Retailers Aren't Worth the Risk

by Mohnish Pabrai

Earlier this week I noticed a banner ad on the Internet proclaiming "Ten Stocks to Get it All Back. Click Here".

The proliferation of financial media in the last two decades has created a substantial demand for pundits to rant about their choice stock picks. I find it amazing how all of them have six to 12 great investment ideas at all times. What intrigues me is that these hot picks almost always include a smattering of retailers.

Virtually every retailer entrepreneur got started with a single store. These entrepreneurs saw an offering gap in the market and rushed to fill it. Sam Walton saw that Kmart never opened a store in town with under 50,000 people, and he felt that a population of 10,000 was adequate to support a Kmart clone. His solution was Wal-Mart.

In the 1960s, Leslie Wexner felt that the correct model for women's clothing was to offer a limited selection (hence The Limited) of high-fashion clothing that was cloned from the Paris runways, but produced fast in Asia (hence Express) at ultracheap prices. His innovation was to have no designers on staff, replicate the latest fashions cheaply and fly the merchandise in from Asia. Because of the speed-sourcing innovation, Express and The Limited were able to change the merchandise mix in lock-step with the vagaries of Women's fashion trends, and the chains scaled rapidly.

Howard Schultz noticed the lack of Italian-style small coffee houses in the U.S., and he projected that Americans would pay up for very high quality coffee served in a caf environment. He was right, and Starbucks mushroomed quickly.

Filling the Gap

Walton, Wexner and Schultz were arbitrage players. They saw a gap among the myriad of retail offerings and rushed to fill it. Bernie Marcus and Arthur Blank saw the same gap and created Home Depot while Thomas Stemberg saw a gap in the office products retail space and created Staples. Arbitrage spreads are a low-risk way to make some good money as long as a wide spread remains.

But all arbitrage spreads eventually close. In the case of Wexner, he enjoyed an amazing 30-year run before the model was dead. Everyone had figured it out, and today everyone is cloning and speed-sourcing. Now The Limited is frantically trying to find the next gap. There isn't much hope for that.

Retail innovation is a crapshoot with an extremely low probability of widespread success. Only a minority of entrepreneurs are able to identify the right gaps and then execute to take advantage of it. For every successful retailer, there are hundreds, if not thousands, of failed retail ventures and strategy initiatives.

Another big problem with retail is the transparency of the business. Sam Walton spent thousands of hours inside his competitors' stores. It's virtually impossible to have any trade secrets in retailing. Your competitors can walk into your stores and, in about 15 minutes, understand your entire business-model advantage and how to replicate it. There are very few industries that are as openly transparent, and that is problematic for the long-term investor.

It didn't take long before others began replicating the Starbucks model. Starbucks' arbitrage spread is narrowing every day, and there isn't a whole lot the company can do about it. Building a brand does help slow the decline of the arbitrage spread, but ingenious entrepreneurs are already creating niches within the Italian-caf category and helping close the gap.

Diminishing Advantages

If you invested in Wal-mart , Home Depot or The Limited 20 years ago, your returns would be amazing. But there were virtually no data points two decades ago that would have given you any comfort that these arbitrage spreads were likely to still be there 20 years out. Innumerable highflying retailers from the 1980s aren't with us today.

As an exercise, think of any retailer that appeals to you as an investment today, identify the arbitrage spread it's exploiting, and ask yourself why you believe that gap will remain intact for 20 years, 10 years, or even five years.

Consider the case of Victoria's Secret, part of The Limited. This chain has grown the market for women's undergarments pretty dramatically over the years and has scaled nicely. The chain has a well-established brand, high product margins and a history of strong innovation. As other hungry innovative entrepreneurs see the dollar signs, I can visualize them begin to carve away at chunks of Victoria Secret's market, while others will clone and speed-source all the company's latest innovations and offer them at lower prices. It's not rocket science.

The counterargument is that the Victoria's Secret brand creates a moat that easily insulates it for another 20 years. Also, it does seem that Wexner's team is less likely to miss the next bra trend than they are to get skirt lengths wrong. The less dependent they are on getting fashion trends right, the better off they'll be.

The bottom line on Victoria's Secret is this: The 20-year outcome is murky and unpredictable, with enough of a probability of market lagging returns that you're better off having nothing to do with it.

If you're still attracted to any multibillion dollar retailer, take a look at an article I wrote entitled The Danger in Buying the Biggest (RealMoney, Dec. 12, 2002). Size is a huge factor in future returns, and buying the biggest retailers is fraught with risk.

I'm reminded of a quote by Warren Buffett: *"A horse that can count to 10 is a remarkable horse - not a remarkable mathematician."*

It's likely that the retailers you love are the most remarkable horses. Your best strategy is looking for the most remarkable business.

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