Banyan Capital Management

April 25, 2017

Dear Client:

Banyan's equity composite was up 6.9% for the first quarter 2017 while the S&P 500 was up 6.1%. Although it is not our first goal to outperform the index, we are always pleased when that happens. (Exclamation of how composite is compiled)

As you have surely noticed, we regularly refer to "economic moats" in our research reports and when discussing investments. We have not taken the time to fully explain what we mean by this and why it matters. Allow us to clarify.

Warren Buffett famously likened a business to an economic castle. If the castle is prosperous (i.e. profitable), raiders (i.e. competitors) will try to sack it (i.e. steal its customers). The owners need economic moats (i.e. competitive advantages) to stifle the raiders' efforts.

The usefulness of this visual is profound. People prefer higher profits, all else equal. This preference is the "invisible hand" directing capital in a capitalist economy. If a business is extremely profitable, capital will flow into the market to finance firms trying to replicate the business's success. This increases competition, and competition corrodes profits.

This is great for consumers, for it makes them the bosses of corporate America. They vote with the all-mighty dollar, and capitalists listen astutely. But what is good for the consumer is not always good for the capitalist. Quite literally, a business's success sows the seeds of its failure, and that makes sustaining excess profits problematic.

To sustain excess profits, a business needs the protections of an economic moat. In other words, the business needs a "competitive advantage," which is a trait barring competitors from competing on equal footing. There are numerous sources of competitive advantages, but they generally result from one of two things – sticky customers or lower costs.

American Express (Amex) is a prime example of a business with a competitive advantage. Amex's "closed-loop" network and affluent customer base allow it to offer more rewards at a given level of profitability, which allows it to retain customers in the face of intense competition. That competitive advantage gives rise to a wide economic moat, allowing Amex to earn excess returns for decades.

Wheat farming is a prime counterexample. Wheat is wheat and virtually anyone can grow it. If wheat farmers begin earning excess profits, money will flood into the market. Wheat farms will crop up everywhere as capitalists gobble up the opportunity. Ultimately, wheat farmers' profits will dwindle to mediocracy as supplies rise and prices fall. The wheat farmers' success sowed the seeds of their failure.

With that said, economic moats are not all-powerful. Businesses with competitive advantages are strong because they are built to withstand competition *in a given environment*. When the environment changes, however, they may no longer be well-suited for the competitive dynamics that follow. Therefore, investors must also avoid unstable environments.

Take Sears Holdings as an example. Sears's general merchandise catalog's ubiquitous circulation provided a competitive advantage when businesses sold goods to rural Americans. Then brick-and-mortar stores became the preferred channel of distribution as Americans moved off the farm and into the suburbs. Sears successfully pivoted, but now the internet is becoming the preferred channel of distribution. Sears missed this trend, and its brick-and-mortar empire, once an advantage, has become a disadvantage. Sears is dying a slow death as a result.

Amex, on the other hand, has a more stable environment, albeit far from rigid. Competitive intensity is high, but the environment has not changed. Card companies still compete on the same basis. As a result, Amex's competitive advantages remain relevant, and its economic moat remains intact. While technology could change this, it has failed thus far. If that changes, so will Banyan's portfolios.

At Banyan, we focus on outstanding businesses. To be outstanding, a business must have a competitive advantage giving rise to an economic moat. In addition, we must be confident that the business's environment is stable. This causes us to shy away from industries ripe for disruption. Otherwise, we cannot ensure the preservation of your capital, which is our primary objective.

It is our goal to ***build permanent wealth*** for our clients. Thank you for the trust you place in Banyan Capital Management.

Sincerely,

Gary L. Watkins
President

Drew D. Estes
Portfolio Manager