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Client Letter - December 31, 2014

Enclosed are your December 31, 2014, portfolio appraisals and our Privacy Policy statement. We are also required to offer our Firm Brochure, which can be found on our website at [www.ycginvestments.com/firm\\_brochure](http://www.ycginvestments.com/firm_brochure) or by calling us at 512-505-2347.

We are pleased to close the chapter on the year 2014 with solid, positive returns for our clients<sup>1</sup>. Despite a rollercoaster ride that was influenced by a surprising 50% drop in oil prices, the S&P 500 index rose 4.9% during the fourth quarter and ended the year up 13.7%. Over the last five years, the index has compounded at an astounding 15.5%. These are not sustainable returns. Over the last one hundred years, the S&P 500 has returned slightly more than 10% per year on average, with 3-4% inflation and 6-7% real returns. We believe returns over the next one hundred years are unlikely to be materially different. If anything, they are likely to be lower given historically high current valuations as measured by common market metrics such as the Shiller P/E and the U.S. market cap/GDP.

Time and time again, however, this overwhelming historical evidence has failed to prevent investors from falling into complacency, helped in large part by our collective susceptibility to recency bias – if the last five years have resulted in steadily rising stock prices, historically low volatility as measured by the VIX, and an economy that feels much better than it did five years ago, then we must be in store for more of the same in the next five years. While this rosy scenario is certainly possible, we continue to abide by Warren Buffett's famous maxim, "The less prudence with which others conduct their affairs, the greater prudence with which we should conduct our affairs."

Because the future is unknowable and because we believe ownership of great businesses is the best way to compound wealth over time, we believe that prudence, except in rare market environments, does not mean holding cash. Rather, prudence means acknowledging the risks of the current environment (in our opinion, profit margins well above historical norms, unsustainably low volatility, slowing growth and potential construction bubbles in some key emerging markets like China, a likely end to the commodity supercycle, and artificially low interest rates) and being ever more careful in constructing a portfolio that is robust to these risks. We believe we have constructed such a portfolio and think that our collection of mostly boring, market dominant, moderately growing, geographically diversified, reasonably priced, consumer staple, toll-taker, and/or utility-like businesses are likely to compound at attractive rates over time and hold up better if any of the risks we have mentioned come to fruition, giving us the opportunity to aggressively snap up bargains in the resulting market turmoil.

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

In the meantime, we continue to scour the market looking for opportunities to add to our collection of businesses with the desirable characteristics mentioned above. Case in point, we'd like to share the rationale behind one of our most recent purchases, Verizon. Generally, in ebullient markets like the current one, the only way to buy great businesses at cheap prices is if they are experiencing short-term, superficial problems that people mistake for long-term, fundamental ones. Verizon is no exception, and we hope our discussion below provides you with useful insight into our investment process.

### **Verizon Communications: The Signal in the Noise**

Over the past quarter, we've built a position in Verizon Communications (VZ), the largest wireless provider with over \$80 billion in wireless revenues, 105 million retail customers, and coverage of more than 95% of the U.S. population. At about 34% market share each, they and AT&T have a commanding lead over their only other significant competitors, Sprint (16% share) and T-Mobile (15% share). We believe we've been able to acquire this business at an attractive price as a result of two primary factors.

The first factor is investor concern over margin pressure stemming from intensified competition. Investors are concerned that in a desperate grab for market share, Sprint and T-Mobile may either merge or continue to cut their voice and data plan pricing significantly, either of which investors fear will significantly impair the long-term profitability of Verizon and AT&T. We are skeptical. If Sprint and T-Mobile are eventually allowed to merge, it seems unlikely to us that they will destroy profitability for a cozy three-player oligopoly. If they are never allowed to merge, as seems to be the case based on the FCC's recent commentary, we still think it's unlikely that they destroy profitability for the two industry giants. Given the rapid growth in data usage and people's increasing reliance on their cellphones as their primary mode of communication, the industry appears to have evolved from a market in which cell phones are chosen on the basis of price to a market in which cell phones are chosen on the basis of their network coverage. In this environment, AT&T and Verizon should be able to maintain premium pricing because of their vastly superior networks. Finally, even if Sprint and T-Mobile eventually achieve network parity, the fundamental limitations of spectrum availability combined with rapid data growth (Cisco Systems predicts 50% compound annual growth in the U.S. through at least 2018) have a very good shot of creating a market in which wireless data demand outstrips supply growth. If this condition persists over a long time period, it is a surefire prescription for sustained pricing power as the wireless providers can sell access to their networks at ever-higher prices to those who most value this access. This pricing power is in great contrast to the wireline business, in which far fewer technical challenges to network capacity expansion as well as the installation of multiple competing lines (from cable to fiber) eventually led to virtually unlimited wireline voice communication supply, aggressive pricing, and razor thin margins.

The second factor is an uninspiring past decade of financial performance that masks underlying changes in both Verizon's business composition and its financial liabilities. These changes have put Verizon on much firmer footing and should drive significantly better future results.

The first change, in business composition, has been dramatic. Over the past 10 years, Verizon has had mediocre operating results as its torrid wireless growth has, to a large extent, been offset by declines in

wireline as more and more people cut their home and business phone cords. Now, however, after years of this dynamic combined with the recent purchase of Vodafone's 45% stake in Verizon Wireless, fully two-thirds of Verizon's business is wireless. Thus, going forward, we believe the wireless business, which operates at an extremely healthy 34% operating margin with mid to high single digit revenue growth rates, should overwhelm the meager results of wireline, which will likely continue to be a 0-2% operating margin business with flattish revenue growth. This much greater impact of wireless results should lead to mid-single digit revenue growth for the overall enterprise. Even better, margins should expand as a simple consequence of the continued mix shift to more and more wireless. If margins in the wireless division continue to expand as well, so much the better. Finally, as Verizon moves closer and closer to becoming a pure-play wireless company, its valuation multiple should increase.

The second change that has muddied the results, particularly over the last five years, is the pension liability, which is fairly material at about 11% of the enterprise value of Verizon. Accounting rules have forced Verizon to run big positive and negative charges through the income statement as a result of changes in the discount rate on pension liabilities and differences between actual and expected investment results on pension assets. This earnings volatility has likely confused many investors, causing them to ascribe a lower earnings multiple to Verizon's stock. Furthermore, the impact of these charges has more often been negative instead of positive as the discount rate on the pension liabilities (by far the biggest swing factor in Verizon's pension charges) has relentlessly declined with interest rates over the last five years. Given that interest rates are likely artificially depressed as a result of the Fed's massive quantitative easing, we think it's highly probable that the discount rate doesn't get much worse from here and reasonably probable that it actually gets significantly better, providing a boost to earnings over the medium term.

So, overall, there's a lot to like. Verizon is the largest and most profitable player in a growing market with utility-like characteristics (i.e. no matter what the economic environment, the vast majority of people will continue to pay their wireless phone bill because of the critical role it plays in their professional and personal lives), and we believe it's cheap because of a number of misunderstandings about the strength of its business model. If we're correct in our diagnosis of the pressures on Verizon's stock price, we believe our investment will generate returns well in excess of the market as the business performance positively surprises analysts. If we're wrong and Verizon's business performance more closely resembles that of the previous decade, we believe we'll still generate solid returns on the back of Verizon's copious and steady cash flow, which we expect to be returned to investors through debt pay-downs, the company's large dividend, and maybe even some future stock repurchases.

### **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, to reiterate (because this point is critical), it is *only* through market

fluctuations that we are able to take advantage of the 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.

We thank you for your trust and loyalty and wish you a happy, healthy, and prosperous 2015!

Sincerely,

The YCG Team

***Disclaimer:*** *The specific securities identified and discussed should not be considered a recommendation to purchase or sell any particular security. Rather, this commentary is presented solely for the purpose of illustrating YCG's investment approach. These commentaries contain our views and opinions at the time such commentaries were written and are subject to change thereafter. The securities discussed do not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. These commentaries may include "forward looking statements" which may or may not be accurate in the long-term. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. Past performance is no guarantee of future results.*