and conclusion.

Indeed, we remember clearly feeling the same about Berkshire Hathaway post studying the company closely in c.2008. ie that we had missed the chance to invest. Your author today owns some Berkshire shares that he bought in 2009 – today they are worth c.6x the price he paid for them! In 2009 the shares were depressed by market falls. In his purchase at the time, he was keen to ensure he did not overpay, thus worked hard on the valuation of the company. However, what has driven the multiplication of the capital invested was not the margin of safety in the initial purchase price. Instead of course it was the continuing compounding of capital that was able to keep taking place at Berkshire, despite it already huge size. I.e. The company's growth did not fade.

This we believe is the position we find ourselves in with Amazon today. A little work on underlying steady state profitability as we performed in the Spring can give today's investors some comfort they might not be overpaying for the shares today. But importantly what will drive future changes in investor capital committed to the shares will be its future growth. That growth cannot be seen today. However, a close study of the culture, ethos and principles widely deployed by all that work at Amazon suggest there is a long, long, runway of growth still ahead of this company.

With kind regards to all

Andrew

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