Ludo Thomasson:

Hello everyone, I am Ludo Thomasson, director of wealth management at Ensemble Capital. Thank you for joining us for our Summer 2018 conference call. Today, the focus will be on the recent performance of our portfolio, the current market and economic situation, and a discussion of how we make the decision to exit positions in our portfolio as we did with two holdings this quarter.

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

Sean Stannard-Stockton:

Good afternoon everyone. Thanks so much for joining us. We really enjoy the opportunity to speak in depth about these topics that we are so passionate about and we really appreciate your interest.

The performance of our equity portfolio this quarter was solid and compared favorably to the broader market. While the final calculation of our equity composite will not be available until later this month, our current estimate is that our equity portfolio composite was up 5.03% vs the S&P 500 up 3.43%. Year to date, that brings our performance to up 6.60% vs the S&P 500 up 2.65%

Our outperformance this year has been driven primarily by stock selection with eight stocks in our portfolio up 20% or more. The stocks range from FAANG member Netflix, a new position in a small pet insurance business called Trupanion, to global luxury companies Tiffany and Ferrari, to the athletic shoe manufacturer Nike, to stable financial data processing businesses Mastercard and Broadridge, to the airplane spare parts maker TransDigm. We've also benefited from avoiding certain sectors. Our strategy has had no exposure this year to the telecom, consumer staples, materials, utilities or real estate sectors. They collectively make up 17.2% of the S&P 500 and each of these sectors are down year to date. Most notably, consumer staples, the largest of those sectors is down 8.9% this year.

For the most part these strong stocks produced solid returns in the second quarter as well as the first. All of the companies I just mentioned with the exception of Broadridge achieved 10%+ gains in the most recent quarter. Apple and Paychex joined the fun as well posting over 10% appreciation.

Rather than any particular unifying trend driving these stocks higher, for the most part they all benefited from company specific results. While many investors focus on capturing market wide trends across their broadly diversified portfolios, at Ensemble our entire approach is oriented around the evaluation of individual companies.

In a blog post on Intrinsic Investing earlier this year, our senior investment analyst Todd Wenning described our appreciation for idiosyncratic businesses. In the post, Todd described how the stock market has a hard time accurately valuing highly differentiated businesses because of the limited comparable businesses available for reference. An easy example of this was the way that Ferrari's stock was valued similarly to publicly traded auto companies in the period after its IPO. Our analysis suggested that Ferrari was in fact better understood as a luxury company with a profit model that was far more lucrative than other car companies. Unique even within luxury automakers, Ferrari's long wait list to purchase one of their cars provides a large buffer against the high level of cyclicality that causes automakers to trade at much lower multiples than Ferrari deserves.

When looking at the businesses we own that have driven our returns this year, we are pleased to see a range of differentiated companies whose individual fundamental results drove their stock price appreciation.

The benefit that accrued to our relative performance from avoiding the sectors that have declined this year was driven more by the unifying theme that rising interest rates make these types of stocks less attractive. But our avoidance of these sectors was not the outcome of a sector level decision, but instead was a function of researching individual companies one at a time and coming to the conclusion over and over again that the stocks we looked at in those sectors were simply too expensive. We profiled the valuation risks in these traditional "safe stocks" two years ago in our post about the high quality company WD-40 and how we believed its valuation was being driven to excessive heights by low interest rates.

Now, we did have underperformers in the portfolio this quarter as we always do. Our new position in Starbucks declined over 10% as did First American Financial. Importantly, we chose to exit our positions in L Brands and Prestige Brands. These two holdings had been significant drags on our performance for over a year and we've talked about them multiple times on past calls. Arif and I will discuss our specific reasons for selling these holdings at a loss in just a moment, but first I wanted to take some time to describe the framework we use for deciding to sell a stock and the frequency with which you should expect us to sell out of positions in the portfolio.

There are four reasons why we sell stocks. Most obviously, we sell stocks when we believe they have become materially overvalued. Unlike some investors, we will not sell a stock simply because it reaches our assessment of fair value. We exclusively own high-quality companies and like the owners of high-quality private businesses, simply being offered a fair price for one of our companies is not enough to get us to part with it. High-quality companies are hard to find. We require a premium bid, generally about 20% above what we consider fair value, to part with a company.

While that dynamic is what caused us to sell out of our holding in Tiffany this past quarter, it is more typical that we sell a stock earlier to buy a much more attractively priced stock. This second reason we sell is more common. After taking into account our overall conviction in a company, we will sell an existing holding to buy something new, or add to another portfolio holding, if the new position offers materially better appreciation potential. We don't switch stocks lightly. Given the tax ramifications of taking gains, we require that a new holding offer enough additional potential that even after taking into account the tax cost, the new holding is better than whatever we are selling.

The third reason we sell a stock is when we trim a position that has increased its relative weight in our portfolio. We believe that position sizing, the decision of how much of any given stock to own, is one of the most important and least appreciated aspects of investing. The question is not just what to buy, but how much. At Ensemble we are willing to hold larger positions of stocks that offer more potential upside and/or in which we have higher conviction that a positive outcome is likely. This second element of position sizing is what many investors ignore. We utilize a strict position sizing framework. If a holding increases beyond our maximum position size for its given mix of conviction and appreciation potential, we will trim the holding. Our framework allows for us to hold our winners for long time periods and lets them increase in relative weight as they outperform the rest of the portfolio. But we control how far we will let this dynamic run. There is a fine line between "letting your winners run" and violating the old Wall Street adage that "bears make money and bulls make money, but pigs get slaughtered." As focused investors, we believe that holding far larger than average position sizes is the key to our success. Our smallest positions would often represent the largest positions in many mutual fund portfolios. Yet all good things have a limit and within the context of our focused approach, we believe that limiting the amount of capital we are willing to have at risk in a given name is one of the most important decisions we have to make.

The three reasons I just discussed for selling are all the outcomes of good events. In the first, a stock that we bought at a material discount to fair value appreciates to well above fair value, in the second we have come across a substantially more attractive investment opportunity, and in the third a stock has so outperformed that we feel obligated to reduce our holding as a form of risk mitigation.

The fourth reason we sell stocks comes about from an unavoidable and more negative course of events. From time to time we lose conviction in a position. In other words, we come to the conclusion that our previously held reason to own a stock was wrong. This is a dynamic that occurs about two to three times a year on average. Realizing we were wrong does not always correlate with a stock performing poorly. Sometimes stocks do well even as we come to realize we were wrong to buy them. Other times we are slow to catch on to what the market has already determined, and we end up selling these stocks at a loss.

This year, we exited DistributionNOW in the first quarter, and L Brands and Prestige Brands in the second quarter. All three of these stocks were losing investments for us. We described our reasons for exiting DistributionNOW on our last call and will discuss L Brands and Prestige Brands today. But briefly I want to talk about stocks we sold for this reason in the past.

In 2017 we sold out of Discovery Communications, Pepsi and National Oilwell Varco. Discovery we sold for a small loss, Pepsi we sold very close to its all time high, while we took a material loss on National Oilwell Varco. In 2016, we sold out of Intel and TimeWarner. We booked profits on both. Sometimes our loss of conviction comes from corporate fundamentals not playing out as we projected. It is in these cases that we usually sell at a loss. But other times our loss of conviction comes from a more subtle issue that may not be causing the stock to trade poorly in the near term. For instance, we sold TimeWarner because we came to believe that the company had the wherewithal to compete against Netflix, but management was simply unwilling to make the tough choices to do so. We sold Pepsi even as the market was bidding the stock higher as we came to believe that the low sales volume growth the company was experiencing was not going to accelerate as we had previously expected. But at the time we sold, the stock market was aggressively paying higher and higher valuations for stable, low growth businesses like Pepsi. Today, this bid has vanished as interest rates have moved higher and our decision to exit the stock has paid off.

Coming to the decision that we are wrong about a company is emotionally challenging. But pruning away less attractive parts of our portfolio is key to driving continued improvement. In the most recent quarter, our sales of this type were in two stocks that have given us and our clients heartburn over the past two years. We've defended our reasons for holding both on a number of calls in the past and so we think it is only right to explain today why we've changed our thinking.

Arif will talk first about L Brands and then I'll cover Prestige Brands. Take it away, Arif.

Arif Karim:

Thanks Sean.

We've discussed L Brands (LB) in the past and why we believed it fit into our investment strategy. To briefly recap, L Brands is the parent company of both Victoria's Secret and Bath and Body Works, featuring everyday use products that are supported by emotional brand content with dominant shares of their respective markets. This has historically led to market leading operating margins and high returns on invested capital – characteristics that are typical of companies we target for our client portfolios.

We entered our L Brands position in 2016, amidst a transition at Victoria's Secret that we believed would be transitory. The brand was refining both its product assortment and its marketing strategy.

On the product side, it was discontinuing its slow growing, highly seasonal $500MM swimwear line while adding sportswear, a faster-growing perennial category adjacent to its core underwear category.

In marketing, it discontinued its mailer catalog, which had been an integral part of its marketing strategy since its start, in favor of greater focus on digital and social media investments.

Effectively, the company reapportioned its portfolio of products within the store towards secular growth categories in categories adjacent to its core underwear segment, while also refocusing on marketing strategies that better reached the younger audience of women that comprise the core of its future growth.

Both made sense to us as periodic changes a retailer must make to adapt to changing times and customer preferences to remain relevant. Given the magnitude of these shifts, we expected some disruptions to the business but believed that it would return to consistent positive comparable sales growth over the course of the following year.

However, despite early signs late last year that the company was returning to health, the changes in the marketplace appear to have undermined the health of the Victoria's Secret business, which resulted in much weaker than expected sales through the first half of 2018.

We believe there are three main reasons for the weakness:

> First, a continuing decline in mall store traffic, from which L Brand's products still derive about 80% of their sales;
>
> Second, a significant fashion trend towards bralettes and sports bras, which are less structured bras that younger women have allocated more of their spending towards, but offer lower barriers to entry, lower average selling prices (ASPs), and lower margins;
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> And finally, a potential loss in the relevance of the message the company stands for, portrayed by the *"perfect"* body shapes of VS models, in contrast to a cultural shift that has been leaning towards a more *"body positive"* acceptance of all body shapes that resonates with today's young women. Many much smaller but faster growing competitors have taken on this *"body positive"* theme as their marketing message and are beginning to win significant incremental share.

While we believed that Victoria's Secret could successfully transition the change in sales channel from stores to online sales if it maintained the relevance of its own branded products, it has been late to adapt its marketing message to fit its younger customers' values and their preference for more casual and less structured types of attire. In other words, its products and brand are losing relevance for their customers.

Ultimately, we determined this is a company that has potentially lost a substantial ability to ward off competition since almost any apparel company can now compete in the bralette and sports bra categories. We concluded that the forces working against Victoria's Secret are stronger than originally anticipated and the competitive advantages are weakening. Consequently, we didn't feel comfortable continuing to be investors in the stock, despite its lower price since our initial buys and the many positive characteristics the company still possesses.

Having discussed our confidence loss on Victoria's Secret, we'd highlight that Bath and Body Works, which accounts for 40% of revenue and half of the parent company's operating profits, has continued to perform brilliantly. However, this business segment alone was not sufficient to override our overarching loss in confidence in the future revenue and profit predictability of the entire company.

Back to you Sean.

Sean Stannard-Stockton:

While we never owned as large a position in Prestige Brands as we did in L Brands, we did sustain significant losses in the stock. Prestige Brands is a small company that owns big brands in small markets. While their competitors include huge companies like Novartis, Johnson & Johnson, and Procter & Gamble, within the niche markets where they compete, their products generally hold #1 or #2 market position and often have market share of well over 50%. As a comparison, Coke holds 42% market share in carbonated soft drinks and so Prestige's market share in their niche markets can be seen as more dominant than the hold Coke has on the soda market.

The company operates in markets where customers use brand as a key signal of quality and effectiveness. If you have a sore throat, itchy eyes, a wart, or your kids are car sick, you want to be sure that what you buy works and buying an established brand is the best way to make sure you get what you paid for. Whether you go to the drug store or order online to treat the conditions I just mentioned, you are very likely to buy products from Chloraseptic, Clear Eyes, Compound W, and Dramamine. All of these brands are made by Prestige and every one of them has the #1 market share position.

Owning these strong brands, in small niche markets, results in Prestige generating the highest profit margins in their industry. While Procter & Gamble and Johnson & Johnson might be a lot more well known, Prestige Brands turns every dollar of revenue into 34 cents of profits while P&G and J&J manage to squeeze our just 26 cents of profit.

In January on our client call we said, "Prestige operates in slow growth end markets. The number of people who have a sore throat or itchy eyes is not going to grow dramatically. But it also isn't going to shrink." Yet by early May of this year, the market had hammered the stock price down to levels that implied that revenue was indeed going to shrink. Some short sellers were making the case that organic growth was in fact already negative but was being hidden by the acquisitions the company had made. This was, and still is today, a view that we did not share. On their May earnings calls, the company reported that in fact revenue growth had been positive in the most recent quarter and they guided to positive revenue growth in the coming year. These results validated our view that the company was not shrinking and the stock rallied 33% over the next three days. However, while the company's guidance for 1% revenue growth in the coming year proved the shorts wrong, it was still lower than the level of growth we expected from the company.

Most investors are familiar with the risks that come with investing in high growth stocks. But low growth stocks present a separate, but just as dangerous set of risks. To earn a 9%, or market rate, level of annual returns, a company that will grow 5% in perpetuity only needs to offer investors a 4% free cash flow yield. The 4% yield plus 5% growth generates 9% annual returns. But if that same company can grow at only 2% a year, the stock must be priced to yield 7% in current free cash flow. This higher yield is achieved via a lower stock price. In fact, a stock with a 4% yield needs to fall 42% to offer a 7% yield.

So while high growth stocks are sensitive to high volatility in near term growth rates, low growth stocks are sensitive to even small changes in longer term growth rates. As we came to believe that we had overestimated the amount of growth that Prestige could generate over the long term, we sharply reduced our assessment of the fair value of the stock. Despite having been buyers at similar prices just a few months early, with our new, lower growth outlook in place, we sold out of our position after the most recent earnings report.

So, thank you all for joining our call today. During this call, we referred to the portfolio holdings of Ensemble Capital Management. If you 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.

Thanks for listening. I look forward to speaking with you on our next call.

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Each quarter we file a 13F report of holdings, which discloses all of our reportable client holdings. Please refer to our current 13F filing or contact us for a current or past copy of such filing.

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