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Client Letter – Second Quarter 2018

The S&P 500 Index returned 3.43% in the quarter ended June 30, 2018.[1]

We believe an investor who aspires to achieve attractive risk-adjusted returns must first identify at least one exploitable and persistent investment mispricing. In our case, as we've discussed in past letters, we believe we've identified two: 1) a great business mispricing that we believe results from investors generally undervaluing the rare businesses with both enduring pricing power and long-term volume growth opportunities and 2) a market-timing mispricing that we believe results from most investors' overconfidence about their ability to enhance their returns by trading around the temporary macroeconomic and operational problems that these great businesses inevitably face over time.

Investment Process and Improvements

However, identification alone is not enough. In order to be successful, an investor must also employ an investment process that reliably exploits these mispricings. Our process starts with stringent filtering. First, we narrow the investment universe down to businesses we feel confident possess both enduring pricing power and significant volume growth opportunities. Because so few businesses are able to thrive in the face of the relentless disruption occurring all around us and because we insist on deeply understanding each business's competitive advantage, this step eliminates more than 99% of publicly traded companies, reducing the list down to a few hundred. Second, we evaluate these companies' capital structures, eliminating from consideration any stocks that we think could have difficulty surviving a deep recession.[2] Finally, we calculate a forward rate of return for each remaining stock, and we exclude those that don't provide enough excess return over the 10-year U.S. Treasury rate[3] to justify the added risk one assumes by owning businesses.

With the remaining stocks, we're ready to construct a portfolio. We first attempt to sufficiently diversify the portfolio across a variety of product categories, which we believe helps to protect the portfolio from unexpected business disruption and/or the inevitable mistakes of analysis we are bound to make over time. Simultaneously, because we believe many exogenous macroeconomic factors are unpredictable, we attempt to ensure that the portfolio will perform robustly across a range of interest rate, business, and political environments. Lastly, since diversification has rapidly diminishing marginal benefits, we compare the risk-adjusted returns of the remaining stocks and cull the portfolio of any that possess comparatively low risk-adjusted returns while adding little to diversification.

[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.
[2] Under our definition, the term "difficulty" includes the need to raise a large amount of equity relative to the company's market cap in order to survive.
[3] The 10-year U.S. Treasury rate is a standard measure of the risk-free rate.

Our current portfolio is the result of this process. Rather than owning a piece of each of the nearly 45,000 securities listed on official exchanges around the world,[4] the vast majority of which are subject to powerful deflationary pricing forces, we have instead winnowed our portfolio down to a select group of companies that we believe can swim against this deflationary tide. This portfolio includes branded consumer goods such as cosmetics, luxury goods, and athletic shoes as well as many essential consumer and business services such as banking, payment processing, real estate brokerage, online search, credit ratings, and productivity software. Moreover, these businesses are disparate enough that we believe they are likely to respond differently to different macroeconomic backdrops. Some of our portfolio companies will benefit from higher interest rates while others may experience temporary headwinds. Similarly, some of our portfolio companies produce steady cash flow streams that are valued during recessionary periods while others are more cyclical and experience accelerating growth in strong economies. Finally, many of our companies are global, limiting our exposure to any one country's economic or political risks.

While we believe the investment process that resulted in this portfolio is robust, it is certainly not infallible. Therefore, we are always evaluating the evidence to see whether we can improve it further. One recent change we've made as a result of this review has to do with the culling part of our process. Historically, when multiple businesses in the same industry have successfully passed through our filters, we've typically picked our favorite company in each product category, believing we can select the most undervalued of the dominant players. However, after looking at our historical record, we've determined that our success in picking the best opportunity in the advantaged categories is mixed, at best. Thus, we've recently made the change that, if a category has multiple clear winners trading at similar valuations, we'll buy them all. To be clear, this change does not mean that we will indiscriminately buy every player in each product category.

Take beauty, for example. Estee Lauder and L'Oreal, the two largest cosmetics players, each have strong market share and global distribution, and we believe they are both very likely to be global winners. Thus, we think it makes sense to buy both. On the other hand, we probably won't buy smaller players such as Coty, Shiseido, Revlon, Avon, or AmorePacific. These companies lack the economies of scale of an Estee Lauder or a L'Oreal. As a result, they can neither leverage their fixed costs nor negotiate with retailers as effectively as their larger peers, resulting in inferior operating margins. Combined with their smaller revenues, this lower profitability leads to big disadvantages in the advertising, promotion, and innovation-driven enhancement of their brand portfolios. Therefore, many of them must instead rely on discounting to drive sales, which erodes pricing power over time. In other cases, companies possess a number of premium brands, but their revenues are too geographically limited for us to have confidence that the brands will successfully globalize. In summary, while all these businesses are in the same industry, we view their future prospects quite differently.

Similarly, where appropriate given tax considerations, we've recently sold some Nike to buy some Adidas because we believe both have a high probability of exhibiting enduring pricing power and volume growth. Their brands possess celebrated heritage and exhibit global appeal, and their scale advantages

[4] See https://www.world-exchanges.org/home/index.php/about/wfe-mission-vision.

in distribution and marketing dwarf their next biggest competitors. Thus, we think it's an improvement to the portfolio to own both. However, just as in beauty, we currently have no interest in owning Puma or ASICS because they both lack many of these characteristics, and we're not convinced we're being compensated for this extra business risk.

A few additional examples of recent portfolio changes (again, where appropriate given client-specific tax considerations) include 1. our diversification into both Mastercard and Visa, which together process 72% of global credit card transactions and 87% of global debit card transactions;[5] 2. our purchases of both Google and Facebook, which together control 61% of global online advertising revenues and 25% of total global advertising revenues;[6] and 3. our investments in both Marsh & McLennan and Aon, which are the two largest and most global insurance brokerages.[7]

Concluding thoughts

By engaging in continuous learning, remaining vigilant to new and old risks, and regularly questioning our assumptions, we endeavor to construct and maintain a portfolio that's robust to the uncertain future. Occasionally, when we identify a new business or a value-added improvement, this objective leads to adjustments such as the ones described above. Most of the time, however, because we're in the fortunate position of owning a collection of, in our view, uniquely enduring businesses, this objective entails sitting on our hands and letting our businesses do the work of compounding our portfolio value and adjusting to incipient risks.

Our business ownership mentality is in marked contrast to most equity investment managers, who, according to Morningstar analyst William Harding, turn over their stocks an average of 130% a year.[8,9] This astounding figure means that the average mutual fund manager completely replaces his or her entire portfolio roughly every nine months, even though the duration of the equity assets he or she owns is measured in decades.[10] We completely disagree with this approach. While one obvious downside is the significant leakage that occurs in the form of extra taxes and trading costs, the much more insidious and profound downside is that this shortened time frame causes investors to focus on ephemeral sources of value such as next quarter's earnings relative to consensus or relative valuation multiples between two equally bad businesses. It also causes them to deemphasize and sometimes completely disregard a business's ultimate source of value, the longevity and magnitude of a business's cash flow production. We believe this unfortunate combination causes these high-turnover investors to be more often blindsided by the future and to more frequently risk catastrophic loss.

So why would most investors behave this way? We believe it's because many have very little personal financial investment in their funds' holdings, with 46% of U.S. stock fund portfolio managers actually having none at all,[11] and very little emotional investment in their clients, as many invest assets on behalf

[5] See page 10 of https://nilsonreport.com/upload/issues/1109_6392.pdf.
[6] See https://www.statista.com/chart/12179/google-and-facebook-share-of-ad-revenue/.
[7] See https://www.biz.uiowa.edu/henry/download/research/MMC_s17.pdf.
[8] See https://www.investopedia.com/articles/mutualfund/09/mutual-fund-turnover-rate.asp.
[9] See http://topforeignstocks.com/2017/10/01/average-stock-holding-period-on-nyse-1929-to-2016/.
[10] See page 6 of https://personal.vanguard.com/pdf/s340.pdf.
[11] See https://www.ft.com/content/2c910bce-7105-11e6-9ac1-1055824ca907, https://www.wsj.com/articles/find-mutual-fund-managers-who-eat-their-own-cooking-1433518014, and https://www.thestreet.com/story/10421602/1/your-fund-manager-have-skin-in-the-game.html.

of faceless endowments or pension funds, reducing their empathy through a psychological bias called the “identifiable victim effect.”[12] We believe this lack of investment incentivizes many managers to either minimize career risk and index hug or, in cases such as hedge funds where outperformance is rewarded more than underperformance is punished, to increase variance (i.e. take more risk by swinging for the fences).

Our business ownership approach, on the other hand, stems from the simple facts that our clients are our friends and family and that, for many of them (ourselves included), we are stewarding the accumulated savings of lifetimes of hard work. Thus, we approach every investment with the knowledge that we are relying on the business’s cash flows to support our clients and their families for the rest of their lives and, in some cases, for those of their children and grandchildren as well. This multi-generational approach focuses the mind and, we believe, leads much more reliably to long-term investment success.

Thank you for your trust, know that we are invested right alongside you, and please let us know if you have any questions or concerns. We are here to help.

Sincerely,

The YCG Team

[12] As Wikipedia states, “The "identifiable victim effect" refers to the tendency of individuals to offer greater aid when a specific, identifiable person ("victim") is observed under hardship, as compared to a large, vaguely defined group with the same need . . . The effect is epitomized by the phrase (commonly attributed to Joseph Stalin), "A single death is a tragedy; a million deaths is a statistic."” See https://en.wikipedia.org/wiki/Identifiable_victim_effect.