



July 8, 2020

To Our Clients & Friends,

Our first quarter at GCAM was a good one. Poppe family accounts were the only ones with performance for the entire quarter ended June 30, 2020, but the largest of those serves as our model, and it performed slightly below the S&P 500 Index, generating a return of 19.64%, net of an annualized management fee of 1%,¹ vs. 20.54%.² Obviously, clients who opened new accounts during the quarter got differing results based on their inception date.

Quarterly results don't mean much, but with a new portfolio, clients and potential clients don't have other data points to look at. We always aim to outperform, and we think our portfolio is well-designed to emerge from the current COVID-19 recession with stronger competitive positioning. We gravitate to businesses with sustainable competitive advantages, high returns on capital, relatively low levels of debt and motivated management teams, often led by a founder.

We hurt ourselves two ways in our first months. First, we carried about 7% cash – we set our sights on a couple of securities we had hoped to buy if the market took a breather, but it never did. When the market goes up 20% very quickly, holding cash feels like an unforced error. We do intend to run closer to fully invested over time, hopefully without sacrificing price discipline.

Our second area of underperformance came from our insurance and financial holdings. We will spoil the ending and say we're content to continue holding this group. Berkshire Hathaway and Markel Corp. declined modestly for the second quarter, while Charles Schwab, Progressive and JP Morgan were up but lagged the index significantly. These five stocks make up more than 20% of our portfolio.

We think we own the best large bank, the most customer-centric brokerage firm and several of the better insurance underwriters in the country. It's also true, however, that we are exposed to a number of companies that generate significant income from the spreads they earn on bank deposits or insurance premium dollars they receive from customers and, in turn, invest either in loans to borrowers or fixed income securities. As interest rates collapse, those spreads narrow, reducing earnings.

Our insurers Progressive, Markel and Berkshire should earn lower rates of return on their large fixed income investment portfolios in years to come. And JP Morgan and Charles Schwab own large banks that may earn less on their lending and investment portfolios. Our lenders, also including First Republic Bank

¹ The family account does not pay a 1% management fee. The return as presented here assumes the deduction of the management fee to show what a client account's performance would have been if it had been invested the same as the family account during the quarter.

² S&P 500 Index returns include the reinvestment of dividends and other earnings. Past performance is not necessarily indicative of future results. The Index is an unmanaged capitalization-weighted index of the common stocks of 500 major US corporations. The Index does not incur expenses and is not available for investment.

and Credit Acceptance Corp., could face significant credit losses if the recession extends for several quarters and the government stops supplying liquidity to the economy.

That said, we see this group as healthy, at least relative to peers. In insurance, we think we're entering a period that will sorely test many underwriters. In recent years, insurance rates have been very competitive. Partly because their investment returns were so good in the past decade, insurers accumulated a lot of capital. They used that growing base of capital to write more insurance, driving down rates. But after a barrage of natural catastrophes, losses in litigation and, for some, COVID-19 exposures they didn't anticipate, they're struggling. Analysts estimate that industry-wide COVID-19 losses will exceed \$40 billion.

Insurance brokers say rates are rising across many categories of commercial insurance by 20% to 25%. We own two commercial insurers, Markel and Berkshire, that have generated underwriting profits at lower rates in recent years. They ought to do even better in a higher-rate environment. While Markel and Berkshire have invested well historically, at the core, they make money writing insurance. That's going to be key going forward.

In auto insurance, the story should be similar. It is not uncommon to underwrite auto policies at break even and make money investing the float, which is the cash customers pay upfront that the insurer will pay out in claims in future years. Progressive's skill at underwriting is such that it typically earns industry leading profit margins of 7% to 9% and generates a relatively small portion of its total income from investing. In a world where interest rates trend to zero and the stock market no longer generates double-digit returns, all the mediocre underwriters who depend on investment income face a reckoning. They have not invested in the technology or analytical expertise to earn a profit writing insurance, much less a direct sales channel to reduce expenses. They can no longer park the bulk of their float in Treasuries that yield 2.5% or 3% and expect to survive.

We think the recent collapse in driving miles may prove to be the lull before the storm. If people fly less as the COVID-19 era stretches on, they may drive more. If they drive more, there will be more accidents and current insurance rates may prove inadequate. Simultaneously, insurers face deterioration of their investment income, the source of most of their earnings. They will need to either raise rates or tolerate declining earnings and lower returns on capital. When rates rise, consumers shop more. When they shop, they tend to find Progressive.

While we understand the argument that cars are safer than ever, all those cameras and sensors mean they're also more expensive than ever to repair. We expect to see fewer collisions in the future, but more costly damage, keeping us confident that auto insurance will remain expensive and that Progressive's advantages will remain meaningful to consumers.

Turning to Charles Schwab, we believe this is a wonderful business with a less-than-wonderful earnings profile. It continues to take large chunks of market share from full-service stockbrokers as investors trust it to offer great value. During the market panic in March, Schwab opened record numbers of new brokerage accounts and took in record levels of new assets. Schwab has consumer trust because it offers good value. Unfortunately, Schwab today earns roughly 60% of its income investing or lending customers' bank deposits. With interest rates approaching zero, that spread between the amount Schwab pays depositors and the yield it receives on conservative fixed income investments is pinched. Wall Street foresees earnings per share dropping from \$2.67 in 2019 to \$2.07 this year.

We continue to feel Schwab is worth holding. Later this year, it should close on the acquisition of TD Ameritrade, itself a fine firm and with a better technology platform than Schwab's. Analysts believe

Schwab can take as much as \$2 billion of operating expenses out of Ameritrade over three years, which would lead to 25% earnings accretion. That might not fully offset the loss of income from lower interest rates, but the combined firm should be much stronger competitively than Schwab is today. And Schwab presents us with a free warrant on rising interest rates. The risk with Schwab is that many of the services it provides, most obviously trading, have commoditized to the point that it has limited earnings sources despite providing superior service to clients. If rates remain low for years, Schwab will need to find other ways to price for the value it creates. Easy to say, not easy to do.

Another weak performer in the second quarter was Berkshire Hathaway. While Berkshire's commercial insurance business should benefit from the harder underwriting market described above, and Geico shares some traits with Progressive, we confess to a bit of anxiety about this holding. We were surprised to learn at Berkshire's shareholders meeting in May that CEO Warren Buffett could not find any good investment ideas in March, when the market plunged 35%. He opined that Berkshire might need every bit of its \$137 billion in cash to weather the COVID-19 induced recession. We appreciate that Berkshire needs to hold cash to backstop its large insurance operations and that this is a frightening time, but we're also reminded of the old Peter Lynch quip that more money has been lost preparing for corrections than in corrections themselves. We'd love to see Berkshire put more of its capital to work or return it to the owners.

In fairness, we hear Berkshire has been aggressive about writing more insurance in this environment, and it made a \$10 billion investment in gas transmission and storage assets in early July. But not even the best investor in the world can outperform the S&P Index if one-third of his portfolio is in cash.

JP Morgan shares have been battered, but the bank earns a well-diversified stream of earnings from investment banking, wealth management and trading as well as commercial banking. While JPM likely will take higher loan loss reserves in coming quarters, it has reported manageable credit losses to date and its hefty dividend seems well supported by earnings.

If our poorest performing stocks were tarred by their exposure to low interest rates, our best performers were ... nearly everything else. Not surprisingly, our Internet giants Amazon, Facebook and Alphabet did well, as did several of our strong franchises that were walloped in the March quarter but quickly recovered.

		YTD through
Top performers	Q2 2020	June 30.
Carmax	66.4%	2.1%
Credit Acceptance	63.9%	-5.3%
Five Below	51.9%	-16.4%
Amazon	41.5%	49.3%
Facebook	36.1%	10.7%
Eurofins Scientific	32.8%	12.7%
A2 Milk	31.0%	28.3%
SS&C	29.2%	-8.0%
Constellation Software	24.7%	16.2%
Alphabet Class A	22.0%	5.8%
S&P 500 Index	20.5%	-3.1%

This chart makes the case that the market is indeed a voting machine in the short term but a weighing machine in the long term. If you'd been on a desert island for six months and looked at the half-year

results, you might not realize anything was amiss, other than noticing Amazon continues to generate otherworldly performance while brick and mortar stores like Five Below suffer. Regarding Five Below, we bought it very close to the bottom of its plunge in March and believe that extreme value stores are positioned well for a post-pandemic world.

The Index was down only 3.1% at mid-year, even as average citizens suffer significant economic hardship. Goldman Sachs expects S&P 500 earnings to decline 24% this year and then rebound by 31% next year. Conveniently, that would put 2021 earnings flat with 2019. In a low-inflation economy where the risk-free rate of return approaches zero, it's not obvious that the market is wrong – so long as earnings rebound next year. The dividend yield on the Index is 2%, about three times higher than the yield on 10-year US Treasuries, further making the case for stocks as reasonably valued.

At the same time, it does seem like many companies have, in fact, suffered a loss of franchise value. Many companies have drawn down the full amount of their credit lines and issued debt or equity to maintain liquidity. In the future, they will have to dedicate more of their income to debt service and less to reinvestment in the business, employee pay or dividends to the owners. We follow one company that sold stock at multi-year lows in March and received a going-concern letter from its auditor, yet subsequently rose six-fold in value. The market is showing some strange behaviors.

We've had several conversations with prospective clients who ask some version of, "What is different about you?" We believe that at a time when the market is preoccupied with fast-growing businesses that are pursuing a land grab of market share, often with indifference to profitability, we remain focused on dominant franchises with proven economic models, preferably led by founders or blessed with exceptional management cultures.

For better or worse, we are not skewed to the five largest S&P 500 Index components, which have outperformed the broader Index by substantial margins in recent years. More broadly, we are not skewed to the phenomenon of the extremely fast growers that are driving Nasdaq performance without necessarily generating income.

The five largest S&P 500 Index components are now technology companies – by market-cap size, they are Microsoft, Apple, Amazon, Alphabet and Facebook. These five make up more than 21% of the Index vs. 13.3% of our model portfolio on June 30. They generated a 35% return on a weighted basis in the second quarter vs. 17% for the other 495 Index components.

Big 5 vs. Other 495	Q2 performance	% of S&P 500	% of GCAM Model Portfolio on 6/30
Microsoft	27.0%	6.0%	0
Apple	43.2%	5.8%	0
Amazon	40.4%	4.5%	1.3%
Alphabet A&C	23.3%	3.3%	7.9%
Facebook	36.8%	2.1%	4.0%
Other 495	17%	78.3%	
S&P 500 Index	20.54%	100%	
GCAM Model Portfolio	19.64%	n/a	

The Big 5 are not in some kind of bubble that is going to pop. They possess deep competitive moats. They grow at double-digit rates, generate lots of free cash and earn high returns on capital. It's easy to be

cynical about large companies – and this group appears monopolistic and does not pay a lot of tax. But it also collectively delivers extraordinary products and services to customers.

However, the Big 5 are also the best of a group of large cap growth stocks that have massively outperformed the market recently without being of uniformly high quality.

The firm Empirical Research published a report on July 1 on the phenomenon of the “Big Grower.” It identified 75 large cap growth stocks with exceptional revenue growth and stock price momentum. This group, says Empirical, trades collectively at 71x the forward price-to-earnings estimate, about 3.5x richer than the market average. These are not small-cap companies. Their combined market capitalization approaches \$7 trillion.

Microsoft and Apple are not included in the 75 big growers, but Amazon, Alphabet and Facebook are. If we subtract these three, the remaining 72 growers have a combined market cap of about \$4 trillion, supported by no trailing earnings and no free cash flow. Twenty-two of the 72 growers are losing money.

The market is telling us that businesses that cater to work, shop and play at home are the future, along with life sciences and automation. The pandemic didn't create this surge in investor interest but amplified it. The market further seems to say today's earnings don't matter because the future trajectory is so clear. And these firms really do grow at impressive rates: the median company on the list has generated 30% annual revenue growth over the past five years, a pace only rivaled by the Big Grower class of 1999.

The prospective math is daunting, however. Empirical says Wall Street analysts expect the median Big Grower to produce 22% EPS growth per year for the next five years. The 10-year expectation is for 13% growth. Over the past 60 years, about 30% of the 75 fastest growers in a given year maintained at least 13% earnings growth for the following decade. The only decade in which half of the 75 fastest growers grew at least 13% was the 1960s, when US Gross Domestic Product grew at a real rate of 5%. In the 2020s, US GDP may not grow half that much.

Fun fact: if a stock trading at 71x its forward earnings estimate grows EPS by 13% for a decade, it would trade for 21x earnings in 2030. That is roughly the current S&P forward multiple. There are enormous expectations built into the price of many growth stocks.

GCAM owns six companies on the list of 75. Three are Alphabet, Facebook and Amazon. The other three are Mastercard, Arista Networks and Five Below. All of them are profitable today, and all of them trade at less than 21 times analyst estimates of their 2024 earnings estimates, per Empirical. Alphabet and Facebook trade for 13x their 2024 estimate; Arista trades for 14x. If these estimates are roughly accurate, then our six growers need two or three years to become reasonably priced, not 10.

No one knows what the economy will look like in 2024, much less 2030, so take that exercise with a grain of salt. But it gets at what we're trying to do: own growing businesses without taking quite so much risk. Per both Morningstar and FactSet, the GCAM portfolio earns higher returns on capital than the Index, while also using less leverage. It generates higher profit margins on a weighted basis than the Index. And while our portfolio is slightly more expensive than the S&P 500 on a PE multiple basis, it is less expensive based on multiples of free cash flow. Half of our companies have a founder as CEO or Chair, which we think leads to better decision making.

Trailing Valuation	GCAM	S&P 500
Price to cash flow	11.9x	13.9x
Net margin	29%	17%
Return on Equity	27%	26%
Debt to Capital	37%	44%

Source: Morningstar

Back to the specifics of our portfolio. We exited one stock during the quarter, Activision Blizzard.

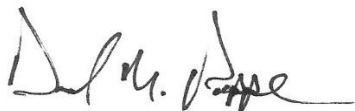
Activision is a leading maker of complex, highly interactive video games, including World of Warcraft and Call of Duty. We've followed the company for years (and owned it personally) and believe it is well positioned to win increasing hours of consumer attention. But Activision has struggled to come up with hit games in recent years. It relies heavily on new iterations of Call of Duty, plus the mobile game Candy Crush. A highly interactive multi-player game can cost upwards of \$100 million to create. We're not sure work-from-home is conducive to this kind of large-scale engineering and animation work.

Activision clearly benefits from the pandemic as people stay at home, but this won't last forever. As Activision caught a tailwind this spring, we opted to exit the business. At best, we were premature. The stock has risen about 20% since we sold it as the stay-at-home theme strengthens.

Finally, I am pleased to report that Al Munro joined us in May to run our operations. Al previously spent 20 years at Rockefeller & Co., where he was a managing director running asset management operations. Clients will be receiving their first quarterly reporting package, which Al has shepherded, along with this letter.

I am deeply grateful to the clients who have joined us in our early days or are in the process of joining – quite a few, I'm happy to report. I'm also delighted with our partnership with Giverny Capital. We're generating ideas together and it feels like both sides benefit from the collaboration. If you'd like to learn more about us, please visit our web site at www.givernycam.com or write to us at gcaminfo@givernycapital.com.

Sincerely,



David M. Poppe