SELECTED INVESTOR QUESTIONS RECEIVED THROUGH JULY 25, 2018

Question
Since key employees are under the obligation to buy CSI shares when they receive a bonus and given the expanding stock price multiple, what measures, if any, have you put in place to maintain employee retention?

Response
We don't think our stock is likely to appreciate in the future at anywhere near the rate it did in the past. That means the opportunity for wealth creation via the employee bonus plan (which is invested in CSI shares) is not as great as it once was. We are offsetting that somewhat by increasing bonus factors for employees. If the employees are instrumental in generating ROIC's and growth at levels similar to the levels achieved in the past, their bonuses will be greater and they will get to invest more in CSI shares than they would have in the past.

If we get this trade-off right, we think most employees will feel that they are compensated fairly, and retention will then become merely a function of providing meaningful work, inspiring colleagues, intellectual stimulus, autonomy, and opportunities to learn and grow… the normal stuff you should be able to expect from work and life.

Mark L.

Questions

1. How do you ignore what the street, media, investors, say about CS and in some cases, yourself? How do you avoid bias (or can you)? Maybe it is just because I am young and inexperienced, but I find it hard to tune out all the noise.

2. How do you set incentives for your team, especially management? To retain talent, sustain a good corporate culture and avoid diluting your human capital.

Response

I've responded to your first question in 3 parts:

"How do you ignore what the street, media, investors, say about CS and in some cases, yourself?"

Most of the time, the street, media and analysts/investors have got it figured out… so I don't ignore them. Sometimes they get it wrong… that's when I try to ignore them.

From your original email it sounds like you are currently working as an investor or analyst. Don't despair. Investors who learn how to provide capital to worthy projects and strive to be great owners can eventually be worth their salt. Sadly, the majority of investors trade pieces of paper in a frenzied zero sum game that arguably adds little or no value to society.

One of the tenets of value investing is that investors who have unpopular but well-founded beliefs ("Correct Contrarians") will outperform the market. Invert that statement, and it implies that Investors who share the street's, the media's, or the consensus investors'/analysts' opinions are much less likely to outperform. As an investor, that is a pretty strong argument in favour of ignoring street/media/investor/analyst opinions if you have good reason to believe that the consensus opinion is wrong.

Constellation was a Correct Contrarian when it entered the vertical market software businesses. We were able to ignore consensus views because we had (and hopefully still have) important facts that others don't have ("IFTODH"). If you surround yourself with curious and questing people, and develop a culture where argument and debate and experimentation are encouraged, then you are more likely to recognise, discover and use IFTODH.

"How do you avoid bias (or can you)?"

The research suggests that bias is incredibly hard to avoid, even for a well-prepared mind. The one defense I've found against unconscious bias, is to surround myself with logical intelligent anti-authoritarian (ideally unemotional) skeptics. They are hard on my ego, chew up my energy, but save me from making fatal mistakes and consistently making the same mistakes. They also provide really good whet stones against which you can hone your IFTODH, and they frequently generate new IFTODH because they are naturally sceptical of consensus thinking.

I love the Merton quote that "Science is organised scepticism". Science has had a pretty good run, so I'm a big advocate of investors and business people cultivating sceptics on their teams.

"Maybe it is just because I am young and inexperienced, but I find it hard to tune out all the noise."

One way to tune out noise is by focusing narrowly. With a tight enough focus, you avoid distraction and rapidly develop the ability to separate signal from noise (within that particular specialty). Value investors refer to this as a circle of competence. At CSI we became vertical market software specialists long before VMS was an accepted term.

If you develop a circle of competence while learning how to discover, defend and use IFTODH, you will be a very rare commodity. Youth will flip from being a liability to an asset.

"How do you set incentives for your team … to retain talent, sustain a good corporate culture…"

Incentives need to be approximately right and perceived as fair. Once people think you are in the ballpark with incentives, it is a bunch of other things like corporate culture that keep the stars and their teams around. By culture, I'm referring to mutual respect, shared values and beliefs, trust, the joy of learning and mastering and sharing. You can't mandate that stuff. It slowly seeps into the coffee and becomes the accepted way that things are done. A bad boss can stamp out a good culture in no time.

For the 6 Operating Group ("OG") managers we have a formulaic incentive plan based on their respective OG revenues (net of third party costs) revenue growth (combined organic and acquired), and profitability (a return on capital measure).

We tried to design the formula to align annual incentive compensation with the annual increase in each OG's intrinsic value.

The OG managers have a sense of their incentive comp at all times based upon the formula and how their OG is performing. Bonuses are paid in cash, but the OG managers must then invest 75% of their after tax incentive compensation in CSI shares that are purchased on the open market. These shares are held in trust and cannot be sold for between 3 and 10 years (it used to be between 3 and 5 years).

We designed the hold periods and the trust to align the managers' capital appreciation with that of CSI's long term shareholders.

I prefer incentives to be formulaic because subordinates are more likely to be candid. When bonuses depend upon a manager's subjective assessment of a subordinate, there's a temptation for the subordinate to optimise their bonus by agreeing with the boss. Formulas also get questions of fairness into the open since the OG managers know the components and relative weightings in the formula and can debate their appropriateness. Not all of our OG managers agree with a formulaic approach to incentive comp… some feel that they have built enough mutual trust between themselves and their direct reports to be able to work with more of an ad hoc approach.

One of the many possible complaints about formulaic incentives is the free-rider problem. Imagine a manager who is doing 50 hour weeks, but is benefitting from an industry tailwind and has a strong group of subordinate managers who are generating superior returns on capital and revenue growth. That OG manager would receive a high bonus. Compare that to an extremely hard working OG manager who is running a cyclical business that is struggling in absolute terms, but doing well compared to its industry peers. An example of the latter would be our Homebuilding OG in '08 and '09, when 80% of their prior years' bonuses were vapourised by the downturn in the homebuilding industry.

All of our OG Managers have been responsible for deploying the majority of their capital to make acquisitions, and for building their teams. If they have built a portfolio of businesses where their investment is disproportionately high compared to the "difficulty" of those business, and their team is not what it should be, then we believe that their incentive should reflect that, irrespective of the effort they are expending to manage their portfolio. Similarly, if the manager has a portfolio of great businesses that "run themselves" and the manager has trained and promoted a competent and inspiring team, then I have no problem with them reaping the incentives provided by the bonus formula. However, if either manager is unethical, is not respected by their subordinates, or is trading off long-term success for short-term profits to optimise bonus at the expense of long-term shareholder value, then we will replace them.

The Portfolio managers and Business Unit managers below our Operating Group managers have incentives that are built on similar, but not identical concepts. Sometimes they have return on sales instead of return on capital as a key portion of their bonus formulas. Sometimes they are allowed to return excess capital rather than deploy it. If all of our managers were experienced and competent capital deployers, I'd hope to see more consistency in our incentive compensation formulas across various levels of the organisation, as that would improve alignment between managers and their reports.

Mark L.

Question

“ … one more answer about IFTODH… these are facts then, not beliefs? … I am working on some small caps, which has been a good learning experience because I usually prefer companies with a proven moat. These small caps are still in the process of building their moat. Is it a IFTODH if I believe their strategy will work, when others don’t?”

Response

You rarely have double blind randomised controlled trials in the business world, and even if you do, the “N” has to be absurdly large for a “fact” to be absolute. Beliefs are about as good as it gets in business and investing. Maybe I should change the acronym to IBTODH 😊.

Mark L.