

This letter is dated March 2021

Introduction: Not for Everyone

Over thirty years ago in a training class for newly-hired investment brokers the head of the firm's investment management group shared his personal investment philosophy. His approach resonated with me. None of my classmates seemed the least bit impressed. Certainly, speakers promoting new and exciting ideas were much more enthusiastically received. I had lost five years of savings on a hot new investment idea leaving me skeptical of anyone touting the next big thing. I was in search of a sound approach and for me his investment principles were like a lighthouse to a sailor in thick fog. All these years later and they are still at the heart of my personal investment philosophy and the foundation of our investment process.

My goal in this letter is to explain, as simply as I can, our approach to investing and the thinking behind it. I am not looking to convince anyone that our approach is the one for them. If it resonates with you, it may be a fit. If not, there are plenty of other options to choose from. I note this because building wealth is difficult and there are stressful tests along the way. I think a personal confidence in your approach makes success much more likely.

We take a different approach than others. It seems that even having an investment philosophy is rare these days. Many people have little interest in understanding what they own. They are mostly just interested in prices. If the price is going up, it must be good. We think betting on price momentum is more like speculating than investing. Those looking to make fast money on crypto currencies or the newest, most complex securities will find our approach is not for them. It is not that we have anything against making money fast, it is that we do not know a dependable way to do it.

To us, high prices, low interest rates and widespread speculation make the current investment environment especially dangerous. While it may not be exciting, we think having a sound process can help investors steer clear of trouble and achieve financial success. Excited buyers can quickly turn into fearful sellers when prices start falling. An investment process can help keep one's perspective squared away.

Our Equity Selection Process: Common Sense but not Commonly Practiced

Our approach is different from passive strategies in that we are highly selective. We prefer to own 20 to 30 positions rather than the 500 or more typically held in index-based portfolios. Our approach differs from the vast majority of active strategies in that we look to hold positions for years rather than trading frequently. We buy to own while it seems the majority of investment managers buy to sell. An important difference in perspective. We believe the most likely path to wealth building is owning quality assets for a long time. That makes the question of what to own especially important. In our experience, the following principles have proved useful in identifying companies well-positioned to deliver attractive compounding returns:

Business Quality Some businesses are better than others. Companies with relatively limited competition and growing demand for their products/services are more likely to make successful investments. Industry structure is often a big factor in the economics of a business. Economies of scale, network effects, regulation, and brand power are all factors that can make the economics of a business especially attractive for industry leaders. Industries ranging from internet search to laundry detergent to business software and transaction processing tend to be dominated by a few highly-profitable companies. We believe businesses that can fund growth through cash flow are less risky than companies that need external financing to expand. Companies that sell low-priced or subscription products/services benefit from steadier demand than companies selling high-priced discretionary products. Lastly, but perhaps most importantly, companies with happy customers tend to outgrow their competition. Enthusiasm for a company's products/services is a great sign for the future and nothing is more important than the relationship between the company and its customers.

Value-Building Management People are a critical factor in most endeavors and investing is no exception. Investors in public companies are dependent on management as stewards of the company's products/services and capital. We look for companies with customer-focused management and a track record of using the company's cash flow and balance sheet to build value. Businesses with expansion opportunities have the potential to be wealth compounding machines. While most investors pay close attention to how much profit a company makes, we think it is even more important to track what management is doing with those profits. Dividends are good but a high return reinvestment

is even better. In our experience entrepreneurial managers with large equity stakes tend to be more effective long-term value builders than highly-compensated executive managers.

Attractive Valuation Paying too much, even for a high quality, well-managed company is risky. While price discipline can lead to missing out on some gains in a giddy market, it can also put us in a better position to capitalize on opportunities when the market's mood sours. We invest when our valuation analysis supports a return potential worth the risk. We will hold cash rather than over pay. We find that attractively priced opportunities come along in time.

Admittedly these principles are more like common sense than a sophisticated investment strategy. This, I think, is a very good thing. Our approach does not require us to be smarter or quicker than the "market". Things we doubt we could do. Executing our approach requires discipline and patience more than anything else. We only buy companies that meet our criteria. Sometimes this means buying nothing. Few investors take this approach, perhaps because so many seem to be in a hurry to make money. Our approach does not promise quick profits. The most likely path to wealth building, in our experience, is in owning a relatively concentrated portfolio of high-quality assets for a long time.

Our Portfolio Building Process: Water the Flowers, Pull the Weeds

Investment decisions are based on probabilities, not certainties. A thorough and disciplined equity selection process can reduce the risk of loss but not eliminate it. Building a portfolio of companies with different performance drivers can help further reduce risk and increase the probability of owning some outstanding performers. In our way of thinking, the key to portfolio management is to let successful positions drive portfolio performance. Simply put, our aim is to make a lot on investments that work and limit losses to a little on positions that don't. Starting with a portfolio of relatively equal-weighted investments allows successful holdings to drive more of the portfolio's performance. The longer the holding period, the more effective. Replacing companies that no longer meet our quality and/or management criteria can help limit losses and increase the potential for owning more outperformers.

Admittedly, like our equity selection process, our portfolio building approach is based on common sense. Still, I am not aware of another investment manager that builds portfolios this way.

We believe that it is possible to build a well-diversified portfolio with as few as 20 positions when careful attention is given to performance drivers. Adding more positions does not necessarily improve diversification. It is possible to build an under-diversified portfolio of hundreds of positions when the holdings are dominated by companies relying on the same factors for success.

Actively-managed funds are generally fully invested day-one. Our portfolio construction can take several months depending on market conditions. This is due, at least in part, to a difference in focus. Our goal is to protect and grow capital over time while most active managers are focused on outperforming an index benchmark each year.

We do not agree with the popular saying that “you do not make money until you sell”. We think the power of compounding favors those holding onto quality assets. Financial markets make buying and selling easy while volatility can make patiently holding difficult. We believe that holding, like buying and selling, is a decision. We view portfolio companies much like employees, the hope is the relationship is long term and their contribution grows over time.

Closing Note: Paying Attention is more productive than Making Predictions

We think understanding what is going on today is the most effective way to prepare for tomorrow. Our work is focused on tracking rather than predicting, on evaluating current data and trends rather than prognosticating about the distant future. In the current investment environment, we see evidence of widespread speculation and inflation. We think that discipline will prove valuable as high prices and speculation typically lead to trouble. In volatile markets, knowing what you own and why you own it can make a big difference. Investing is a personal journey full of challenges and we believe the probability of success is much greater when you are confident in your approach.

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March 2021

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CRC 5411568 04/2026