January 1, 2021

Wiedower Capital 2020 Annual Letter

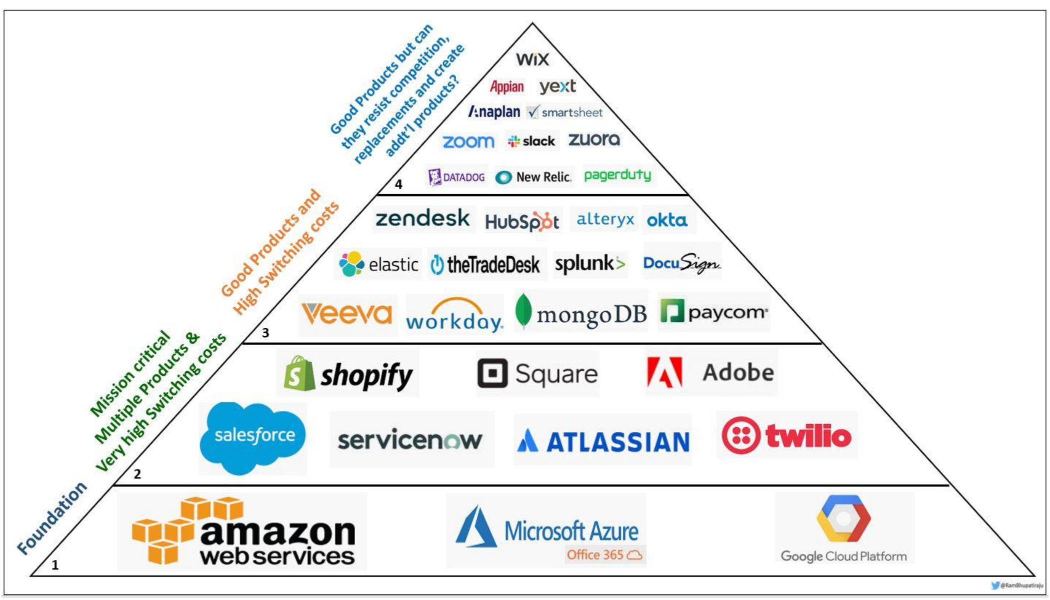
Wiedower Capital invests in high-quality companies and CEOs that have industry tailwinds behind them and long runways for growth ahead of them. Research is focused on how an industry may evolve over the next 5-10+ years and if a company's competitive advantage can expand within that evolution. Qualitative factors are emphasized over quantitative, and the portfolio is concentrated with long holding periods. See Appendix 1 for a summary of Wiedower Capital's investment philosophy.

For the first ten years or so of my investing career, I avoided technology companies. That was pretty stupid. Technology is the future. It is hard for me to imagine a world 30-years from now where tech companies do not dominate most industries. Previously, I think I avoided tech because I did not understand it and changing that would have required a lot of effort. It was easier to just say those companies were outside my circle of competence. Nonetheless, in 2017 I had a realization that avoiding tech was lazy and probably a recipe for disaster when thinking long-term about my investing career.

Since then, a significant amount of my time has been dedicated to tech. In 2017, I started doing high-level research to get comfortable with the space in general. I knew I was not going to invest in tech for a while, but I hoped I could get a decent base of knowledge within a couple years.

The first tech companies we invested in were Facebook in late 2018 and Netflix in 2019. Both of these are consumer tech companies that I am a frequent user of, so they were easier for me to wrap my head around. In addition to consumer tech, I was also spending a lot of time studying enterprise software. Due to me not being in the target market for these products, they are inherently harder for me to understand. Realizing that, I have been very purposeful about how I expand into this space.

I really like the below triangle depiction of the enterprise software space that [@RamBhupatiraju](https://twitter.com/RamBhupatiraju) posted on Twitter in November 2019.



This image is over a year old, so some companies have arguably moved around, and others need to be added. But broadly speaking, I think it is a helpful way to visualize the layers of enterprise software.

The big cloud providers are at the bottom of the triangle because they provide the basic underlying computing power that many other businesses run on top of. Amazon Web Services, Microsoft Azure, and Google Cloud Platform have spent billions of dollars building data centers filled with servers all around the world. That physical infrastructure makes for a very large barrier to entry.

Now, that is not to say their competitive advantages are insurmountable. They themselves are replacing companies like IBM and Oracle that benefitted from strong competitive advantages in legacy computing infrastructure. Nonetheless, I generally find that companies lower in the tech stack have stronger competitive advantages than those higher up. This is why my research and investments in this space started at the bottom and have slowly moved up as I get more comfortable.

For every company we are invested in, I have previously experienced a moment of crystallization when I was researching that company. Studying a new company, especially one in an unfamiliar industry, often starts with a couple weeks of confusion while I am trying to piece the new puzzle together. After stumbling around for a bit, the puzzle usually starts to come together—the CEO's vision, how their competitive advantages intertwine, where the industry is heading, etc. When that picture crystallizes in my mind, I start getting comfortable enough to potentially invest in that company someday.

Sometimes, that picture never crystallizes for me—something about it just does not click. In those cases, I either pass on the company outright, or I continue to follow the company in the hopes that I understand it better in the future. This is what happens with the majority of enterprise software companies I look at.

Looking at that triangle diagram above, I have researched quite a few of the companies in the top two sections. However, I have yet to get comfortable with even potentially owning any of them. In fact, there are currently zero enterprise software companies on my list of companies that I want to own. There are a few that I have been following for a while that I like, but I am not comfortable enough with them yet to even consider investing.

For tech companies that I am a user of—like Facebook and Netflix—getting to that point of crystallization can be relatively quick. Amazon's e-commerce business fits this same mold. Amazon.com has accounted for a significant amount of my purchases for many years. I did not have to read Amazon's 10-K to understand why their shopping experience is better than going to the mall.

Amazon being both consumer tech (Amazon.com) and enterprise software (Amazon Web Services) allowed for a smooth introduction into the enterprise software space when I started following Amazon back in late 2017. Despite that, it still took another year and a half for me to feel like I understood Amazon Web Services well enough to invest in Amazon.

The next enterprise software company we invested in, Microsoft, was a similar story to Amazon. I have been using Microsoft products since I was a kid, and that allows an easier route to understand their enterprise software businesses. As a reminder, I spent nearly half of the 2020 interim letter discussing my thesis for Microsoft (and Amazon).

In September of 2020, we invested in our third enterprise software company, Twilio. Despite being built on top of Amazon Web Services, Twilio is still very much a core internet infrastructure company. In my last letter I wrote the following:

> A common narrative among investors—and one that I generally agree with—is that it is often better to sell picks and shovels during a gold rush than it is to go digging for gold. It is possible to find gold and get rich, but more often than not, selling products that every person digging for gold needs is going to be more profitable.

I think the digital economy is a gold rush that still has a long runway for growth. And I want to invest in the picks and shovels that allow companies to operate digitally. Amazon Web Services and Microsoft Azure provide much of the underlying computing infrastructure. Twilio provides much of the communications infrastructure.

When you interact with a tech-forward company—through text, phone call, or email—there is a good chance you are using Twilio. Twilio integrates with telecommunications operators and internet service providers in over 180 countries. And companies can plug into that communications infrastructure by using Twilio's products. It used to be difficult for companies to communicate with customers around the world. Twilio makes it easy.

There are other communications software companies, but Twilio is both larger and growing faster than their closest competitors. They are the 800-pound gorilla of this industry. Twilio has the most global coverage with the widest breadth of products. Through Twilio, a company can communicate with their customers through voice, video, messaging, chat, WhatsApp, and email. None of Twilio's competitors offer all of those. To Twilio's customers, consolidating all of their own customer communication on one platform makes them more efficient. However, Twilio's vision is much bigger than owning the communications layer of the internet.

What Twilio has been known for to date—managing things like texts, phone calls, and emails—is about helping companies communicate with their customers. A lot of this communication is done through a company's contact center. That is why Twilio has rolled out a contact center platform that ties into everything else they do.

Understanding these customer interactions that Twilio enables also affects how companies market to and sell to their customers. And that is what Twilio wants to own. They want to continue to help companies communicate with their own customers, but then also help them understand those communications to get better at marketing and sales. Twilio wants to be the first customer engagement platform that covers all customer interactions from end to end. This could allow companies to understand their customers at a much deeper level than ever before.

As with every company we own, a big part of my thesis is based on the CEO. And Jeff Lawson, Twilio's founder and CEO, is no exception. One of Jeff's most notable traits is his customer obsession. In this regard, he reminds me a lot of another CEO who is world renowned for obsessing over customers—Jeff Bezos. That resemblance probably is not a coincidence given Jeff Lawson was one of the first employees at Amazon Web Services.

> "*Instead of deploying significant resources towards one product with an unsure reception from customers, why not try many experiments and let your customers guide your path? Our general philosophy about innovation is this: Nobody truly knows which products will ultimately win… You listen to customers and hear their problems, and then invest in answers to problems that you believe are particularly painful and widely shared among customers. As a platform, we minimize friction wherever possible to encourage more experimentation by our customers—which will ultimately lead to finding successful solutions*." – Jeff Lawson

Being guided by customer problems is what led Twilio to develop their contact center solution. Next, they realized the problem their customers need help with is much bigger than just communicating with their own customers—it is how to understand those customer engagements.

When I am looking at a new company, one of the first things I do is pull up the most recent proxy statement and read their philosophy on compensation (or lack thereof). It amazes me how few companies—even founder-led companies—do not put much thought into their incentive structures. In my experience, the majority of public companies default to the standard of paying high salaries and annual bonuses with large equity grants. Usually, the bonus is tied to performance metrics like revenue or EBITDA growth that seem reasonable on the surface.

However, since reading *The CEO Pay Machine* in 2017, I have become much stricter on what I consider good compensation. My main takeaway from that book was that virtually every incentive has unintended negative consequences. Thus, simplicity is best: low salary + no bonus + long-term equity.

As I discussed in my last letter, setting a good company culture is critical to business success over the long-term. But humans are—understandably so—selfish creatures. One of our most basic instincts is to do what is in our own best interest. Thus, creating incentives that encourage employees to do what is both in their own best interest and the long-term interest of the company is one of the most important things a founder does. Yet, reading proxy statements makes it obvious that most founders fail in this regard. And when I see a founder who does not think critically about something so important to their business, I cannot help but wonder what else they overlook.

It may seem like a minor thing, but one detail that immediately gets me excited about a new company is if they do not pay annual bonuses. I believe it is extremely difficult to create annual compensation metrics that cannot be gamed in a way that is at least somewhat counterproductive to long-term value creation. The majority of a company's intrinsic value comes from the distant future, not near-term results. And incentivizing executives to achieve annual targets is often not conducive to that long-term success. On this topic, Amazon's proxy statement is a master class. The below excerpt encompasses my point.

> Because of our executives' low salaries, the absence of an annual bonus program, and reliance on restricted stock units with long vesting periods, we believe that our executives' compensation is tightly aligned with our shareholders' long-term interests, and therefore that performance conditions on our stock awards are neither necessary nor, given the nature of our business, appropriate. As a company that relentlessly pursues invention across a wide range of opportunities, we believe it would be inappropriate to utilize a few discrete or short term financial or operational performance measures that may narrowly focus our executives on the success of only isolated initiatives, instead of on the long-term success of the Company as a whole.

Jeff Lawson has taken a similar approach to compensation at Twilio. The highest salary at Twilio for 2019 was $610k (Jeff's salary was only $134k), there are no annual bonuses, and most compensation comes from equity that does not start vesting until two years after being granted. When researching new companies, I keep an eye out for unusual small things such as that two-year grant. Most company equity grants start vesting within one year of being granted, yet Twilio's does not start until two years have passed. It is one of many small data points that point to a founder and a company culture that are oriented to focus on the long-term.

Not surprisingly given the above, Jeff cares a lot about Twilio's culture. But nowadays, most CEOs claim their company has a unique culture. It seems like every newly public company brags about culture in their S-1 filing. And when everyone talks about culture, it can be difficult to tell who is serious about it and what companies actually have great cultures. But as the saying goes, the proof is in the pudding. A founder who puts in the effort to create good compensation structures probably cares about what culture they are incentivizing.

Another clue I have started paying attention to is when a company's culture is brought up by people who have never worked there. My ears perk up when I am reading a news article, watching an interview, or listening to a podcast, and someone mentions another company's culture. Amazon's culture of two pizza teams and customer obsession is very well known. Likewise, I have heard outsiders talk about Twilio's culture—unprompted—on numerous occasions. I doubt cultures so well respected do not originate from the top.

These topics that Jeff Lawson focuses on—customer obsession, incentives, and company culture—are all very important aspects of my investing process. Yet, none of them show up on the financial statements (directly at least). I believe qualitative factors are more important than quantitative factors when analyzing companies, especially given my long-term holding periods.

That is why valuation is the last thing I do as part of my research process. I spend the majority of my time looking for high-quality companies. And when I find one, I have no problem leaving it on my want-to-own list for months or years until it falls below my valuation threshold. What I do not want to do is look for companies that appear "cheap" and then look for quality within that group.

The majority of my 2019 annual letter was spent describing how I transitioned Wiedower Capital's portfolio management to a model that I custom built. To quickly refresh, after my initial research on a company is complete, I score the quality of the business. Every company is scored on the same criteria that I have chosen to reflect my own investing philosophy. This quality score, combined with a valuation score, is how the model makes its buy and sell suggestions.

After finishing it in late 2019, 2020 was the first full year I used the model. While one year is not a long period of time in the investing world, 2020 was unlike most. I could not have asked for a more volatile year to test my model. While things did not go perfect and I had to make a few changes to the model throughout the year, overall, I am very happy. In fact, it would be difficult for me to overstate the positive impacts I believe this model has had on my investing process. Ten years from now, I think I might look back at the model's creation as a major inflection point in my career.

In my 2019 annual letter, I stated my original goal of building the model was "to remove emotion, bias, and subjectiveness from my investment process." In late February and March of 2020, it felt like my income and net worth were falling every day—along with the state of the world. Throughout this period, I was also dealing with a family emergency that significantly affected my mental health.

Despite going through an emotional roller coaster, I still felt like I was able to make sound investment decisions thanks to the model. Because I designed the model based on my own investing philosophy, I trust it and I do what it tells me. Through the first few weeks of the stock market collapse, the model did not suggest any trades. But when it suggested I make two new investments on March 12th, that is what I did.

To quote that same 2019 letter again, "it actually shocks me how few emotions I experience as part of my decision-making process now." While that sentence was true when I wrote it a year ago, it is good to confirm after a very volatile year.

If there was one thing I could go back and convince my younger self of (although I doubt younger Travis would listen to a 30-some version of myself claiming to be from the future), it would be that the emotional part of investing is every bit as important—if not more so—than the actual research and analysis part. While it took me years to admit that to myself, I feel like I have now solved many of my previous problems of letting emotions get in the way of good investing decisions. I am even more excited about my model-based approach to portfolio management than I was a year ago. One specific problem I discussed last year was anchoring bias.

> Anchoring bias is a very common problem among investors, and it's one I've struggled with in the past. Basically, this is when investors focus too much on past stock prices when making current decisions. An example is when an investor is hesitant to purchase a stock at $100 because they previously passed on it at $80 (i.e., the investor is anchored to the $80 price). But that is meaningless. What matters is the expected value from this point forward. That's it.
>
> Thankfully, anchoring bias is not even a thing with this new portfolio management model. With stock prices completely disaggregated from my investment decisions, I don't even see prices until after the

model tells me what needs to be done and I go to make the recommended changes. By the time I open Interactive Brokers to make those trades, the stock prices I see don't matter. I've already decided what I'm doing.

While I may have been a little quick last year to claim that "anchoring bias is not even a thing with this new portfolio management model," I can now confirm that is accurate. During 2020, I think I made every combination of buy or sell that, in the past, could have potentially been harmed by anchoring bias. I added to and sold shares of holdings that were up significantly and down significantly. The two positions we added in March were both down on the year, while Twilio had tripled off its March low when we invested in September.

Needless to say, the model has really helped me separate stock prices from my buy and sell decisions. Whether a stock is down 50% or up 200% recently does not matter at all—what matters is my estimate of the stock's expected value looking forward. And in terms of portfolio management, what matters is the expected value of each of our holdings relative to each other.

It is amazing how mentally freeing it is to remove stock prices from my investment process. Especially with companies on my want-to-own list, I can go months without seeing what those stocks are doing. If I run the model once per week and the companies on my want-to-own list never surpass my valuation threshold for ownership, there is no reason to look at their stock prices. And the less often I see how the overall stock market or individual stocks are performing over the short-term, the easier it is to focus on the long term.

In an additional effort to force myself into long-term thinking, the model no longer allows me to invest within the first three months of researching a new company. That three-month moratorium is a change I made to my process in early 2020. So far, I have really liked it. When a new company is researched, I take note of the date I read the annual report. Three months from that date is the soonest I am allowed to buy shares of that company. And if I am not going to invest in a company for at least three months, there is no reason to value the company until then. Thus, the first three months of following a company is dedicated 100% to qualitative analysis.

Initial research on a company generally takes me between two and four weeks. During that time, a significant portion of my work is dedicated to that company as it is rare for me to research two companies at the same time. So, once that initial research is complete, there is another roughly two months before I can even consider investing. I have found two major benefits of forcing myself to have this moratorium.

In my 2019 annual letter I described how several of my past mistakes were due to me researching a company, getting excited about it, and immediately investing. That excitement often resulted in me not being strict enough on price. Not allowing myself to invest for three months gives time for that initial excitement to die down. Investing quickly during the initial excitement phase also resulted in me not fully appreciating risks and overlooking them.

Second, during that two-month period after my initial research is complete, I experience what is called the Baader-Meinhof phenomenon, or the frequency illusion. Have you ever bought a new car and then started noticing that car everywhere? It is the same thing here. Once I complete my initial research on a company, I inevitably notice more news articles or find other investors talking about it. By the time that three-month period is up, I am generally much less excited about the company—in a good way—with a more balanced view of the pros and cons. And if I do decide to invest in that new company after three months, the max position size I can make it is 2.5%. That max position size then gradually increases over time.

The net effect of the above is that when I research a new company, I know it cannot have a material effect on our portfolio for at least 9-12+ months. Thus, next quarter's results are meaningless to me. Right off the bat I am thinking about the company's medium to long-term future—because that is what might affect Wiedower Capital's results.

In case it is not obvious, I am really excited about the investing machine that I have built. Now, I need to feed more potential investing ideas into that machine. One of my biggest frustrations during the market collapse in February and March was that I did not get to buy even more great companies at bargain prices.

The high-quality businesses I want to own do not fall below my valuation thresholds very often. In 2020, we made four new investments (by the way, I consider that a very busy year and expect the norm to be 0-2 new purchases per year). Those four companies traded below my valuation threshold for the following number of trading days: 11, 14, 1, 9. Excluding Burford Capital, which spent the entire year below my valuation threshold, every other company that is either in our portfolio or on my want-to-own list spent 11.7% combined of the total available trading days below their valuation thresholds.

Given 2020 had 253 total trading days, that means the average high-quality company in my current investing universe was only below my valuation threshold for 30 days. And that was during a very volatile year in the markets. In normal years, I expect that 30 days number to decrease.

Given the purposeful slowness of my investing process, it is often impossible for me to start researching a company after its stock has collapsed and be able to purchase it before the stock has rebounded. In March, there were several companies on my research list that collapsed significantly—and that I was confident would meet my quality threshold—but had rebounded above my valuation threshold by the time I researched them, and my three-month delay had passed. Realizing this, I made a few changes to my process with the goal of increasing the number of companies I can research in a period of time.

Every new company I research goes through similar steps: read the annual report, proxy statement, two years of conference calls, etc. The last step of my research process for each company used to be a pretty lengthy checklist I had created. I realized, however, that over the last several years I had implemented the most important points of my checklist into other areas of my research. Thus, the checklist had become largely redundant. In addition, there were a couple other small parts of my process that, when looked at with fresh eyes, I realized had either become redundant or were not adding much value. As a result, I have been able to shorten my initial research process.

More importantly, though, I reorganized a few steps of my research process with the goal of passing on companies quicker. Previously, one of my last steps was to dig into the CEO and company culture. The problem is that this is probably the single thing that causes me to pass on the most companies. Even among high-quality companies with strong competitive advantages, it is rare that I get excited about a CEO and the company culture they have created. Thus, on a regular basis I used to waste a week or two researching a new company only to pass on it when I spent more time on its culture.

Now, I dig into the CEO and culture right from the start. My goal when researching a new company is to pass on it as fast as possible. Whatever makes me say no to the highest percent of companies is what I should spend time on first. That will result in me passing on companies quicker, thus leaving me more time to research companies that do have the rarest traits I look for. Now, when companies do get through that CEO and culture analysis, it will more often be worth it to spend weeks studying the company.

The net effect of these changes is that I have gotten a lot better at spending more time on companies that Wiedower Capital may someday own—and less time on the rest. There were numerous examples through the second half of 2020 of companies I passed on after a few days of research that I think I previously would have spent a week or two on to get to that same point. This means I can feed more investing ideas into my model.

More ideas fed into the model gives me more data to analyze, more potential investments for the model to suggest, and thus hopefully improved results over time.

During a year of so much volatility in the markets, thankfully our holdings mostly benefitted to the upside. At various points throughout 2020, six of our nine holdings were offered at stock prices that were above the midpoint of my fair value range. I could have taken these opportunities to sell out of these holdings. However, I have no desire to sell the high-quality businesses Wiedower Capital invests in, regardless of their share price. I may sell down these positions to a smaller size in order to buy more of other holdings that I believe are more undervalued, but I do not sell completely. There are four reasons I have little interest in selling high-quality companies that have reached, or even exceeded, my estimate of their fair value.

First, my estimates for fair value are always wrong—sometimes on the low side and sometimes on the high side. Valuing companies is a guessing game played with imperfect information based on an unknowable future. My goal is only to be in the ballpark of whatever the theoretically correct number is—if there even is such a thing. And the higher quality the company is, the more likely I am to understate its fair value.

I believe the best companies have more unknown upside optionality to them as opposed to low-quality companies that have more unknown downside optionality to them. Basically, unpredictable good things happen more often to good companies, whereas unpredictable bad things happen to bad companies. It is hard to put a number on unknown upside optionality—because it is unknown—but it is one reason that I believe qualitative factors are more important than quantitative factors when evaluating companies.

Next, a fairly valued company still has a positive expected value in terms of stock appreciation in the future. Fairly valued just means that a stock's return will be in-line with the market's return. Because of the first two reasons, I still expect a fairly valued company that we own to match or slightly beat the market going forward—maybe 6-10% expected returns per year. So, if I sell what I believe is a fairly valued stock just to sit in cash, I am costing Wiedower Capital an expected 6-10% per year on that position size.

Finally, Wiedower Capital's portfolio is kind of like my own personal art collection. I invest in companies to enjoy owning them for a long period of time—not to sell them to someone else. Public markets allow me to partner with some of the best CEOs who are trying to make the world a better place. I think that is pretty damn cool and it is something that gives me pleasure. I do not sell that enjoyment because my estimate of a stock's annual return goes from 15% to 7%.

The above paragraph explains a lot about my approach to investing. It is why I do not get tempted by lower-quality companies that appear "cheap." Some investors can buy commodities at the bottom of a cycle and make a killing. There is nothing wrong with that, but it is not conducive to my goals. On a similar note, I do not invest in tobacco or other businesses that I do not believe are making the world a better place. I have zero desire to invest in most companies—no matter the price. I want to be a small part of great companies for long periods of time.

With that being said, there are of course situations where holdings are sold completely, but they generally do not relate to valuation. If a company's competitive positioning significantly worsens or I no longer trust the CEO, I will consider selling. If the founder leaves unexpectedly, that could be cause for concern. See my 2018 annual letter for a detailed example of when I sold a company solely because I lost trust in management. I have zero tolerance for management who I do not trust with Wiedower Capital's money.

Travis Wiedower

Appendix 1: Wiedower Capital's Investment Philosophy

1. Long-term focus: I look at companies through a long-term lens. When I invest in a new company, I go in with the mindset that I will own it forever (while recognizing that won't come to fruition very often).

   A company is worth its future free cash flow discounted back to today. A discounted cash flow analysis shows that the majority of a company's intrinsic value comes from the distant future, not near-term results. If how a company will perform over many years is the majority of its worth today, then the durability of their competitive advantage is of paramount importance.

   Because of this, my research is focused on how an industry may evolve over the next 5-10+ years and if a company's competitive advantage can expand within that evolution. This is only possible if the CEO is focused on, and incentivized by, the long-term success of the company. Often, the CEO traits I look for are found in passionate founders who are internally driven to see their own business succeed.

2. I'm very picky: The vast majority of companies are un-investable for me at any price. I have a small circle of competence (that is slowly expanding) and I have zero tolerance for management that isn't aligned with me.

3. Learning mindset: Even more than investing, I love learning. Investing just happens to be a perfect outlet for that—there will always be more companies, industries, and countries to learn about. Beyond that, a lot of outside disciplines indirectly help my investing. Much of what I consume on a weekly basis may not directly benefit my investment results, but I believe there is a lot of value to learning broadly and trying to understand the world better.

4. Alignment of interests: As much emphasis as I put on finding CEOs who are aligned with outside investors, I also want the same alignment between myself and my partners.

   Wiedower Capital is structured to align my own incentives and my partners around a long-term investment strategy. My performance fee is earned over multi-year periods and new partners are subject to a three-year lockup. In addition, performance fees can be clawed back, management fees scale down as assets under management increase, and assets are capped at $100 million.

Appendix 2: Historical Results*

Period	Wiedower Capital	S&P 500
2015	-11.91%	-1.37%
2016	19.19%	11.95%
2017	22.28%	21.82%
2018	-18.61%	-4.39%
2019	-3.36%	31.48%
2020	36.99%	18.37%

Cumulative	38.34%	100.15%
Annualized	5.70%	12.58%

* Started February 24, 2015. Wiedower Capital results are net of fees and are based on a model account that has been active since inception. The model account pays fees as a non-qualified client, which is currently 2% per year. All accounts are managed the same, but individual account results may vary from the above results based on different fee structures and minor position size differences. S&P 500 results include dividends.