thoughts

FROM HANSON+DOREMUS

MAY 2024

Help wanted: Seeking a hard working inflation slayer...

Price increases have moderated this year, to a 3.5% increase on an annual basis. That's good news. But consumers are still glum. They remember the 8%-9% annual increases back in mid-2022 and are still struggling to digest the consequences.

When there was plenty of Covid money around this was not such a big issue. But the pandemic income bonanza is over, and consumers today are trying to dodge higher prices wherever they can. McDonald's recently noted, "consumers are more discriminating with every dollar that they spend."

In the grocery aisle, there is a new kid on the block who is painting itself as America's food inflation answer. Aldi is a big German food discounter that is expanding rapidly in the U.S. (the name Aldi is a combination of Albrecht, the founding family name, and Discount). It is still a private company, with a rather peculiar history. When the two Albrecht brothers inherited the Aldi business from their father 60 years ago, they disagreed on whether to sell cigarettes. One brother wanted to. The other thought it would lead to too much theft.

So they split the company. Aldi Nord took over stores in northern Europe and Aldi Sud got the south. They each have expanded to the U.S. Aldi Nord bought Trader Joe's but doesn't operate Aldi stores here. Aldi Sud is the sole operator of Aldi stores in the U.S. Clear, right?

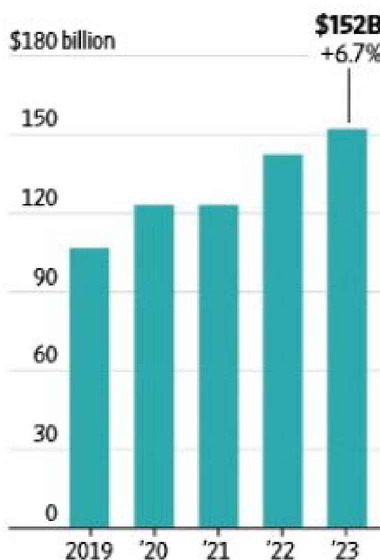
Aldi is razor focused on price. Their stores are small, less than half the size of a standard supermarket, and they sell only about 1,600 unique products compared to over 30,000 for, say, Kroger. Ninety percent of what they sell are no-frill private label items which means lower prices. Like Costco, products are sold in the same cardboard boxes they are shipped in.

And finally, a unique feature is the use of digital price tags throughout the store. Prices shown on the shelves can be changed automatically by computer, cutting down on costs and staff needs. According to the consulting firm Customer Growth Partners, a basket of 50 typical household items is 6% cheaper at Aldi than at Walmart.

Aldi recently purchased the parent of Winn-Dixie supermarkets, and if current plans pan out, they will be second in terms of number of stores in the U.S. in five years. Aldi does little marketing which is one reason you probably haven't heard much about them, and they are still only about 3% of total U.S. grocery sales. But if inflation continues its relentless march, you may become a lot more familiar with the company in the future.

- Eric Hanson

U.S. FOOD AND BEVERAGE PRIVATE BRAND SALES



PRIVATE BRAND SHARE OF OVERALL U.S. FOOD AND BEVERAGE SALES

Source: *The Wall Street Journal*; Circana

Hanson+Doremus Investment Management is a registered investment advisor offering integrated investment management and financial planning to individuals, businesses, and nonprofits. It was founded in 1995 and is regulated by the U.S. Securities Exchange Commission.

802.658.2668
hansondoremus.com

431 Pine Street, Suite 302
Burlington, Vermont 05401

©2024 Hanson & Doremus Investment Management

SPORTS MARKETS

By Evan Pemberton

Psychology and the NFL draft...

The NFL Draft was held last month in Detroit to record-breaking fanfare. Over 770,000 fans attended in person and the event was broadcast on multiple networks and media platforms. But it's not just spectacle, the draft has evolved into a highly strategic event and a dynamic marketplace for new players. As investors, when we see a market we often wonder, is that market "efficient"— meaning, do NFL teams price their talent accurately?

The draft's structure is straightforward. Teams select newly eligible players, primarily from college, with the worst team from the previous season getting the first pick in each round. The second-to-worst team gets the second pick, and so on, down through picks and rounds until all players are selected. These picks can be traded, and the market has become very advanced. But that was not always the case.

The first big innovation came in the early 1990s. Jimmy Johnson, then coach of the Dallas Cowboys, developed a chart assigning specific values to each pick. For example, 3,000 points for the first overall pick, 2,600 for the second, down to the final pick worth just two points. The system gave Johnson a framework for draft decision-making, and he used it to great effect, completing 51 trades over five years. This was a big change, and Johnson's success with the Cowboys, including multiple Super Bowl wins, led other teams to develop their own valuation charts, trade more strategically, and act on their improved sense of each pick's value.

Then came the psychologists, who questioned how good teams actually were at putting a value on draft picks. Daniel Kahneman, the Nobel laureate who died in March, identified cognitive biases that cloud our judgement. Kahneman applied much of his work to the field of economics and how investors behave in financial markets. Leaning on his work, and recognizing similarities between financial markets and the NFL draft, economists Richard Thaler and Cade Massey studied the draft in research published in 2005.

They found that Kahneman's "overconfidence bias", so prevalent in investing, was also alive and well among NFL teams, which systematically overvalued early draft picks and undervalued later ones. They put too much weight on their ability to choose. The learning was that draft picks across rounds are more evenly valued than Johnson's chart might suggest. "Trading down," or swapping one first-round pick for multiple later-round picks, could exploit this bias.

PERCENT OF DRAFT PICKS TRADED AT LEAST ONCE

Source: *New York Times* and ProSportsTransactions.com

These insights have contributed to a rise in trading activity in the market for draft picks, with a recent *New York Times* article showing that the percentage of picks traded at least once has risen from 10% to over 50% since 1970 (*chart above*). Additionally, recent analysis from Dartmouth Sports Analytics indicates that trades now align more closely with predicted draft pick values, reflecting a trend towards a more analytical, data-driven approach and more efficient pricing.

But there are still plenty of examples of inefficient trading. Teams often get hyper-focused on a specific player and will trade away too much "draft capital" to move up and "get their guy." For instance, in the 2023 draft, the Panthers traded a star player plus four draft picks to move up from the ninth to the first overall pick. Their selection ended up struggling in his rookie season.

Another issue might be the dazzle of headline statistics from the NFL Combine. This event involves scoring players on various drills like the bench press, vertical leap, and 40-yard dash. It's not uncommon for teams to fall for impressive Combine results and overlook the player's actual on-field performance. There are many examples of teams drafting speedy players assuming they can then coach them into good receivers.

One of the tricky things with cognitive biases is that being aware of them does not necessarily make us less prone to committing errors. Investors fall prey to this same trap all the time. As for the NFL, at least for now it seems teams are on a level playing field in terms of the analytical tools they bring to the draft.

By Neil Macker

What's in a moat?...

At Hanson + Doremus, one of the primary qualities we screen for in prospective companies is the presence of an economic moat. While I am still relatively new here, I spent the last nine years as a senior equity analyst at Morningstar where moats are so highly thought of that the concept forms the foundation for the firm's stock research philosophy. So why are moats important?

The concept is neither exclusive to Hanson + Doremus nor new. Warren Buffett, the legendary investor and chairman/CEO of Berkshire Hathaway, popularized the term and has used it in his widely read annual shareholder letter well over 20 times since 1986. Buffett describes a moat as the qualities that defend the valuable "castle" (i.e. the company) from external threats (i.e. competitors). A firm with an economic moat owns a durable competitive advantage that allows it to outperform its competitors over several years. In theory, a moat should help the firm earn excess cash flows and higher returns than its peers. This advantage is durable if the moat protects these returns persistently, for a decade or more. Higher returns in terms of cash flows over multiple years should increase the intrinsic value of the company.

At Morningstar, the obsession with moats meant the firm attempts to add some rigor to a process that remains as much art as science. We would look qualitatively for the presence of a moat from five potential sources:

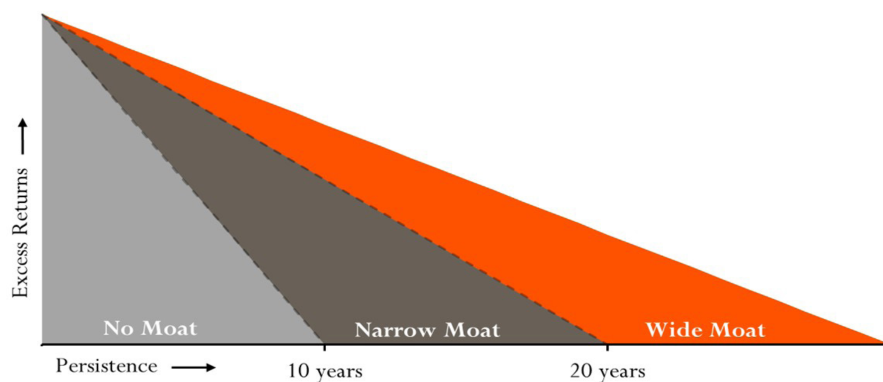
1. **Intangible assets** are brands, patents, proprietary technology, and regulations that allow firms to charge more for their products.
2. **Cost advantage** is the ability to produce goods or services at a lower cost than competitors and thus offer lower prices or generate higher margins. This advantage is usually the result of size, closeness to customers, and/or lower cost of raw materials.
3. **Switching costs** are the one-time costs customers incur when changing from one product/service to another. The costs, in terms of money, time, risk, and/or hassle, can sometimes be high enough to deter the switch.
4. **Efficient scale** exists in markets small enough to be served by one or a few companies. New entrants are deterred from entering since returns won't be large enough to survive (examples include regulated utilities, wireless telecom, and railroads).
5. **Network effects** provide a moat when new and existing users gain value from a good or service as more users join the network. Economic profits to the firm must also increase with users, as with Facebook, eBay, or Windows.

Analysts also use a quantitative screen to understand how durable a moat is. For a "narrow" moat, the analyst's cash flow model must deem the firm's excess profits are more likely than not to persist for more than ten years. For a "wide" moat, this advantage must persist for more than 20 years. Companies whose excess profits disappear less than ten years into the future receive no moat rating (*see chart at bottom*).

For a brief example, we can turn to Costco. Costco's wide moat comes from cost advantage and intangible assets. The cost advantage is evident to anyone who has shopped at the firm's no-frills warehouse stores. Costco offers a low number of products (4,000 SKUs) relative to either Target (80,000 SKUs) or Walmart (140,000 SKUs), simplifying both procurement and supply chain logistics. Additionally, the modest annual membership fees generate enough income to allow the firm to offer very low prices. The intangible assets for Costco are its deep supplier relations and vast consumer data set, which help with selecting the right products for both national and local distribution. As a result, Costco has been able to generate excess returns consistently for decades.

While moats are very important, we don't simply invest in every firm with a wide moat—and there are good investments that have no moat at all. We examine a mosaic of information that also includes company fundamentals, opportunity costs, portfolio construction considerations, and other factors. And of course, as value investors, we care deeply about the price we pay for what we're getting.

MEASURING A MOAT - EXCESS RETURNS OVER TIME



Source: *Morningstar*

FROM THE OBITUARIES

By Eric Hanson

In lieu of flowers: Lives worth remembering...

Obituaries are not a regular part of our newsletter. In fact, this is our very first page highlighting recent obituaries. These three people are very different but they each made unique contributions to our world.

Amnon Weinstein's father, a Jew, escaped to British-run Palestine just before World War II. The family was lucky but not so were many of their relatives, who didn't survive. When Weinstein asked his mother about this, she showed him pictures of the Ponary Forest, near Vilnius in then-Poland, where the Nazis killed 100,000 people, mostly Jews.

Amnon followed his father into the business of making and repairing violins. In the 1980s, a man brought in a badly damaged violin which he said his grandfather played walking to and from the gas chambers at Auschwitz alongside those selected to die.

After repairing the instrument Amnon went on to save and repair hundreds of Holocaust era violins. This led to a project, Violins of Hope, where professional musicians using his instruments played concerts across Europe and America. Earlier, the violins had witnessed indefensible death and sadness. Now these restored instruments symbolize a message of victory and hope. Amnon Weinstein lived to 84, dying on March 4, 2024.

Walter Shawlee II, the creator of the website, "The Slide Rule Universe," was

AMNON WEINSTEIN

Source: *The Economist*

WALTER SHAWLEE

Source: *The New York Times*

dubbed Mr. Slide Rule by his many followers. He died September 4, 2023.

Walter Shawlee was a college dropout and a tinkerer/engineer who started and ran a small, successful aviation communications firm. Then in the 1990s he rediscovered an old slide rule which, as a teenager, he had saved up all summer to buy. This reignited a passion for everything slide rule and led to a full time career selling, repairing, and reporting on the world of a bygone device. He bought slide rules everywhere and some observers claimed he "cornered" the world market. At his death there were over 1,000 slide rules on his dining room table.

Slide rules were replaced by electronic calculators in the 1970s, but many engineers still feel very nostalgic for the analog calculator. As Joe Pasquale, a computer science and engineering professor at the University of California San Diego notes, with electronic calculators you blindly accept the results on the screen. You lose your number sense. Slide rules require you to be actively involved in every step of your calculation. Mr. Shawlee was 73 years old.

Michael C. Jensen, one of the most influential and divisive economists of his generation, died on April 2. Jensen grew up in Rochester, Minnesota in a family that struggled with finances. After graduating from Macalester College, he completed his PhD at the University of Chicago. He taught at the University of Rochester before becoming a professor at Harvard Business School.

In the 1960s executives were taught that companies should have a social conscience. In 1970 Milton Friedman countered by arguing that the sole mission of a corporation was to produce profits. Professor Jensen, a free market advocate like Friedman, took this one step further, writing that to better align corporate executives with shareholders you needed

MICHAEL JENSEN

Source: *The New York Times*

to add incentives. Chief among these were stock options and the use of golden parachutes, the latter ensured that executives didn't worry about losing their jobs in a takeover.

Later in his career Jensen, who was one of the most influential professors at Harvard in the 1990s, came to rue many of his proposals. He claimed stock options had become "managerial heroin" and that corporate incentives in general had spiraled out of control. Professor Jensen was 84 years old.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Hanson+Doremus Investment Management ("Hanson+Doremus"), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Hanson+Doremus. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Hanson+Doremus is neither a law firm, nor a certified public accounting firm, and no portion of the newsletter content should be construed as legal or accounting advice. A copy of Hanson+Doremus's current written disclosure Brochure discussing our advisory services and fees is available upon request or at www.hansondoremus.com