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Capital Management

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What is *fin tech*?

Definitions:

The word *Financial* refers to the finances or the financial situation of an entity or individual. It factors in any item pertaining to or related to money matters. It can also refer to the management of money, banking, investments and credit. As a sector or industry, *Financials* are often considered to be traditional banks, insurance companies, broker dealers or asset managers.

Technology can be defined in numerous ways. It is the practical application of science or knowledge to solve problems or invent useful tools. It is an activity that can inform or change culture. As a sector, *Technology* companies are classified into categories like software, hardware, services, online and consulting.

Classifications:

The S&P 500 can be segmented or broken down into 10 different sectors: Healthcare, Technology, Financials, Industrials, Consumer Discretionary, Staples, Energy, Utilities, Materials and Real Estate.

We try to avoid these strict definitions and industry classifications. Instead, our investment philosophy looks for wonderful businesses and attractive valuations regardless of sector. It is coincidental that many of the companies we identify during our process tend to be financial or technology-based businesses.

In the financial sector, our preference is for transaction-based businesses. These tend to be recurring revenue models that generate predictable and sustainable results. We are attempting to identify transparent businesses that do not have complicated and complex balance sheets.

In the US, there are 12,500 banks, credit unions and financial institutions. We would argue that traditional banking is a commodity business, with the commodity simply being the US dollar. Unfortunately, many financials have terribly complex balance sheets. Whether a broker / dealer is proprietarily trading or a bank is making loans, too much uncertainty surrounds their success. We prefer to understand how our companies generate their revenue and income. We model these businesses in excel and make various assumptions about future results. Opaque balance sheets, unpredictable trading results and untimely credit risks are not desired traits we look for.

Most Financials are credit sensitive and therefore quite cyclical / un-predictable. In its simplest form, a bank earns the spread between its borrowing costs (i.e. a savings account) and its loan income (i.e. lending rate). This spread is often a function of interest rates, which tends to be driven by numerous macro factors. The Fed bases its Federal Funds rate on employment and inflation expectations.

Obsolescence:

While we appreciate the numerous benefits of great technological advances, we rarely are on the cutting edge, especially with regards to hardware. With hardware, we view many companies as manufacturers. Products (e.g. computers) have a given lifespan and will get replaced in a certain number of years. Each hardware manufacturer will claim certain benefits like speed, memory, etc. However, we are hesitant to invest in hardware as it can become obsolete quickly. Pricing tends to fall over time, competition is intense and hardware trends can be fickle. Are these manufacturers constantly investing in the latest research and development projects or are they falling behind? It is this risk of obsolescence that worries us. There always seems to be something newer or better just around the corner and we do not have an edge in identifying that latest trend.

Fin Tech:

Like cloud computing a few years ago, Fin Tech has been in the news quite a bit recently. Our view of *Fin Tech* is fluid and somewhat unique. We are looking for any business that is utilizing technology to change an established process or its normal routine. This can range from altering workflows, changing from paper to digital processes. Within outsourcing, it could be moving a human interaction to one that is more computerized. Any opportunity to disrupt the normal flow of money or business is the essence of *Fin Tech*. We realize this is quite broad, but we prefer not to be restrained with category classifications. We have seen estimates that *Fin Tech* is only a $55 billion industry each year. We have also seen guestimates that *Fin Tech* approaches $1.3 trillion dollars annually. We are confident it is somewhere between these two figures.

What are examples of *Fin Tech*?

Here are some real examples to illustrate our views on this constantly changing industry.

Payments:

We believe the digital payments industry is a great example. Many payment companies are considered Computer Service businesses inside of the Technology sector. Once again, we are not terribly concerned about their sector classification. We are attracted to the underlying business fundamentals and opportunity for long-term secular growth. We believe there are literally decades of solid growth for the payments industry. MasterCard estimates that 85% of global purchase transactions are still conducted in cash and check. The adoption of credit, debit and electronic transactions will continue to steadily grow and lower this paper percentage over time.

Companies that will benefit from these trends are the payment networks like Visa (V), MasterCard (MA) and PayPal (PYPL). In addition, merchant acquirers and processers will see growth in their transaction-based business models.   These are often less popular or well-known companies like Global Payments (GPN), Vantiv (VNTV) and Fleetcor (FLT).   These are not credit sensitive companies, but rather are earning revenue and profits on every payment transaction that occurs. We are fans of toll-keeper models, as opposed to bridge-builders (e.g. manufacturers).

Exchanges:

One of our all-time favorite movies is Trading Places. In it, Dan Akroyd and Eddie Murphy can be seen trading orange juice futures in the pits. For a century, floor traders have communicated with complex hand signals and allowed the market to determine fair value and price.   While it can appear to be quite chaotic, open outcry was the best and only way to determine accurate and efficient trading. The open outcry and physical trading market still exists today and covers products ranging from equities, interest rates, commodities, energy, foreign exchange and metals. With the introduction of technology however, this process has begun to be altered forever.

CME was founded in 1898 and was originally known as the Chicago Butter and Egg Board. It was an agricultural commodities exchange, allowing buyers and sellers of butter and eggs to transact. CME created and launched its Globex trading platform in 1992. This electronic trading platform allowed for future contracts to be traded electronically. Transactions could now occur at the exchange, in a booth or even at one's office or home.

New technology allowed for financial transactions to occur easily and more efficiently. One could be thousands of miles away from the physical trading floor and still be able to transact at market prices. This is just another example of *Fin Tech*, but it is over 25 years old. Companies like Chicago Mercantile Exchange (CME), Intercontinental Exchange (ICE) and Chicago Board Option Exchange (CBOE) are all beneficiaries of *Fin Tech* even if this is not a recent development.

Industrials:

While we may be agnostic to sector classifications, could we make an argument that an industrial company is a Fin Tech play? Ritchie Brothers (RBA) is deemed an industrial. It is the largest industrial equipment auctioneer in the world and dominates this $100 billion industry. Instead of manufacturing this equipment, RBA acts as a trusted intermediary to conduct transparent, unreserved auctions. Buyers and sellers of construction, agricultural and transportation equipment leverage RBA's systems to transact and determine fair market value. A few decades ago, transactions needed to occur at the auction site. With advances in technology and online access, the percentage of equipment sold online has dramatically improved. Back in 2012, online business represented 36% of sales. Today, online transactions have eclipsed 50%. Just like the previous exchange example, this is clearly a business that has greatly improved efficiency and volume through technology advances. Although somewhat unusual, this represents another example of *Fin Tech*.

Looking forward:

Bitcoin is a controversial payment system and digital asset. Many deem it to be the epitome of *Fin Tech*. We take a slightly different approach to viewing this developing market story. Some argue that bitcoin is an emerging digital currency. We disagree. In our opinion, a valid currency is something that can be widely used as a medium of exchange for products or services. It should be a generally accepted form of money, coins or paper notes. This currency normally gets issued by a government and then gets circulated within an economy. Bitcoins are created as a reward for computing and processing work – called mining. Bitcoin is not accepted as a form of payment outside of a few random locations (roughly 100,000 merchants) and frankly its valuation swings too widely to be deemed a stable form of payment. The use of bitcoins by criminals has attracted the attention of financial regulators, governments and law enforcement officials. The US Treasury categorizes bitcoins as a decentralized virtual currency.

Blockchain:

In our opinion, the network that records payments and transactions for bitcoins is its most interesting development. This public ledger system is a type of open sourced software. It functions as an intermediary. It is a network that records transactions in a public distributed ledger system. This is what is commonly referred to as blockchain technology.

As we attempt to simplify the complicated, we think of blockchain technology as a public ledger of transactions. We do not believe that Bitcoin is the real *Fin Tech* story, but we see ample opportunity for blockchain to become a great technological innovation. It can become the main repository of information about transactions. Examples could range from handling all payment transactions to recording all equity transactions. The end uses are really just starting.

Using a traditional banking example, the blockchain is a full history of one's banking transactions (e.g. ATM withdrawals, bill payments, check deposits, etc). Using this protocol, a database is created and participants can have full access and insight into all transactions. We envision that blockchain technology can become a large opportunity for banks. As they look to track inter-bank transactions, blockchain technology can become a unified solution and reduce the costs of maintaining distinct databases. On the payment front, this transaction ledger can simplify the billions of transactions between cardholder, issuing bank and end merchant. Traditional financial institutions are quite aware of the risk of falling too far behind and are scrambling to make investments in this emerging technology. It is way too early to deem a winner, but we believe this will be a collaborative effort with multiple participants.

Conclusion:

Is using a card simpler than using cash in a taxi? Is swiping a card simpler than fumbling with a coin or token on a subway? Is it easier to use coins or cash to pay tolls or utilize an automated system like Easy Pass or Sun Pass? These are just a few examples of how *Fin Tech* is becoming a larger part of our lives.

Is Visa a financial company since it moves money between customers, banks and merchants? Is it a technology company because it can handle 56,000 transactions per second in a safe and secure manner? Is it a consumer discretionary company since most of us regularly use it for transactions at all types of merchants? We view Visa as a *Fin Tech* company that will be a prime beneficiary of the growth in digital payments.

What our examples show is that one should not rush to judge what is or is not *Fin Tech*. It does not need to be a financial or frankly even a technology company. Instead, we prefer to deem it anything that simplifies or makes a transaction more efficient.

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WHAT IS *FIN TECH*?

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