CUBICASSET MANAGEMENT, LLC

2020 2nd Quarter Stock Market Commentary

RE-LEARNING THE THREE Rs

"Leaders win through logistics. Vision, sure. Strategy, yes. But when you go to war, you need to have both toilet paper and bullets at the right place at the right time."

- Tom Peters

In 1987, a fourteen-year-old boy named Ahad Israfil, was shot in the head when his employer accidentally knocked a gun onto the floor. The shot destroyed most of one side of his cerebrum, necessitating a five-hour surgery in which doctors removed one side of his brain completely. Surprisingly, Israfil eventually recovered most of his faculties, and even went on to earn a college degree.

This operation, a rare procedure known as a hemispherectomy, has been performed hundreds of times at Johns Hopkins University as a last resort treatment for individuals (mostly young children) with severe epilepsy who suffer hundreds of debilitating seizures each day. Remarkably, a 1996 study of 52 individuals who underwent this operation found no long-term effects on memory, personality or sense of humor, and minimal changes in cognitive function. Roughly 20% of patients who have this procedure go on to find gainful employment as adults. This is an astonishing illustration of the brain's resilience, its ability to compensate for dramatic loss of brain structure to regain nearly normal function.

Biological systems have evolved other mechanisms to preserve fitness. For example, it has been known for some years higher organisms frequently exhibit genetic redundancy. This is a situation where two or more different genes code for the same protein. When this occurs, a mutation in one gene will have little or no effect on the functioning of the organism.

Both resilience and redundancy produce what is known as robustness, defined as the persistence of traits and abilities under unexpected disturbances. These three Rs (resilience, redundancy and robustness) are what enable biological systems to endure despite genetic mutations and sudden environmental changes.

But robustness comes at the expense of efficiency. After all, it is costly in terms of resources to maintain alternative or duplicative systems. Unfortunately, over the past 35 years, too many business leaders have opted to sacrifice the safety provided by robust systems on the altar of

short-term profitability, by adopting lean manufacturing and just-in-time inventory techniques, and by leveraging up balance sheets to boost return-on-equity and earnings-per-share. It has taken a catastrophe like the COVID-19 pandemic to reveal the consequences of this trade-off.

Prior to the novel coronavirus, Paul Martin, Dean of the Rotman School of Management in Toronto, offered an illustrative example of the danger inherent in maximizing efficiency. For most of America's history, almonds were grown in many different parts of the country. But it turned out that California's Central Valley had the perfect microclimate for almond production, and companies could achieve economies of scale by concentrating production in a single geographical area. As a result, that region now produces more than 80% of the world's almonds. The industry made a conscious decision to design away its redundancies, leaving it vulnerable to a drought or a new virus. Moreover, since all the almond trees have the same soil and weather conditions, they require pollinating by bees during the same brief interval. Bee colonies need to be trucked in from all across the United States. However, a massive bee colony collapse has created concern that there will not be enough bees to do the job.

Just-in-time inventory and lean manufacturing refer to the system developed after World War II by Toyota Motor Corp under which companies boost efficiency by accepting small quantities of parts from suppliers as they are needed, rather than maintaining extra inventory. It allowed Toyota, Honda and Nissan to out-compete their more bloated rivals in the global automobile market who moved to adopt these techniques. But then in 2011 came the devastating earthquake and tsunami in coastal Japan north of Tokyo. This severely disrupted supply chains around the world and caused a rethinking of just-in-time inventory. Cars like Lexus and Infinity, which were manufactured only in Japan, were not available for months. But even American car manufacturers were affected. For example, the German chemical used company Merck KgaA had a single plant worldwide producing a type of automobile paint that gives a car a metallic sheen, called Xirallic. The plant was exposed to radiation from the Fukushima reactor and no stores of the product were held in inventory at other locations. The result was that General Motors, Ford and Chrysler had to limit orders in specific colors. Since that time, Merck has begun maintaining inventories of this product at sites scattered around the world.

The above example of the business risk inherent in the use of just-in-time manufacturing is only one of many similar occurrences. The 1995 earthquake in Kobe Japan disrupted the production of brake shoes for Toyota cars sold in Japan at its sole supplier. The resulting loss of production cost the company an estimated $200 million. In March 2000, lightning struck Ericsson's cell phone manufacturing plant in New Mexico, knocking it out of commission. Over the following eighteen months the Swedish company lost over $2 billion in sales, eventually forcing it to enter a joint venture with archrival Sony.

The COVID-19 pandemic has brought into stark relief the vulnerability of our supply chain for drugs and personal protective equipment. In January 2020, shortly after the Chinese government made the world aware of the epidemic in Wuhan, one pharmaceutical maker alerted the FDA that it would be unable to supply one drug because it is sourced from a shuttered Chinese plant. The FDA declined to name the drug, but did initiate communication with 180 different drug manufacturers about potential disruptions and identified another 20 drugs that are vulnerable to

disruption. The vast majority of generic drugs available in the United States are produced in India, but the active pharmaceutical ingredients are primarily sole sourced in China.

It is interesting to note that there is one large industry in which just-in-time (JIT) manufacturing has taken a back seat to other business objectives – the defense industry. The goal of JIT is to reduce waste and increase profits. But the primary objective for the Department of Defense is defending the United States and its national interests. This requires the forward positioning of equipment, in direct opposition to lean inventory management, and the flexibility to deal with a wide number of low probability scenarios.

It is not only in manufacturing that companies have strived for leanness. Activist investors have pushed managements to return "excess" cash to shareholders in the form of dividend and share repurchases. At the end of 2017, there was approximately $2 trillion in cash on corporate balance sheets, much of it parked overseas. The tax overhaul legislation that was passed that year gave companies the opportunity to repatriate those funds at a relatively low 15.5% tax rate, down from 35% prior to the law's passage. Activist investors, like Nelson Peltz at Trian Fund Management, Glenn Welling of Engaged Capital, Value Act's Jeff Ubben or Paul Singer at Elliott Management, to name a few, were quick to target companies that they believed needed to "reform" their working capital management by returning cash to shareholders in the form of increased dividends and share repurchases. The word *reform*, in this case, should be interpreted to mean to help enrich the activists at the expense of the resiliency that would be so useful in the current crisis. The targets included such corporate stalwarts as Proctor & Gamble, Honeywell, Benchmark Electronics and Microsoft. According to a Price Waterhouse Coopers study published in the Harvard Law School Forum on Corporate Governance, companies increased spending on dividends and share repurchases from 22% of operating cash flow in the year prior to being targeted, to 37% the year after. Activists were quite successful in reducing the robustness of the business model of corporate America.