Conference Call Transcript: January 5, 2017

Ludo Thomasson:

Hello everyone, I am Ludo Thomasson, director of wealth management at Ensemble Capital. Thank you for joining us for our Winter 2017 conference call. Today, the focus will be on the current market and economic situation, the presidential election, and two of our portfolio companies, Paychex and Distribution NOW.

Speaking today will be Sean Stannard-Stockton, chief investment officer of Ensemble Capital and portfolio manager of the Ensemble Fund, and Arif Karim, senior investment analyst.

Sean Stannard-Stockton:

Good afternoon everyone. Ensemble Capital Management offers separately managed accounts as well as a publicly traded mutual fund called the Ensemble Fund (ENSBX). On our call today, I'll be speaking about our general view of the market and economy as well as specific portfolio companies that are held by both our separate account clients and by the Ensemble Fund.

Individual client account performance varies based on a variety of factors including asset allocation and client specific portfolio customization. The Ensemble Fund – which is a pure expression of the equity investment strategy we use across our client base – was up 2.92% in the fourth quarter vs the S&P 500 up 3.82%. For the full year, the Ensemble Fund was up 12.96% vs the S&P 500's increase of 11.96%.*

The story of the fourth quarter of 2016 revolves around the U.S. presidential election, the unexpected win for Donald Trump and the just as unexpected strongly positive financial market reaction to his election.

In the weeks leading up to the vote, financial market participants and commentators broadly expected that Donald Trump would lose and generally agreed that should he win, the market would experience a steep selloff. Yet, on November 8th, investors were reminded once again that not only is their ability to forecast the future extremely limited and error prone, but even if they could accurately predict how the world will unfold, they still can't know how the market will react.

It is this double level of difficulty that makes trying to time the market almost impossible. Yet, rather than accepting that timing the market is not possible, many investors are now falling victim to what behavioral economists refer to as hindsight bias. Suddenly, it seems quite obvious that the election of Donald Trump will result in lower corporate tax rates, less regulation, lower income taxes, government spending on infrastructure and a wide range of other pro-business policies. Yet if this outcome is indeed obvious, why then did market participants so broadly accept the idea that Trump's election would lead to a market crash?

To be clear, at Ensemble Capital we did not expect Mr. Trump to win the election and we shared the concern that if he was, the market might experience a significant decline. We recognize that we are as subject to the behavioral biases that plague investors as anyone else. But importantly, our strategy does not include attempting to predict macroeconomic or geopolitical events and we did not deviate from this practice in either the leadup to the election or in the aftermath. The lesson of Mr. Trump's unexpected victory and the unexpected market reaction to the victory is not an easy one for investors, including us here at Ensemble, to accept. But our investment process is built around a company specific analysis discipline that makes it hard for behavioral biases related to macro events to creep into our portfolio management decisions.

I want to repeat what we said about the election on our last call, prior to the outcome being know. We think that in spite of the unexpected events, these comments are just as valid today:

"The stock market is not a mechanism for passing judgement on everything that happens in the world. Instead, the market is simply a way for investors to trade ownership of various companies whose value is primarily a function of how much those companies will earn in the future. The majority of the issues debated by our political parties, have little impact on the earnings of public companies.

That being said, we do recognize that this election is more unusual than most. Our advice to not let politics drive your investment behavior is not meant to suggest that investors stick their heads in the sand and ignore what is going on in Washington. The outcomes of elections can have a material impact on important market drivers such as interest rates, corporate tax rates and regulation. But by focusing on the economic outputs of politics, rather than simplistically thinking about which party claims victory in the current election, allows investors to evaluate the attractiveness of the specific companies they hold in their portfolio rather than trying to guess which way the market will bounce next."

We mentioned interest rates, corporate tax rates and regulation as three market drivers that can influenced by election outcomes. Today, we believe that these three issues have been the primary drivers of changes in stock market prices since the election.

We'll discuss corporate taxes first. The US corporate tax system is different from almost all other developed nations in a number of ways. The simplest and most obvious is the fact that the stated Federal corporate tax rate is 35%. While decades ago, similar levels were prevalent in many other developed markets, the average corporate tax rate around the world is now around the mid-20% range. In a demonstration of how dysfunctional the US political system has been in recent years, there has been broad agreement on both sides of the aisle that corporate taxes should be significantly reduced. President Obama endorsed a reduction to 28% while the GOP proposed a 25% rate. Yet the because of their inability to work out a political compromise, the rate has stayed stuck at 35%.

For the last couple of years, at Ensemble Capital we have assumed that the corporate tax rate would be reduced over time. We believe that part of what appears to be a relatively high P/E ratio for the US stock market, can be explained by the market pricing in a similar assumption. As an example, if the S&P 500, or any given stock, has a PE ratio of 18x – a 16% premium to the long-term average – under a 35% tax rate, a decline to a 25% rate would increase earnings by 15%, reducing the PE ratio right back to the long-term average.

So, the increased likelihood of corporate tax reform today is a significant positive to the value of U.S. stocks, but one that we have been assuming would occur at some point no matter who was in office. That being said, the positive impact of tax reform will not be spread evenly, with companies (including companies in our portfolio) that generate significant earnings outside of the U.S. likely to see their tax bill increase (again, an outcome we have already incorporated into our valuation models).

But a true wild card related to corporate tax reform persists. The GOP "blueprint" calls not just for a reduction in the stated tax rate, it also includes wholesale changes to the way taxes are assessed. Some of these changes cannot be simply categorized as pro-business. For instance, the proposal to levy a tax on companies that import products for sale in the U.S. resembles a European style VAT tax and the deeply conservative Koch brothers have said that this tax "could be devastating" to the U.S. economy. The GOP "blueprint" also calls for an elimination of the deductibility of interest costs, a major negative for many companies and one that would, oddly, deeply undermine companies such as Donald Trump's real estate empire that depends heavily on use of debt.

So, while we have urged investors not to make calls on the overall stock market due to election outcomes, we are tracking closely the evolution of corporate tax reform and will be monitoring the potential for specific rules that may enhance or detract from the cash flows that our portfolio companies produce.

Interest rates are a second key issue to watch coming out of the election. At Ensemble, we have believed that interest rates have been at unsustainably low levels since the Great Recession and have expected them to increase over time. While the positive reaction in the stock market has garnered media attention, the 5% rally in the market pales in comparison to the 56% increase in the 10-year treasury yield during the same time.

Higher interest rates have a number of impacts on the stock market. Most directly, they increase the cost of financing to corporations. However, because we have already assumed that rates go higher over time, the recent increase helps validate the valuations we believe our portfolio companies should trade at rather than undermine them. On the other hand, stocks that currently trade at levels that is only reasonable if interest rates stay low forever may be in for a rough time.

Our portfolio is currently far more focused on economically sensitive companies than in more defensive sectors. This has been due not to our having a particularly bullish economic outlook, but because we believe that most defensive sectors and stocks have traded at far too high valuations while more cyclical stocks offer significant value to investors. This is an unusual situation given that we are over seven years into an economic recovery. But investors have been slow to reembrace risk and low interest rates have made defensive stocks appear to be attractive "bond proxies" in comparison.

With rates spiking higher, defensive sectors have not participated in the recent rally the consumer staples sector for instance is down over 1% since the election while the utilities sector is also down marginally. Our portfolio continues to be concentrated in more cyclical companies, but as interest rates move higher and the valuations of defensive sectors contract to more historically normal levels, we look forward to our companies specific, bottom up analysis identifying a greater number of companies with limited economic cyclicality to add to our portfolio.

Finally, regulations across a range of sectors is likely to change. We believe it is important for investors to categorically avoid companies whose economic robustness is dependent on government mandates. So, our portfolio does not have heavy exposure to companies which may benefit from more limited regulation. We also think it is important for investors to recognize that government regulation, or the lack thereof, is not likely to be effective in changing long-term economic trends

For instance, while less regulation on coal may be a short term positive for these companies, we would note that the shift away from coal in U.S. power production was not generally an result of regulation but due to the falling cost of natural gas in reaction to advances in fracking technologies.

Likewise, the repeal of Obamacare will not change the fact that the U.S. health care system is woefully inefficient and a massive drain on our country's economic resources with almost 20% of every dollar earned going to pay for health care. So while we would absolutely warn investors to avoid companies whose economic viability is dependent on specific provisions of the ACA, we continue to think that companies who can help reduce the cost of health care while improving patient outcomes have bright prospects over the long-term.

If you happen to be of a political persuasion that causes you to worry that the changes that may be wrought by Donald Trump will be a disaster for the U.S. economy and stock market, I'll quote from our last call once again; "Republicans who bemoaned the election of Barack Obama in 2008 would have done better if they had set aside their concerns and bought stocks." There is no doubt that the market is in a different place today than it was in 2008. And there can be no guarantee that the next four to eight years will generate strong returns for the stock market. But we know too many conservative investors who missed out on the massive rally of the past eight years due to their political views and we suspect that many liberal investors will be prone to make the same mistake in the years ahead.

So, as we enter 2017, we urge investors to recognize the limits of their ability to make accurate short-term forecasts and ensure that the investments they make are predicated on long-term economic trends. Most importantly, we believe that the best way to protect a portfolio from short-term turmoil is by finding companies who possess competitive advantages that will help protect them from the unexpected.

Two companies in our portfolio that we think exhibit these characteristics are Paychex and Distribution NOW. To discuss Paychex, I'd like to introduce our senior investment analyst, Arif Karim.

Arif Karim:

Thanks, Sean. As Sean mention, we generally believe that less economically cyclical companies, especially those with relatively high dividend yields have been viewed by investors as "bond proxies" and given the ultra-low interest rates seen in recent years, these stocks have been bid up to excessively high valuations. For this reason, our portfolio has been more tilted toward economically cyclical, "growth" companies than is normal based on our history.

But we believe Paychex is an exception and as of December 31, this relatively defensive, high dividend yielding stock was the top holding in the Ensemble Fund (7.5%). The company provides payroll and human resource services to small companies. While businesses close and people get laid off during recessions, Paychex's business is surprisingly stable and resilient. During the two-year period ending with their May 2010 fiscal year – in other words, the very heart of the financial crisis – revenue declined a total of just 3.3% from the pre-recession peak. EBITDA – earnings before interest, tax, depreciation, and amortization – was down by 9%. So, while Paychex isn't as defensive of a business as say a Procter & Gamble or Johnson & Johnson, even the worst recession since the Great Depression didn't derail their profit-making ability.

If you think about it, while the 10% unemployment rate seen during the recession was catastrophic in historical terms, it meant that about 5% fewer people were employed than prior to the crisis and that's more or less the amount by which Paychex's revenue declined.

Paychex also offers a dividend yield of 3% -- about half a percent above the 10-year treasury yield – and has been increasing their dividend payment by about 10% in each of the past couple of years.

So, on the surface, Paychex looks like the defensive, high yield stocks, such as those found in the consumer staple and utilities sectors that have been bid up to historically excessive valuations. But while Wall Street analysts are almost universally bullish on Procter & Gamble and Johnson & Johnson, of the 23 analysts who cover Paychex, only 3 rate it a buy and over a third actually rate it a sell. Those analysts almost all recognize that Paychex is a high-quality company. But they almost uniformly compare its PE ratio of about 30 time to its growth rate in the mid-high single digits and proclaim it too expensive. This is despite the fact that the company traded at a PE above 30 pretty much consistently since going public in 1990 until 2007, before the financial crisis lead investors to mark down the shares to historically low levels.

We think Paychex's business model is far more valuable than their revenue growth rate might suggest. First of all, Paychex runs an outsourced business processing service that is largely built and can carry significantly more client transactions without significant incremental costs. So, over the last 10-years, the company has increased service revenue by 85% while their operating costs, or what might be thought of as their cost of sales, has increased by just 53%, yielding incremental gross margins of 78%. So, this is a business that is able to transform a huge amount of new revenue into profits, which they can then reinvest for growth or pay out to shareholders.

Reinvesting in growth is something the company has done well. While the core payroll services industry no longer offers significant growth, the company has done a great job of extending into human resources services, offering such as things as 401k administration, and that segment has grown at consistent double digit rates from about 20% of total company revenue a decade ago to 40% today.

But what really makes the company valuable, is that they are able to deliver growth while needing to invest next to nothing back into the business. Over the last decade, the company has generated net income of over $6.2 billion while the company has reinvested nothing into working capital and just $100 million into fixed assets. With free cash flow in excess of net income in every year of the past decade, the company has been able to maintain a dividend payout ratio of over 80% even while opportunistically buying back stock, executing on the occasional acquisition, and yet have not had to take on any debt.

Most businesses don't operate like this. Most companies require management to allocate a significant portion of earnings to growth. Indeed, the average publicly traded company must reinvest approximately 40% of their earnings in order to grow just 5%. Paychex on the other hand has had to reinvest next to nothing into their balance sheet.

This lack of capital requirement to grow their business means that every dollar of earnings generated by the company is more valuable to its shareholders than the same dollar of earnings generated by an average company. If the average company needs to reinvest 40 cents of each dollar to grow, that dollar is only worth about 60 cents to shareholders. But Paychex only needs to reinvest about 5 cents of each dollar, leaving 95 cents to pay out as a dividend, buy back stock or make smart acquisitions. In other words, a dollar of Paychex earnings is 60% more valuable than a dollar earned by an average company.

It is this cash producing mechanism that drives Paychex stock to be worth such a high multiple of earnings. When analysts look at just the growth opportunity, with is solid, but not exciting, they fail to recognize that amazing cash generation that is at the heart of the company.

Of course, when a company generates cash, it is important that management looks after that cash as if it was their own. But since the founder of Paychex, Tom Golisano, is the chairman and largest shareholder with over 10% of the shares outstanding, we feel confident that the management team will continue to deploy the flood of cash they generate for the benefit of shareholders.

Sean Stannard-Stockton:

Thanks, Arif. From the relatively defensive area of payroll processing, I'm going to take us into the super cyclical oil patch.

DistributionNOW, which is 8th largest holding (4.7%) in the Ensemble Fund as of December 31, is one of just two major distributors to oil producers in the US. Every time a well is drilled and oil is produced, a whole bunch of stuff is used. This can be pipe or drilling equipment, it can be safety equipment like gloves and helmets, or gaskets and valves. All this stuff needs to be purchased and consumed to produce oil and natural gas.

Now the energy market is a commodity business and not an area where you might expect to find the sort of competitively advantaged businesses in which we invest. But we hail from the San Francisco Bay Area, and one thing we know is that the great fortunes of the Gold Rush were not made by the gold miners (a commodity business), but by the people who sold stuff to them. Levi Strauss's jeans and Ghirardelli's chocolate are still names gracing San Francisco because these companies, essentially distributors to early gold miners, were able to build competitive advantages.

Now not every distribution business is a quality company. But some distributors benefit from what is called an Hourglass Distribution model. In the case of DistributionNOW and their one meaningful competitor MRC Global, who between the two of them have about half of the US market share, this means that there are many customers, none of whom are dominant in the industry and there are many suppliers. This leads to a situation where a given oil producer must go out to many different suppliers to acquire the inventory they need and each supplier has to deal with many customers. In this sort of market, as opposed to one where the customer base or the supplier base is concentrated in a few key players, distributors can add significant value to both sides of the transaction and earn a nice economic profit for themselves.

While the company does not generate sky high returns on capital in the way Paychex does, we think they can produce returns well in excess of their cost of capital. And while their end market is highly cyclical, their cash flow is counter cyclical with them burning off inventory during down turns and investing to build their inventory when demand is strong. This internal counter-cyclicality was on display during the past two years when free cash flow was an amazing $2.95 a share in 2015 even while EPS fell to a loss of $0.62 a share as revenue collapsed by 27%. 2016 has been a similar story. While demand has recently rebounded, the company is expected to generate another meaningful loss on the order of $1.50 a share even while free cash flow per share is a positive $1.30 or so.

If you own DistibutionNOW, the cash generation dynamics provides significant protection against a financial crisis at the company when demand for their products goes through the occasional crash that characterizes the oil patch. While the recent decline in oil prices was dramatic, 50% declines tend to occur with frightening regularity. These declines are not simply a function of fracking or changes in OPEC's strategy. They are intrinsic to the nature of industry. Before buying any oil related company, we would advise investors to read the outstanding, Pulitzer winning book *The Prize: The Epic Quest for Oil, Money and Power* by Daniel Yergin that explores the history of the oil industry. The book makes clear that if you want to play in the oil patch, you have to recognize that booms and busts will happen and you must manage your business in such a way that recognizes their inevitability. With DistributionNOW, we think we've found just that sort of business.

While we don't know where oil prices will go next month, we do believe that the number of oil rigs operating in the United States today is well below the level needed to meet demand over the long term. Even though the US rig count has rebounded an amazing 50% from the low this past spring, it is still 60% below the 10-year average rig count that prevailed from 2005 through 2014.

But a great business model isn't enough. You also need an excellent management team that plays for the long term rather than being seduced by the short term "strike it rich" mentality that pervades too many energy companies. DistributionNOW was spun out of National Oilwell Varco, another holding of the Ensemble Fund (4.3%) and when that occurred, the outstanding CEO of National Oilwell, Pete Miller, left to become the chairman of DistributionNOW.

Miller had an outstanding career at National Oilwell with Morningstar naming him CEO of the year in 2012. Miller's gift is in pursuing acquisitions. But while many acquisitive CEOs are seduced by growth, Miller, in the memorable words of one sell side report we rather liked, looked at each acquisition in terms of its ability to strengthen one of Porter's Five Forces, which is the most widely known framework for understanding competitive advantages.

When National Oilwell faced a market without attractive M&A opportunities, Miller pulled the lever to start returning cash to shareholders through dividends and buybacks and spunout DistributionNOW. With a spotless balance sheet without a dollar of debt, a fragmented distribution industry with over 50% of US market share owned by small companies and an opportunity to expand internationally and into industrial customer bases, DNOW looked set up to fully utilize Miller's M&A expertise.

The spinoff occurred right into the collapse of the oil market. With the stock getting decimated along with most other publicly traded energy stocks, the timing looked bad. But as investors, we know that the best time to deploy capital is in a downturn. While MRC Global entered the downturn with a fully levered balance sheet, was not able to do any acquisitions in 2015 or 2016 and even had to issue new equity, DistributionNOW was able to do $700 million of deals (about a third of their market cap) in the last seven quarters at what we believe will prove to have been excellent prices.

Investors don't always have the long-term perspective that we look for in our management teams and there's no ignoring the fact that it felt pretty touch and go back in February when the stock cratered by a third in just two months and was trading down 70% from its pre-oil crash high. But with the stock rebounding along with the US rig count and our expectation that the US rig count will be volatile but continue to rebound significantly in the years ahead, we think that this company offers investors significant potential.

Thank you all for joining our call today. During this call, we made reference to the Ensemble Fund (ENSBX) and to the portfolio holdings of Ensemble Capital Management. If you would like to receive a prospectus or fact sheet for the Ensemble Fund, or would like to request a copy of Ensemble Capital's historical equity composite performance or our 13F holdings disclosure, please send an email request to info@ensemblecapital.com.

I look forward to speaking with you next time and thanks for listening.

**See relevant disclosures below. Please contact us if you would like a comprehensive report on the performance of the Ensemble Fund. In addition, Ensemble Capital publishes a composite of our client account investment performance each quarter. Please contact us if you'd like a copy sent to you.*

Quarterly Returns as of December 31, 2016

	4Q16	1 Year	Since Inception*
Ensemble Fund	2.92%	12.96%	7.61%
S&P 500	3.82%	11.96%	7.89%

Total returns presented for periods less than one year are cumulative, returns for periods greater than one year are annualized.

**Inception Date: November 2, 2015*

Performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. You may obtain performance data current to the most recent month-end by visiting www.EnsembleFund.com.

All returns include changes in share price, and reinvestment of any dividends and capital gains distributions. Indices shown are broad-based, unmanaged indices commonly used to measure performance of US stocks. These indices do not incur expenses and are not available for investment. The fund's expense ratio is 1.00%.

Short-term performance, in particular, is not a good indication of the fund's future performance, and an investment should not be made based solely on returns.

Investors should consider the investment objectives, risks, and charges and expenses of the Fund carefully before investing. The prospectus contains this and other information about the Fund. You may obtain a prospectus by calling the transfer agent at 1-800-785-8165. The prospectus should be read carefully before investing.

Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

An investment in the Fund is subject to investment risks, including the possible loss of the principal amount invested. There can be no assurance that the Fund will be successful in meeting its objectives. The Fund invests in common stocks which subjects investors to market risk. The Fund invests in small and mid-cap companies, which involve additional risks such as limited liquidity and greater volatility. The Fund invests in undervalued *securities. Undervalued securities are, by definition, out of favor with investors, and there is no way to predict when, if ever, the securities may return to favor. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. More information about these risks and other risks can be found in the Fund's prospectus. The Fund is a non-diversified fund and therefore may be subject to greater volatility than a more diversified investment.*

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Glossary of Financial Terms

- P/E Ratio: The price-earnings ratio (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.
- Working Capital: Working capital is a measure of a company's efficiency and its short-term financial health. Working capital is calculated as: Working Capital = Current Assets - Current Liabilities.
- Fixed Assets: A fixed asset is a long-term tangible piece of property that a firm owns and uses in the production of its income and is not expected to be consumed or converted into cash in less than one year's time.
- Dividend Payout Ratio: The dividend payout ratio is the percentage of earnings paid to shareholders in dividends.
- EPS: Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.
- M&A: Mergers and acquisitions (M&A) is a general term that refers to the consolidation of companies or assets. While there are several types of transactions classified under the notion of M&A, a merger means a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.