PART I

THINK LIKE AN OWNER

THE ART OF THE ENTREPRENEURIAL INVESTOR

The entrepreneurial investing style is defined by focus, opportunity, and personal involvement.

This section explores five simple ideas behind the entrepreneurial investing style:

- See things for yourself, and trust your own intelligence.
- Cool heads prevail in the stock market.
- Stick to what you know.
- Diversify enough to mitigate risk, but concentrate enough to amplify results.
- Style boxes arbitrarily limit opportunity.

CHAPTER 1

Eyes Believe What They See; Ears Believe Others

Warren Buffett says that one of the most important things he learned from Columbia University professor and value investor Benjamin Graham was this: "You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right. That's the only thing that makes you right."[1]

Years earlier, Wall Street legend Bernard Baruch purportedly said that every man is entitled to his own opinion but not to his own facts. However, separating fact from opinion presents challenges in this age of blogs, sound bites, and bumper-sticker philosophizing. Or does it? Maybe we just need to pay attention and look around us.

Pay Attention

In 1992, the *New York Times* reported that President George H. W. Bush was "amazed" by supermarket scanner technology, suggesting that the president was out of touch with the American people, belonging to a caste of aristocrats for whom others did the shopping. Although the story turned out to be apocryphal, evidence suggests there really is an elite group of Americans who haven't done much grocery shopping in recent years—the analysts and institutional investors of Wall Street.

Supermarket chains such as Safeway (SWY), Kroger (KR) and Albertsons have been in trouble for years. The competitive landscape shifted dramatically when retailing giants Wal-Mart (WMT) and Costco (COST) expanded their merchandise lines to include groceries. The trouble had been brewing for a very long time, but Wall Street noticed quite late. We think this situation illustrates the arrogance of overeducation: Investment professionals studied analysts' charts and graphs, but didn't notice the Costco, Trader Joe's, Whole Foods (WFMI), and Wal-Mart grocery bags being unloaded from their neighbors' cars.

Customers seem to know well in advance when a company is in trouble, but Wall Street often notices after the damage is done, then severely punishes the stock.

Backyard Barbecues Predicted Supermarket Sector Decline

Education without experience is knowledge without wisdom. Remember the fortune cookie: "Your eyes believe what they see; your ears believe others." We think anyone could have seen this crisis in the supermarket business coming. Thirty years ago, if you went to a multifamily barbecue, the host bought the meat at a butcher's shop. Ten years ago, the host bought the meat, drinks, and paper goods at the supermarket. For the last five years, the host has bought the meat, drinks, paper goods, lawn furniture, potted plants, outdoor speakers, and barbecue itself at Costco or Wal-Mart.

What goes great with a sport utility vehicle and a giant stainless steel freezer? A huge cargo of dry goods and frozen meats—it's all part of the super-sizing of America. Our huge middle class does not have the cash-flow worries of 30 years ago; they are better able to realize economies of scale by shopping "club" style and buying in bulk. Of course, few top-floor Manhattan restaurants host multifamily barbecues, so quite a few stockbrokers missed this trend until it was too big to miss.

Kodak Fails to Focus on Digital Photography

Long-term investors must distinguish trends from fads. Large companies are, by definition, long-term investors in themselves, but many seem to miss trends that the average person and the competition clearly identify. We cannot say Eastman Kodak (EK) missed the fact that large numbers of people would embrace digital photography, for Kodak was an early entrant into the market and then chief executive officer George Fisher was committed to transforming the company. They simply mishandled it because the entire organization did not buy in. Offering low-priced, feature-poor cameras and very expensive, high-end cameras, Kodak misallocated resources for at least 10 years and remained focused on producing film, utterly missing the mass-market feature set and price points for digital cameras. They also seem to have missed the market for digital media such as compact flash cards, the products that are replacing film.

The company will insist that it was listening to customers. We believe it was listening to marketing focus groups, but it failed to watch customer behavior. In 2001, we noticed a colleague who rhapsodized about the quality of his 35mm Nikon cameras was leaving the 20-pound camera bag at home and taking his tiny digital camera everywhere he went. It's what people do every day that really counts.

Young Adults Herald the Wireless Future

A visit to any college community since 1999 shows the future of telecommunications. School-year renters no longer bother with landline phone service; everyone has cell phones. In these same communities, DirecTV and digital cable systems now deliver television programming and high-speed Internet access. Landline phone companies and dial-up Internet services seemed dumbfounded as their customers fled en masse for the obvious benefits of wireless telephony and high-speed DSL or cable Internet access.

Television Loses Its Reason for Existence

People don't like to acknowledge this, but television news and entertainment are mere subsidiaries of the advertising industry. What will happen as more consumers gain the power to avoid commercials through time-shifting digital recorders like Tivo? The advertising industry is currently reacting with more in-program product placement, which has drawn regulator and consumer advocate attention, but not much revenue.

What is the future of the advertising industry if people have the power to avoid ads? When will the ripples hit content and distribution companies like Viacom (VIA-B), Disney (DIS), and NBC (GE), whose products are paid for by advertising revenue?

Grocers Lose Touch, and Their Identity

Wal-Mart revolutionized retailing through technological mastery of their supply chain, ensuring that the most popular items are always in stock, and always at the lowest prices. With their remarkable distribution and information technology systems in place, conquering grocery retailing must have seemed a simple matter. In fact, in 2001, Wal-Mart surpassed industry leader Kroger with an estimated $65.3 billion in food sales. Somehow, before anyone thought of them as a grocery store, Wal-Mart became the nation's biggest grocer.

Other, smaller competitors position themselves to make traditional supermarket shopping seem like drudgery. People talk about a trip to Trader Joe's as an *event.* A quirky alternative for those who love to experiment with an ever-changing inventory, Trader Joe's offers gourmet fare at discount prices, and does so with humor and personality. Whole Foods positions itself as a morally superior alternative for healthy, environmentally friendly, and socially conscious shopping. It uses its unique identity as its competitive advantage.

Wal-Mart, Costco, and specialty retailers like Whole Foods and Trader Joe's are expanding and taking market share from Albertsons, Safeway, and Kroger. The declining stock prices of these large supermarket chains reflect Wall Street's reaction to the customer exodus.

Frontline Coworkers and Customers

Although Yogi Berra's famous remark that a certain restaurant was "so popular that no one goes there anymore" is an amusing oxymoron, it may have been accurate. Customers know when the wait is too long, and word gets around. As soon as digital photography looked plausible, customers started complaining about the inconvenience of 35mm film—the mystery, waiting, and expense. When decent digital cameras broke the $500 price point, customers bought them.

Was it not clear that as soon as wireless matched the quality of landline telephones, the latter would be redundant? Was it not apparent that everyone using high-speed Internet access at the office would clamor for high-speed access at home?

Did some of the largest companies in America watch their customers, or did they listen to marketing consultants, accountants, stock analysts, and other experts? Did they even listen to their own frontline employees, those firsthand witnesses of customer behavior?

The Smartest Man in the Room?

It's been said that a good writer does not have to be the smartest person in the room, just the most observant. Likewise, a good investor doesn't have to know everything in the world about investing, but ought to know what's going on in the world. We think Wall Street brokers and analysts talk to each other more than they watch consumer behavior. It's interesting to hear how other people invest money, but it's more profitable to watch how consumers spend their money. Pay attention.

In 2003, a strike by supermarket workers put a lot of pressure on supermarket chains and delivered a spike in sales and profits to smaller chains. Figure 1.1 compares supermarket giant Safeway and niche player Arden Group (ARDNA), which owns Gelson's markets. Note that Safeway's and Arden's performance diverged years before the 2003 supermarket strike, but since 2003 Safeway has also underperformed the Standard & Poor's (S&P) 500. Also note that shoppers and investors continue to reward the major supermarkets' competitors long after the strike.

Supermarket chains have been steadily losing ground to niche players who can more profitably serve specific market segments. Costco and Wal-Mart attract price-conscious shoppers, while quirky and upscale markets like Trader Joe's and Gelson's appeal to enthusiasts who are willing to pay for the experience.

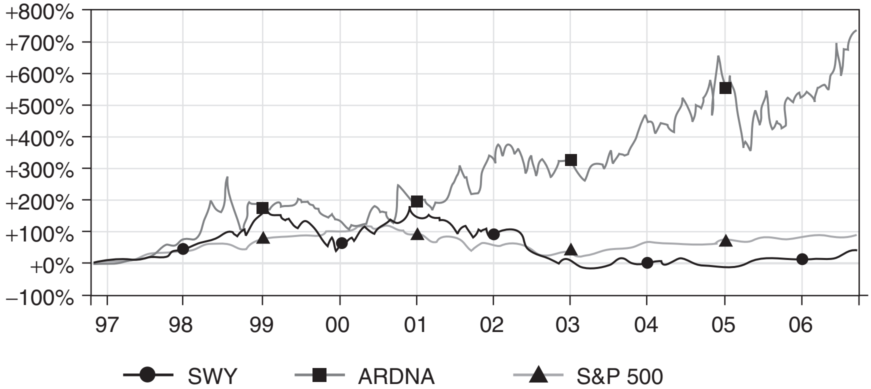

Figure 1.1 Did Shoppers Know before Wall Street?

Data Source: FT Interactive Data via Capital IQ, a division of Standard & Poor's.

Squeezed into the middle, supermarkets that were already competing on razor-thin margins now face serious disruption in their industry. Is it only in hindsight that we could see how the Wal-Mart business model would help them surpass industry leader Kroger so quickly? As someone who likely buys groceries at least once a week, could you have profited from the changes happening around you?