11701 Bee Cave Road, Suite 217, Austin, Texas 78738

Client Letter - September 30, 2014

The S&P 500 managed to eke out a 1.1%[1] return during the third quarter, although it did not come easy. A confluence of soft global economic data (particularly in Europe), uneasiness over the anticipated end of the Fed's bond buying program, and geopolitical crises with Russia in the Ukraine and ISIS in the Middle East have all helped contribute to making this multi-year bull market appear exhausted. Furthermore, a strengthening of the U.S. dollar is expected to temper results at multi-national businesses. Nevertheless, the market continues to trade near all-time highs. Despite these higher prices in general, we were excited to be able to identify another "high return on tangible assets" business at a good price this past quarter.

Express Scripts: No RX Needed

In the last quarter we took a position in Express Scripts (ESRX), the largest Pharmacy Benefit Manager (PBM) in the U.S. PBMs help insurance companies bargain with drug manufacturers and/or retailers to get better pricing. Since payers for drugs are fairly fragmented, a PBM can leverage its scale to negotiate better prices on branded and generic drugs. The PBM then takes a cut of the cost savings it generates for its clients. Interestingly, each additional claim the PBM generates is more profitable than the previous one since the resulting greater scale allows even more leverage with drug manufacturers and/or retailers as well as greater leverage of the PBM's fixed costs.

Express Scripts has a commanding lead in this oligopolistic $280 billion industry at about 34% market share, with its main competitors being CVS with a 25% market share and Optum, a division of United Health, with a 12% share of the market. Since scale is everything in this business, ESRX's market dominance allows it to generate industry leading returns on invested capital and profit margins while, at the same time, giving its customers at least as good deals on their drug purchases as ESRX's competitors.

The PBM business is also wonderful because it is capital-light, produces strong free cash flows, and has stable end-user demand, making its business performance robust in a variety of economic conditions. Most of the management teams in the industry are very savvy and rational, and ESRX is no exception. CEO George Paz has more than doubled the business's size in the 10+ years since he moved up from the CFO position, and he is heavily incentivized to continue this exemplary performance given his over $50 million dollar stake in the company.

[1] For information on the performance of our separate account composite strategies please visit www.ycginvestments.com/performance. For information about your specific account performance, please contact us at (512) 505-2347 or email info@ycgfunds.com.

Additionally, the potential for growth in the PBM market is large. The healthcare market, which makes up 17% of GDP, is expected to grow at about 6.2% for the next couple of decades in part due to an aging U.S. population. The drug market, which is only about 15% of total healthcare spending, is expected to grow at about the same rate, but profits for distributors such as ESRX should grow even faster as more and more drugs go generic, which is negative for revenues but positive for gross profits. Overall, generics are expected to grow to approximately 85% of total volume in the next few years. Lastly, the shift towards more niche specialty drugs over primary care drugs will increase the future need for a PBM to negotiate to lower costs for the insurance companies.

While the historical results of ESRX and the PBM industry have been very strong, the market has a number of concerns about the industry's future profitability. We believe these concerns are unfounded.

First, while Express Scripts does not have a highly concentrated client base, it does have a couple of large clients, such as WellPoint at 14% of revenues with a contract expiring in 2019 and the Department of Defense (DOD), which just renewed a 7-year contract, at 11% of revenues. We think the market fails to recognize the stickiness of these clients. The Department of Defense is not allowed to negotiate pricing on its own and so ESRX is still the most logical solution for the DOD given its superior scale and thus likely ability to offer the best drug pricing. We believe the same argument holds true for WellPoint, which would lose significant negotiating leverage if it were to attempt to insource its drug purchasing. Express Scripts' 97% retention rate (excluding acquisitions) supports this viewpoint.

Additionally, a set of concerns arose due to the Affordable Care Act (ACA, or "Obamacare") in regards to the effect of companies such as Walgreens, IBM, Time Warner, and others moving to the private exchanges and also the risk of the US moving to a single payer system.

We believe the concern about private exchanges is somewhat overblown. Stats on the current and five-year projected size of the healthcare exchange market suggest that a scenario where private exchanges dominate the market is fairly unlikely in the short or medium term as even the most bullish estimates we've seen suggest the private exchanges will be no larger than 10-15% of total insurance by 2018. Even if actual enrollments far exceed current projections, we expect Express Scripts to play a critical role in the private exchange market in the future since companies on a private exchange will still need a PBM to negotiate with drug manufacturers.

In the second case, while a move to a single-payer system certainly wouldn't bode well for Express Scripts, this risk seems relatively low in the short to medium term due to the current political climate and sentiment towards the Affordable Care Act. Regardless, Express Scripts at least finds itself on the "good" side of healthcare reform due to its mission to reduce costs and cut waste out of the system.

Most recently, concerns regarding earnings and potential structural issues resulting from a recent merger with Medco have depressed the stock, providing an attractive price to enter. While Express Script's stock is priced attractively relative to the current level of earnings, we think it's even more attractive when one considers that earnings actually understate the true level of cash flow that the business produces. As a result of accounting complexity from the Medco merger, free cash flow is substantially higher than earnings yet many investors still focus on earnings multiples. As free cash flow and earnings converge over time, the free cash flow multiple should expand.

Furthermore, disappointments in post-acquisition earnings have led some investors to think something is structurally wrong with the business. However, management teams are often overly optimistic about revenue and cost projections in a merger in order to make it happen. Thus, we believe these issues are much more likely to be related to the realities of merger integration and thus temporary in nature rather than evidence of a structural weakening of Express Scripts' competitive position or rate of growth.

Overall, recent concerns have led to an opportunity to own what we believe is a solid business at a good price. In addition, there is always the chance that the Medco acquisition actually becomes the cherry on top by leading to synergies and growth in the future. In the meantime, management has promised share buybacks at bargain prices, which will continue to boost shareholder returns.

Concluding Remarks

For the last several years, we have all become accustomed to watching the market head in one direction and, for the most part, with abnormally low volatility. As valuations continue to stretch, we would welcome some more turbulence in the market. This may seem counterintuitive because it would likely impair short-term returns, but it is through market fluctuations that we are able to take advantage of great opportunities that typically arise in such environments. . As investors right alongside you, we will continue to be patient and objective as we diligently seek out the best risk-adjusted expected returns for our portfolios.

Thank you for your continued trust and confidence,

The YCG Team