



August 10, 2021

"Roads? Where we're going we don't need roads!!!"

–Doc, Back to the Future

Dear Investor,

The half year mark presents the opportunity to reflect on aspirations heading into the year and expectations for the balance of it. Heading into the year, our letter explored one of the most important mistakes we made in our investing careers and emphasized the clarity with which we now pursue opportunities.¹ With hindsight, the clarity with which we invest seems obvious and all our best ideas fit the criterion neatly, though it took trial and tribulation to succinctly synthesize what we call our 'worldview'. While we are now reflecting on the first half of 2021, we are simultaneously pondering a full year of the COVID-19 pandemic, and we similarly are finding clarity in how we dissect the investment landscape.²

Last year at this time, we introduced our framework for analyzing the impact of COVID-19 and the accompanying global response on companies in "The Tale of Two Markets." We continue to apply our filter, analyzing the temporality or permanence of change induced in each of the winner and loser buckets. This has been incredibly helpful in keeping us focused and nimble around first-order consequence, thematic market trades like "buy the reopening basket," or "sell the winners on tough comps." At the same time, we have found ourselves viewing the world through a new kind of binary prism that is an adaptation of a mental model from improvisational music.

Elliot spent a portion of his guest appearance on the Business Brew with Bill Brewster speaking about his affinity for the band Phish and connecting it to investing.³ Improvisational music takes on many forms, but in Phish-lore there is a distinction between "Type I jamming" and "Type II jamming." Type I is "Jamming that is based around a fixed chord progression" whereas Type II is "Jamming that improvises chord progressions, rhythms, and the whole structure of the music."⁴ In other words, Type I jamming is improvisation around a core structure; whereas, Type II jamming is leaving the structure entirely, in exploration of uncharted territory. Both types of jamming leverage each individual musician's ability to

¹ https://www.rgaia.com/wp-content/uploads/2021/02/Year-End-2020-Commentary_FINAL.pdf

² http://rgaia.com/wp-content/uploads/2020/08/Q2-2020-Investment-Commentary_FINAL-1.pdf

³ <https://podcasts.moiglobal.com/business-brew-s1e17/>

⁴ <https://phish.net/faq/jamming-types>



listen to his band members, feed off the audience and inject spontaneity and randomness into the music itself; however, the distinction between riffing off of a structure and leaving structure entirely is a meaningful one.

There is no precise moment when “structure” becomes “not structure.” Instead, there is a period wrought with tension that inevitably must be released in a push to unity in purpose and direction. Consequently, when structure is left, both risk and reward are amplified by several degrees in contrast to the simpler noodling around a core. Without structure, each specific moment becomes the sole driver for the next direction, with the choice of one individual musician potentially (though not necessarily) steering his peers into a new direction. There is a dynamic feedback loop whereby each musician is listening to the sum of the whole to individually drive his or her own instrument forward, with one bandmate’s choices feeding into the future direction of the group as a whole.

Not since the wake of World War II have the global masses collectively left structure and emerged with a blank slate to reforge a new epoch in humanity. Unfortunately, the tension that makes way for leaving structure as a society tends to be imposed on us by dark forces. A silver lining with the dark tension of COVID is how evolutions in technology facilitated a softening of what could have otherwise been a far more harmful and disjointed transition from normal life to defending against this century’s pandemic. The deployment of technology is not done without its own tensions, but by and large, huge portions of our way of life were able to persist, while others were melded together in an entirely new way. Although some of these changes would have happened via inertia alone, the shock of COVID imposed it all in an instant. As we sit here today with some degree of reopening upon us globally, it feels as though we are in the late stages of the tension period and will soon emerge with a new normal.

More granularly, we see parallels in how all companies were either doing Type I or Type II improvisation around the impacts of COVID-19. In the Type I form, companies were able to take their existing trends and keep driving on and around them in the direction of their existing inertia. For a smaller group of companies, COVID-19 was an entire exit from existing structure, requiring the deployment of existing assets and creation of new assets for adaptation to their new environment. While the shades are binary, in some instances, as is the case with improvisational music, a specific company might have degrees of each. PayPal is such an example--while core trends around the digitization of payments accelerated and PayPal persisted with this inertia, in other ways, the company used the impact of COVID-19 to shake up its developmental roadmap in steering towards the West’s first true SuperApp. This was not in the script nor the structure the company outlined heading into 2020; however, as clearly articulated in their February 2021 Investor day:

what a super app wants to do is turn all of those separate apps into a connected ecosystem where you can streamline and control data and information between those apps. Between the act of shopping, the act of paying for that, all of your financial services can all come together where you create a simple way through



this super app to enable to pay and to track transactions across all touch points. And then you have this common platform and common data that allows machine learning and artificial intelligence to kick in and give personalized recommendations to those consumers.⁵

We are keenly attuned to companies who have stepped into this Type II jamming environment and have the opportunity for asymmetric outcomes given a departure from core structures and forays into new, interesting directions. While these situations are not without risk, the potential rewards are vast. In effect, what COVID-19 has done for such situations is inject complete dynamism into the environment in a way that had not previously existed. In environments which become stale and driven by inertia, dynamism can sometimes lead to tremendous shake ups. Sometimes this dynamism is injected purposely (for example, a hockey team who surrenders an early lead might change their goalie), while other times an outside shock provides the spark. Our research and process gravitate towards situations where change is present--whether that be change on the corporate or sector level--and given our preference for such situations, we are finding some uniquely compelling opportunities.

From Scarcity to Abundance to Curation

COVID changed where we work (work from anywhere) how we watch TV (as evidenced by Roku's acceleration in active accounts), how we speak with our coworkers and family (Zoom), how we pay (digital wallet adoption and buy online, pickup in store), how we eat (soaring delivery and takeout business), where we want to live and what we expect in our homes (millennials finally becoming homeowners, building firepits and outfitting home offices), how we exercise (Peloton) and more.

One of the biggest changes in general is how we shop and one theme we are following closely amidst this dynamism is the transition from the scarcity required by physical commerce to the abundance of digital commerce. Abundance can best be summed up by Amazon's ambition and delivery in building "The Everything Store" to the world. In creating the digital abundance of physical product, where the friction between catalogue, buy button and arrival at your door was driven to the lowest common denominator, Amazon permanently changed consumer behavior. Consequently, the company has been rewarded tremendously by both customers and investors alike.

As everything moves online, our biggest challenge becomes knowing what exactly we want when faced with a panoply of abundance. Even before COVID, we encountered a fascinating article by Alex Carter declaring the 2020s the era of "personalized discovery." Here is how Alex describes where we are headed:

The promise of tech offers so much more: access to everyone and everything, on-demand, at our fingertips, all of the time. With the advent of useful machine learning technologies and the untapped use of social graphs, I believe a huge part of the digital consumer experience in the 2020s will be dedicated to solving

⁵ PayPal Holdings Inc Investor Day, February 11, 2021.



for serendipitous discovery; that is, optimizing personalized discovery across a number of discrete content and product verticals, where queries alone won't suffice.⁶

Each year, tech companies collect more data on us and their prowess in analyzing and deploying that data grows in tandem with the volumes of information we hand over. Recently there has been much consternation about the darker side of data collection; however, if you truly believe and value curation and the altruistic goals of solving for “personalized discovery” the world has gotten more interesting and we are on the brink of a powerful step forward. When we look through our portfolio, we see several companies who play a role in deploying technology to solve discovery, including Alphabet (beyond the obvious, Google Photos combined with Home is one of the more impressive uses of AI to solve the problem of abundance wrought by liberating picture taking from the physical limitations imposed by film), IAC (both Angi and Care.com), and Match Group, while seeing promising efforts in discovery from Twitter and Naked Wines. During the second quarter, we purchased a new position--Stitch Fix--which is attacking this problem of abundance and the friction of shopping digitally head on with curation and personalization.

Your Own Personal Clothing Store

Stitch Fix is incredibly interesting. Founded by Katrina Lake in 2011, Stitch Fix turned apparel shopping into a delightfully personalized, subscription-based platform. The company collects numerous data points when onboarding a customer from the generics and quirks of each individual's size and shape to tastes in designers, colors and styles. This empowers the company's stylists to curate a “fix” with five clothing items on a periodic cadence (monthly, quarterly, semi-annually, etc.) of the customer's choosing. A box arrives with its contents formerly unseen by the customer, with the constant being each item is already a known fit based on the size and shape of the customer's body type and the trove of data Stitch Fix has on other “look alikes” across their customer base. Of the 5 items, a customer can keep all or none, but they must pay \$20 irrespective of whether they keep anything. After reviewing the items, a customer can keep all items (for which they would get a 25% keep five discount) or return some items and checkout online to pay full price.

We owe immense gratitude to Mario Cibelli for helping us think through this company the right way (Mario covered the company in depth with Elliot on a recent episode of This Week In Intelligent Investing).⁷ It is a company we first analyzed and found interesting heading into IPO, deploying the same customer lifetime value framework that led us into our Roku position early. Stitch Fix was intriguing and challenging through this lens, because churn is high in the measurable data, making the CLTV of each individual customer very sensitive to small changes in churn. Mario insisted the more appropriate way to

⁶ <https://medium.com/@AlexCartaz/the-2020s-personalized-discovery-9224282efea3>

⁷ <https://twiii.podbean.com/e/special-surviving-20-years-stitch-fix-deep-dive-with-mario-cibelli-and-elliott-turner/>



think about this company is comparing them to a retailer like Nordstrom. People start their journey with Stitch Fix, buy a bunch of clothes over several months and then shut off the subscription once a satisfactory portion of their wardrobe has been replenished. Customers reengage once another round of refreshment is needed, but while some churn is the bad kind, not all fits that mold.

Nordstrom is an interesting example. The oft unstated, but true historical role of a department store was that of curation. A department store by name signaled the range of product a customer could expect, in terms of brand, price and quality. The buyers at department stores were tasked with purchasing inventory fitting of their customer's expectations. Before brands had the opportunity to use the internet and sell direct, suppliers relied on these stores to find customers, and this gave department stores immense value in the ecosystem with customers and suppliers alike. That role has been disintermediated in various ways, from both customer and supplier sides, but with an emphasis on abundance the role of curation has been abrogated by much of the digital ecosystem.

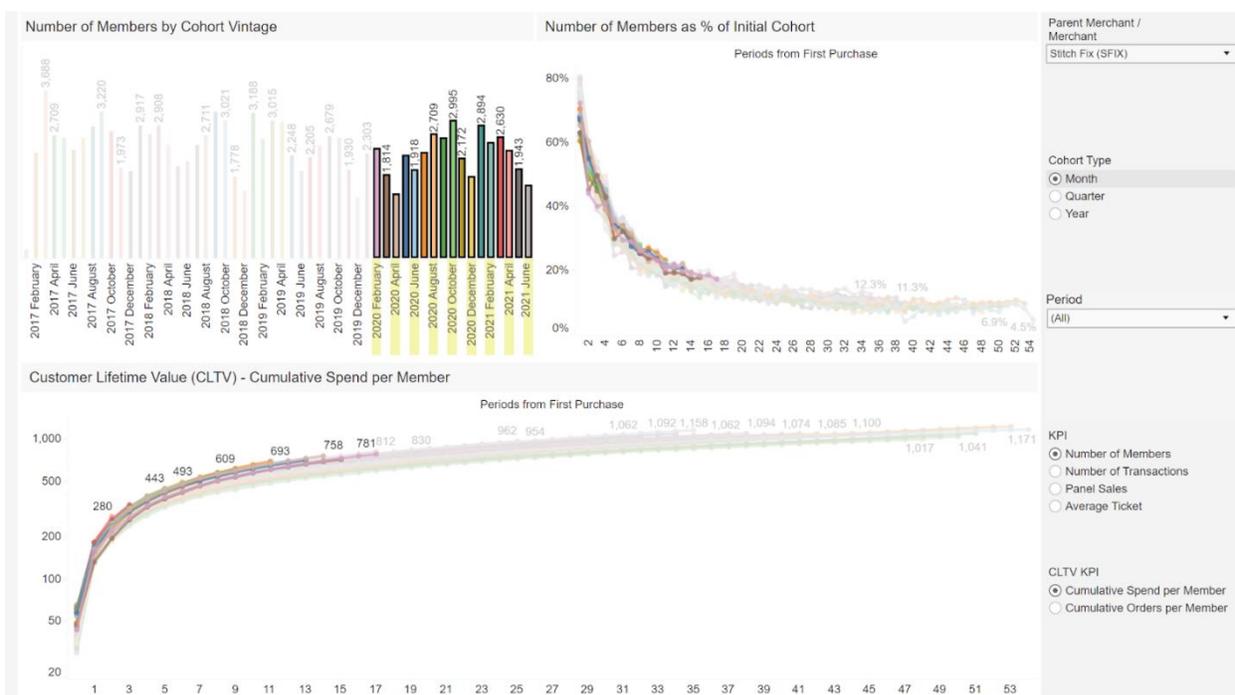
What really intrigues us about Stitch Fix is the push to Direct Buy. The fact that this new offering is reaching customers amidst the COVID backdrop offers a Type II jamming opportunity for Stitch Fix, to depart from core structure and become something fundamentally greater than previously fathomed. While the core fix has some basis on which it is comparable to Nordstrom, the move to Direct Buy makes Stitch Fix a much more similar and accessible experience to the average consumer, but in an entirely novel way. No longer do customers merely need to crave a periodic fix, sight unseen, but rather, now the offering is evolving to a unique tailored store that a customer can shop an assortment of inventory that is uniquely suited to their shape and tastes. Most importantly, every single customer who opens the app or signs into the site will get a personally tailored store that is entirely unique to them alone. Each item will be uniquely tailored and relevant to that customer. Incoming CEO Elizabeth Spaulding is driving the company full speed into the Direct Buy opportunity and while this was in the roadmap heading into COVID, the dynamic environment gives far more opportunity to achieve the lofty ambition. Before it was evident founder Lake would commence a succession process, Spaulding spoke to the importance of Direct Buy on the company's second quarter earnings call:

Now let me discuss some of the exciting progress we've made with direct buy, where the offering continues to scale among our existing clients and increase client engagement and purchase behavior. With nearly 1/4 of our women's active clients having made a direct buy purchase to date, we're pleased to see such strong engagement from our largest client category. In addition, since launch, nearly 2/3 of these women's clients have returned to make repeat purchases within 6 months of their initial purchase. We've also found that clients we've acquired through paid marketing channels in the past few quarters are actively engaging with direct buy and are delivering higher early lifetime values than previous cohorts. Specifically, we've seen that these clients are generating more cumulative contribution profit in their first 3 and 6 months than clients 1



year ago who were largely Fix clients only. This incrementality gives us more optimism to believe that as our direct buy offering expands, client lifetime values will continue to grow.⁸

While we had no reason to question Spaulding here, it was important for us to visualize the veracity and extent of these claims through our subscription with Earnest Research for credit card data.



What you see above in the full colors are all of the cohorts who have been onboarded since Direct Buy was rolled out broadly. What you can see clearly in the lower chart are that these cohorts spend per month is in the upper shading of all cohorts going back to the beginning of 2017. In other words, you can see quite clearly that Stitch Fix is getting more wallet share out of cohorts who have come in since the launch of Direct Buy. In the top right is customer churn. Here too, you can see a clustering in the upper end of the shadowed range for these cohorts, demonstrating that not only is each individual customer spending more, but at the same time, customers are staying on with Stitch Fix for longer periods of time. This makes sense intuitively, because Direct Buy takes what formerly was purely a periodic commitment and turns it into something customers enjoy checking the app for somewhat regularly and a reduced friction shopping experience where buying simply one piece is possible.

⁸ Q2 2021 Stitch Fix Inc Earnings Call. March 8, 2021



Stitch Fix is the perfect example of a company who used one wedge product and now has a platform from which to expand the range of what it can do for customers, while constantly enhancing its own capabilities from data analysis to logistics. Today, Direct Buy remains available only to those who have shopped for Fixes; however, in the coming quarter, Direct Buy will be available for anyone. This will give Stitch Fix opportunities to reactivate past customers and find new avenues to market to new ones. It will also create paths towards more efficient inventory management. While all inventory is owned today, the company eventually sees an opportunity for 1/3rd owned inventory, 1/3rd consigned inventory and 1/3rd drop shipped inventory. These latter two buckets require no capital for Stitch Fix, unlike owned inventory and a sale from either drop shipped or consigned inventory will thus carry a higher return on invested capital even if gross margins are slightly lower (which we do not think will be the case). Also interesting is how Direct Buy consumers choose what product to buy as the algorithm populates their own personalized store, thus no longer necessitating a stylist and the accompanying cost against an order.

Stitch Fix trades at much lower multiples (on EV/S in particular) than similarly situated, growth companies. To an extent, this reflects the market's expectation that the at-maturity margin structure here will inherently be lower than that of some other platforms. Further, we think the market punishes Stitch Fix for having delivered profitability essentially since inception. To Katrina Lake's immense credit, she took one rejection after another on funding her startup as fuel to not only succeed, but do so profitably. This seems quaint at a time when the average growth company with no cash flow is valued far more aggressively than equivalent ones with cash flow. With the push into Direct Buy, short-term profitability and capital intensity will certainly be different (read: less good) than in the recent past, in the short-run, but we think in five years Stitch Fix will be a much larger business and remain on track to deliver on their 12-13% long-term EBITDA margin target. As we size up our DCF, this is a company one would be willing to pay up to \$70 for 10% returns, assuming a 20x terminal free cash flow multiple (a 5% free cash flow yield that at the time should still be growing in the double digits) and a five-year sales CAGR of 20% (which is slightly below the Sales CAGR experienced between 2016 and 2020 containing negative impacts from COVID-19).

Based on these assumptions, we underwrote to a mid-teens IRR from our purchase price. Considering these assumptions are ahead of Street estimates, we think should the company deliver on expectations, we would still be looking at low double-digit returns, and if they fall short, we think the likelihood of an actual loss over five years is fairly low. We expect active client growth to be the foremost driver of the business' growth, despite the evidence that Direct Buy will drive growing wallet share. We are trying to balance our expectation that Direct Buy unlocks incremental client growth, with the fact that its existence alone makes Stitch Fix more like a traditional retailer and thus less likely to capture the full extent of the wallet share opportunity compared to the competitive positioning of the core Fix itself as a subscription service. Even before Direct Buy is available to new customers, Active Client growth is accelerating for the first time in several years, due to the combination of reopening post-COVID, where body types and tastes



have changed, alongside the expanded offering. Given both are in the early stages, we think this is sustainable and can be further accelerated with a sharper, more aggressive marketing strategy around Direct Buy for all.

While these are hardly slam dunk expectations, there is room to fall short on today's expectations and still end up with a pretty good outcome, but more importantly, if Direct Buy becomes the unlock we expect for personalized curation, then the outcome should be far better than how we are sizing it up. John Maynard Keynes is credited (among other things) with the quote that "it is better to be roughly right than precisely wrong," and to that end, we expect our DCF to be completely wrong as time marches on. The beauty is that one need not believe the premise that the world is fundamentally different going forward than it was in the past to grasp the opportunity for Stitch Fix; however, should the post-COVID world prove to sustainably change certain key behaviors, we think Stitch Fix is uniquely positioned to shape the future of the apparel industry. This would open up opportunities currently unfathomable when purely analyzing the inertia of the business on a go-forward basis (inertia being the triumvirate of persistent share gains in apparel generally, a growing customer base and growing wallet share). We are excited to watch this opportunity play out, and jam on.



Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we’ve included our direct dial numbers with our names, below.

Warm personal regards,

A handwritten signature in red ink, appearing to read 'Jason Gilbert'.

Jason Gilbert, CPA/PFS, CFF, CGMA
Managing Partner, President
O: (516) 665-1945
D: (516) 665-1940
M: (917) 536-3066
jason@rgaia.com
[@jasonmgilbert](https://twitter.com/jasonmgilbert)

A handwritten signature in dark blue ink, appearing to read 'Elliot Turner'.

Elliot Turner, CFA
Managing Partner, CIO
O: (516) 665-1945
D: (516) 665-1942
M: (516) 729-5174
elliott@rgaia.com
[@elliottturn](https://twitter.com/elliottturn)

Past performance is not necessarily indicative of future results. The views expressed above are those of RGA Investment Advisors LLC (RGA). These views are subject to change at any time based on market and other conditions, and RGA disclaims any responsibility to update such views. Past performance is no guarantee of future results. No forecasts can be guaranteed. These views may not be relied upon as investment advice. The investment process may change over time. The characteristics set forth above are intended as a general illustration of some of the criteria the team considers in selecting securities for the portfolio. Not all investments meet such criteria. In the event that a recommendation for the purchase or sale of any security is presented herein, RGA shall furnish to any person upon request a tabular presentation of: (i) The total number of shares or other units of the security held by RGA or its investment adviser representatives for its own account or for the account of officers, directors, trustees, partners or affiliates of RGA or for discretionary accounts of RGA or its investment adviser representatives, as maintained for clients. (ii) The price or price range at which the securities listed.