March 2020

Washing Hands Won't Help: Corona-Mania is Spread via your iPhone

Summary: Stocks needed an excuse to pull-back. The media storm and negative feedback loop around coronavirus have proven to be just the trick. Our view: Don't change your investment strategy. The DJIA dropped 12% last week. The severity of the sell-off is due to three factors. First, stocks were extended following the recent resolution of uncertainty on trade disputes with China. Second, financial and other media have stoked fear by massively amplifying reporting and risk around the threat of coronavirus. Lastly, companies and industries are experiencing a real negative impact from reduced consumer spending, travel, and disrupted supply chains. Earnings will be lower than previous estimates.

The Financial Media is a Noise Machine with One Objective: Retaining Your Attention for as Long as Possible

Like a weather forecaster anticipating the storm of the century, the media's heightened state of excitement on Corona-Mania is hitting a fever pitch. Bloomberg has created a special function on its $2,000/ month news terminals to track articles on coronavirus. FactSet (another financial media service) has started sending out daily summaries of coronavirus infection counts. Other websites have created coronavirus trackers with quasi-real-time updates of case counts and death tolls. Yes, there are many financial journalists with integrity who do excellent investigative work and write insightful articles. The media *as an industry*, however, has a business model based on selling ad impressions attached to content. Fear is a powerful motivator and Coronavirus has been a godsend.

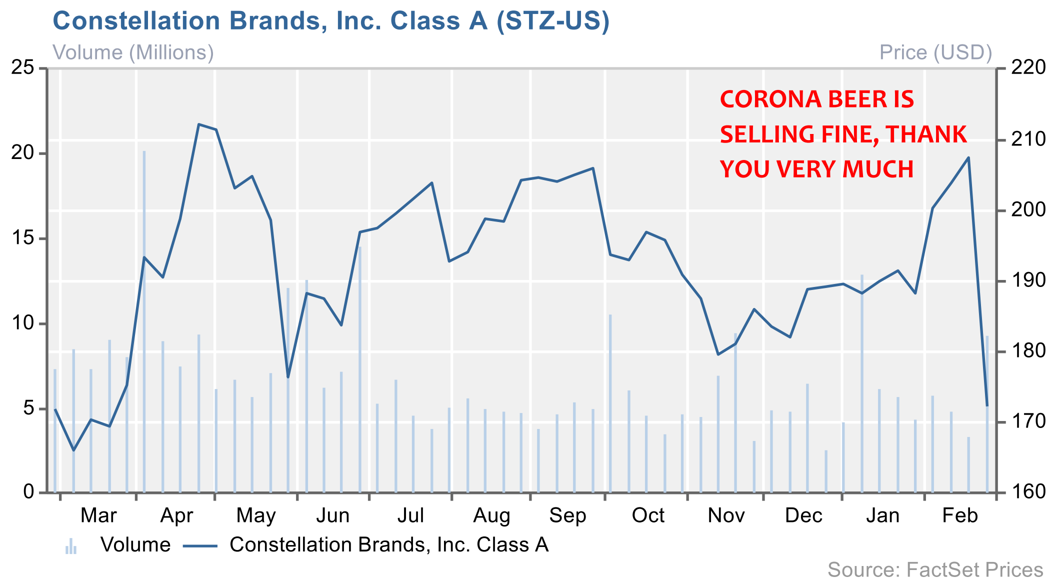
Sales of Corona Beer are Surging

In this is contained a very important lesson about investing. Responding to inaccurate made-up reports claiming that the spread of Corona-Mania was hurting sales of Corona Beer, Constellation Brands (the owner of the Corona Beer brand), issued a press release late last week revealing that ***the sales growth rate of Corona Beer had doubled***. Surprised? Apparently one billion impressions of the word "Corona" in the news is so powerful that even when twined with "virus" it creates a positive selection bias for consumers perusing the beer isle at the grocery store. This effect is something marketeers have known for a long time.* Our brains are often simple stimulus-response mechanisms and behavior can be depressingly deterministic. There is a whole area of study called behavioral finance that is focused on exploring the relationship between our investing decisions and our brains. Simplistically, we know that our brains are the products of millions of years of evolution and retain structures adapted to survive in the natural world. Unfortunately, the same mental applications that proved so useful in avoiding being eaten by lions or finding the best place to fish have rather the opposite utility when applied to investing. They influence us, among other things, to sell when fearful and buy when feeling good. Frequently, these emotions are unhelpful and as investors it's important to recognize these influences and avoid acting on them. This does not mean we should ignore the unfortunately real impact of coronavirus. Rather, the idea is to escape the Corona-Mania currently gripping the market. Also, still keep an eye out for lions.

*Perhaps coronavirus was in fact invented by the marketing geniuses at Constellation Brands? No, that's taking it too far…

SEE DISCLOSURES ON PAGE 4-5

Figure 1. Please pass the lime: Shares of Constellation Brands, the maker of Corona Beer, fell last week with the market, despite accelerating sales growth.



Professional Investors Are Driven by a Short-Term Incentive Structure, but You are Not

Wall Street is a transaction-driven industry. Above we discussed how media is an industry that creates and trades *content* for advertising and subscription *dollars.* Finance is an industry that creates and effects *transactions* for which it *charges a fee*. Media is focused on impressions, which is how it creates value for advertisers. Finance is focused on generating activity including mergers, acquisitions, IPOs, and trading which may-or-may-not create value for any of the participants. Professional money management is typically viewed as a product, not a service. To be sold, it must be marketed to the public or other professional investors. The basis of the sales pitch is usually the fund's track record, typically expressed in short-term periods (such as one year). Management compensation is tied to producing this performance, and thus it becomes the focus of portfolio managers and analysts who may also have to adhere to complex risk guidelines or investment mandates. If successful, funds hit targets and salespeople sell the product, thereby generating the all-important fee, allowing the music to keep playing and circus to go on. *Bref,* our point is that Wall Street needs to sell you something, and fund managers need to hit short-term targets to be sold. This makes it very challenging for professional managers to avoid getting caught up in short-termism amidst the uncertainty of Corona-Mania. Individual investors, on the other hand, do not have these constraints and should endeavor to take advantage of the situation.

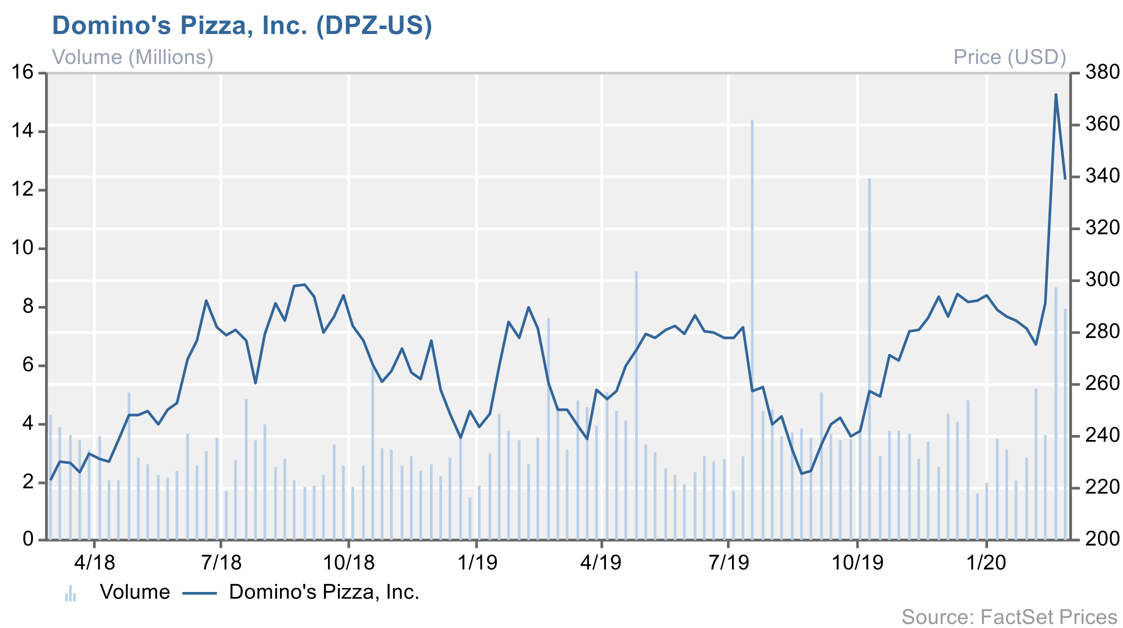
Tying these Threads Together

Corona-Mania is a serious disease, inflamed by the media, transmitted person-to-person via iPhones, and is disrupting industries and economies. Coronavirus is real and it is dangerous for a tiny percentage of people. It's probably less dangerous to you than your morning commute but be that as it may. Corona-Mania, on the other hand, is particularly insidious. It's causing the cancelation of events, a reduction in consumer spending and creating supply chain disruptions. These are and will have a material impact on individual company cash flow production and earnings. Total economic figures will be hurt. This is true for both the U.S. and for other countries, with China especially hit hard. It is rational for stocks to move lower based on this. As we mentioned above, the severity of the decline is amplified by the elevated position from which the fall began and the need for professional investors with short-term time-horizons to reduce risk by selling. We also think it's natural to feel fear given the media onslaught and collective panicking going on all around. That being said, our investment perspective starts by posing the question whether the long-term outlooks for growth, cash-flow and earnings has permanently changed due to Corona-Mania. We believe the answer is no. Accordingly, despite a reasonable expectation that the Mania has not peaked and that prices could be lower yet near-term, we think the best course of action is to maintain positions in the best companies we already own and evaluate the stocks of others opportunistically.

Selection from our Model Portfolio: Domino's Pizza (DPZ)

Could pepperoni pizza act like a vaccine for Coronavirus? We have owned shares of Domino's Pizza (DPZ) in our client portfolio since inception. DPZ is a global franchisor of pizza delivery locations with 17,000 locations in 90 markets around the world. Half the company's revenues come from outside the U.S. The company's franchise model means that margins and return on capital are very high. (DPZ has a 19% EBITDA (earnings before interest, taxes, depreciation and amortization) margin.) The stock has been incredible since bottoming at about $3 per share in November 2008 during the depth of the financial crisis. The reasons for its success have been two-fold. First, in 2009, Domino's publicly admitted that its pizza tasted like cardboard and reinvested in quality and upgraded the product with improved taste. The combination of the better product

Figure 2. Extra cheese: DPZ shares have gained 15% YTD vs. an 8% decline for the S&P 500.



and self-deprecating advertising worked. Secondly, around the same time, DPZ was launching one of the best apps for ordering pizza that included the innovative real-time pizza tracker. This app put DPZ ahead of the competition at a time when the adoption of smartphones was accelerating. Together, these two changes contributed to run in the shares to nearly $300 by late 2018. By this time, however, investors began to become concerned that the explosion of food delivery services (Uber Eats, GrubHub, DoorDash, Postmates, etc.) was creating incremental competition for the pizza delivery category in general and Domino's specifically. DPZ's sales growth did slow. Expectations were reduced and DPZ shares traded in a range over 2019. Until a week and a half ago. The company reported a surprise acceleration in sales, which burst the bear-case that incremental delivery competition was hurting the business, sending the shares up ~25% in one day. We continue to like the company, which fits many of our favorite themes including a strong brand, global footprint, ability to grow, financial position, and innovative use of technology. See figure 2 above for a chart of the two-year performance of Domino's Pizza shares.

March started with a cancelled half-marathon and a cancelled analyst day in New York. Adding to the annoyance of dealing with daily Corona-Mania headlines, my eight weeks of training for the Paris half marathon came to naught as the race was cancelled at the last moment. Apparently 44,000 healthy people running outside is a greater risk for Corona-transmission than the daily transit of one million people enclosed in the Paris Metro, which proceeds unrestrained. Tomorrow I am (probably) still flying to New York (who knows I could become gripped by fear on the way to the airport and call it off) where I was previously planning on attending the now-cancelled Target Corp. (TGT) analyst day presentations. Beyond that I also have plans (likely to be cancelled) to meet with the new CEO of Tractor Supply Corp. (TSCO). I am also scheduled to give a guest lecture at a graduate-level securities analysis class at Columbia University.

Do you already have enough ETFs and mutual funds? If you are looking for a more concentrated, thoughtful portfolio constructed by a manager available to answer your questions, please get in touch. You can sign-up for our newsletter or read past editions on our website by clicking this link .

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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York and Paris, France.

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The analyst who is the author of this report has a long position in shares of Domino's Pizza (DPZ). Quo Vadis prohibits analysts from trading in a way that is inconsistent with opinions expressed in reports [subject to exceptions for unanticipated significant changes in the personal financial circumstances of the analyst].

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