

Winter 2020 Investment and Market Update of Ensemble Capital

This article is excerpted from a letter by MOI Global instructor Sean Stannard-Stockton, president and chief investment officer of Ensemble Capital Management, based in Burlingame, California. Visit [Intrinsic Investing](#) for additional insights.

2019 began with recession fears stalking investors. It ended with the strongest annual return for the US stock market since 1997. These two facts are not unrelated. Investors were not “wrong” to worry about a recession a year ago. It seems clear that the odds of a recession were indeed elevated as we discussed in our letter a year ago. However, 2019 is a near perfect case study in how it is changes in expectations that drive market returns. This is why the market was so strong, even as economic growth did indeed slow. Investors had priced the market a year ago as if a recession was a foregone conclusion and those investors who recognized the very real risk of a recession, but the very real probability that a recession may not occur, were extremely well rewarded for thinking in probabilities rather than trying to guess if a recession was going to occur or not.

One of the frustrating things about investing is that the outcomes you achieve tend to be separated from the actions that lead to those outcomes by a significant amount of time. For instance, in the 4th quarter of 2018 the Fund underperformed as we stuck with and added to names in our portfolio that we believed had sold off excessively based on overblown recession fears. But those actions actually led to incrementally worse performance in that same quarter. But it was those same actions a year ago that set the stage for our strong performance this year.

In fact, if you look at our strongest performing stocks in 2019, it was work we’ve done over the past few years that generated our strong performance. Ferrari (6.8% weight in portfolio) was up 67% this year, but it was our decision to maintain our position despite the unexpected and untimely death of their CEO in the summer of 2018, and the insights we brought back from this trip to attend the company’s Investor Day in Italy, that were the actions which led to strong outcomes this year. The 84% return in Transdigm (2.1% weight in portfolio) this year was something we benefited from due to the extensive work we did in 2017 when the company came under extensive pressure from short sellers claiming the company was engaged in fraud. An accusation that we did not believe, and which seems to have now been thoroughly refuted. And the 59% return this year for Mastercard (6.2% weight in portfolio) cannot be traced to any actions we took this year, but to our recognition years ago that the company was not at risk of disruption, but rather was empowering a generation of financial technology companies to innovate and improve on global payment systems.

I highlight this because while it would be easy to say that we had a “good year” this year, the fact is we won’t know the outcomes related to this year’s actions until the next few years play out. Was our decision to add significantly to Google (7.2% weight in portfolio) earlier this year the right action? How about our decision to maintain our weight in Charles Schwab & Co (5.1% weight in portfolio) in the face of trading commissions becoming free? Or our decision to exit Oracle? Or the fact we chose to stick with Netflix (7.0% weight in portfolio) even as

Disney Plus entered the market to massive customer sign ups.

Each of these decisions were themselves not individual, unique actions, but instead came out of cumulative analysis and experience. We've followed Google since their IPO, and Charles Schwab & Co going back to the inception of Ensemble Capital. We never would have become bullish on Netflix if we hadn't owned Discovery Communications many years ago at the dawn of streaming TV and then later owned TimeWarner while they attempted to use HBO as a vehicle to compete against Netflix.

When we talk about long-term investing, it's not just about the length of time that we typically own a stock, but rather its embedded in our whole research and portfolio management process. The research and relationships we undertake in any given year compound our ability to build conviction in the companies we invest in. And that conviction underpins the actions taken in our clients' portfolios. It's not usually the case that the work done in any given year, with the extraneous circumstances that always manifest themselves, will result in a direct line between our work and the returns from the portfolios we build. In some years, such as 2019, our portfolio companies are rewarded greatly, while in others they may not get the recognition of the valuation that we believe they deserve.

This ambiguity, this inability to actually pass judgement, good or bad, with certainty on an investment strategy is one of the most frustrating things about being an investor. However, we do know that while in any given quarter, or year, the performance of our portfolio can vary depending on the "mood" of the market, or economic, or political concerns, over the long term, we believe that the underlying value creation and associated future cashflows will be the ultimate arbiters of the quality of our investment process.

This is why it is so critical for investors to develop a strategy they believe in, refine it over time of course, but stick to the core principles. For the Ensemble Fund, that means owning businesses with strong competitive advantages and bright futures, with outstanding management teams, and operating with a business model and product offering that we think we can understand and forecast with reasonable accuracy. This is what we did in 2018 as well as 2019. Yet 2018 saw the Fund fall in value and slightly underperform the market, while 2019 saw a massive increase in the Fund's market value and strong outperformance.

We know that for our investors, staying invested when our strategy underperforms or when the market is weak can be challenging. So, we deeply appreciate the confidence and trust our investors have placed in us to the extent that this past quarter the asset under management of Ensemble Capital, the advisor to the Fund, surpassed \$1 billion. Our growth over the years has been due to the trust that our clients and investors have placed in us. Thank you for having entrusted us with your wealth and telling your friends and family about the Fund.

But enough with the philosophy, let's move on to what happened this past quarter before we dig into two of our portfolio holdings.

On the weak side, First American (4.2% weight in portfolio), Starbucks (4.2% weight in portfolio) and Landstar (4.4% weight in portfolio) were all flat for the quarter. First American had a strong year as the real estate market returned to growth after a yearlong period of declining home sales. But in the quarter, home sales data was mixed and the stock gave back some of its gains. Starbucks, which nearly tagged \$100 a share over the summer as investors finally realized that the company could return to solid levels of same store sales growth, backed off earlier in the quarter before another strong quarter of same store sales

growth in both the US and China reminded investors just how dominant this company actually is.

Landstar, which provides trucking logistics services, bounced around during the quarter as investors have been trying to get a read on whether the US manufacturing sector is about to rebound, or is stuck in neutral. Modest weakness in truck loads shipped and sharp weakness in revenue per load for Landstar, is indicative of weak demand for moving manufacturing goods around the country. But having owned Landstar for many years, we're well accustomed to the mini cycles the company goes through. The last time the company posted results as weak as they are currently, was in mid-2016. Over the following year, declining revenue reversed and shot 20% higher with the stock appreciating by 40%. The cyclical behavior of Landstar's results aren't lost on the market though, which is why the stock still returned 20% this year even as revenue and earnings declined.

On the strong side this quarter, First Republic (7.0% weight in portfolio) was up 22% as the company reported record high levels of new loan originations and the yield curve ended a period of inversion, where long-term rates are lower than short-term rates, pointing to stronger earnings power for the company in the year ahead. Netflix, which returned almost exactly 0% during the first three quarters of the year, shot higher by 21% this past quarter. In the face of Disney Plus rolling out and landing 10 million subscribers on its first day, we've stayed bullish on Netflix as we believe that a Disney Plus subscription is a complement to, not substitute for, a Netflix subscription. While data on this question is scarce and preliminary at this point, Netflix has rallied as early indications appear to support our thesis. For instance, a survey from research firm Cowen & Company suggested that 80% of all Disney Plus subscribers report also maintaining a Netflix subscription and only 5% of Disney Plus subscribers report having canceled Netflix.

Like Netflix, Charles Schwab & Co was another leading stock this past quarter appreciating by 14%, despite (or maybe due to) the stock generating flat returns in the first three quarters of the year. This dynamic of some of our weakest stocks earlier in the year being our best performing stock this quarter is characteristic of the mean reversion that is a powerful force across financial markets. While we are long term investors and often hold positions in companies for many years, when you see us trimming a rapidly appreciating stock or adding to an underperformer, it is due to the sort of mean reversion we saw at work in Netflix and Schwab this quarter.

Setting aside the stock's performance, Charles Schwab & Co had one of the most interesting years in our portfolio. For a full analysis, we would point you to our blog post on October 28th titled [schwab kills commissions to feed its flywheel of scale](#). In the post, we argued that Schwab's decision to make trading commissions free would greatly enhance their competitive position within their industry, despite the fact that the stock dropped 10% on the news and we knew earnings would decline in the near term.

As we discussed earlier, there is typically a significant gap in time between the actions we take and the outcomes we achieve. But in the case of Schwab, less than a month after our post, the company announced they were buying rival TD Ameritrade in a deal that we believe greatly enhances Schwab's earnings power and would not have occurred if not for Schwab's willingness to eliminate trading commissions and thus, demonstrate to TD and other rivals that their business models were now in extreme danger vs Schwab's business model that depended far less on commissions to generate profits. In early October, after the elimination of commissions, investors were running for the exits and pundits were proclaiming the retail brokerage business a commoditized industry. So, we must say we took pleasure in reading

some of the awestruck reporting on Schwab's announced deal for TD Ameritrade.

Here's Dave Nadig writing for ETF.com about the deal:

"Let's get one thing straight. When Malcom Gladwell writes his 2025 bestseller, "Cowboys & Ninjas: Renegades in America," he's going to have a whole chapter on the fall of 2019, and the mantle of "ninja" is going to land firmly on Schwab CEO Walt Bettinger's shoulders.

And that's because the chief executive officer has proven that Schwab isn't just a carnivore: It's a honey badger. Honey badgers just don't care what the rest of the animal kingdom does to defend themselves: bees, cobras, jackals. Yawn. The honey badger just keeps eating and growing and doing its own thing—and will devour anything that gets in its way. That's what Schwab's going to do.

In a few short weeks, Walt Bettinger took what some considered a potential weakness of Schwab's and turned it into an extremely sharp sword."

At the heart of everything we do in our investment strategy is our focus on competitive advantage analysis. While many investors try to find cheap stocks or quickly growing companies, at Ensemble Capital we seek businesses with strong competitive advantages and management teams that deeply understand how to wield those advantages to the benefit of their stakeholders. So, while Schwab's stock was our worst performing stock this year, up only 17%, it won the prize for the most aggressive and successful competitive maneuvering. Due to the significant additional earnings power that we believe Schwab will accrue from acquiring TD, we believe that it currently offers the most potential upside of the stocks in our portfolio today.

We'd also like to note that we exited two positions this past quarter. We sold out of Oracle after losing conviction that the company can achieve the transition to their software-as-a-service business model with the speed and earnings power that we had expected. The transition had been taking longer than we initially forecasted and the company has stopped reporting on certain key measures that we believed were important indicators for us to track the progress. After much debate, we decided that the company no longer fully meets our requirements for inclusion in our portfolio due to the businesses future simply not being forecastable enough for us to have confidence in valuing the stock.

On a happier note, we exited our position in Tiffany after the company received a buyout offer from luxury conglomerate Louis Vuitton Moet Hennessy (LVMH). The deal resulted in 38% appreciation for Tiffany in Q4 up until the day we sold and 62% appreciation in 2019. If you'd like to learn more about why we owned Tiffany, please see our Quarterly Letter for the 3rd quarter of 2019 where we provided a deep dive into the company.

Company Focus: Paychex, Inc (PAYX) and Broadridge Financial Solutions, Inc (BR)

Paychex, Inc (4.3% weight in portfolio): We've long held Paychex, a business that we believe is a fantastic one because of the stickiness of its service, its strong cash generation, and its relative stability through economic cycles.

We last wrote about Paychex in our Quarterly Letter exactly 3 years ago, so here we'll provide an overview and update since our last comments. One of the biggest ways that Paychex has changed is that it has become the 2nd largest professional employer organizations (PEO) services firm in the US, just behind market leader ADP. We'll go into what that means later.

Of course, we love the parts of the business that haven't changed since we last talked about it, which is that Paychex provides mission critical payroll and employee management services to its target small and mid-size business customers, commonly referred to as SMBs, in addition to the more comprehensive PEO service.

While properly managing employee payroll, benefits, and regulations are critical for all firms to operate, these are not the core skills or critical value-creating activities of most SMBs. Hence, outsourcing those functions to a reliable payroll and HR services partner like Paychex makes a lot of sense so these SMBs can then focus their limited resources on their core value creation and competitive differentiation to grow their own businesses.

In addition, given the amount of personal confidential information that SMB employers will share about their employees and the need to deliver payroll and provide benefits without a glitch at every pay period means the vendor switching costs are very high. These customers are highly likely to stick with Paychex so long as their needs are met reliably, comprehensively, and at sufficient service quality levels. This is at the heart of what we think of as Paychex's moat.

Finally, the payroll and HR services business lends itself to very high returns on invested capital and high cash margins because of its low capital intensity, making it what we call a "cash machine". In other words, Paychex does not have to reinvest a substantial proportion of its earnings into growing the business at its targeted mid-to-high single-digit growth rates, which frees up earned cash to either distribute to shareholders, or add capabilities opportunistically via M&A.

So, Paychex has this great sticky payroll business, the founding service offering, which it grew to great success in its first couple of decades. Over the last decade it grew its HR management services, which wrapped employee management software and services around its core payroll offering. The revenue from HR services accounted for 80% of all revenue growth over the past decade and doubled its share of revenue to 50% of total revenue.

The PEO administration services are even more integrated with customers' employee management and benefits programs, with their employees considered co-employees of the PEO service provider. This allows Paychex to aggregate the employees of all its SMB customers into a larger pool and then provide benefits to them at a much-reduced cost, particularly health insurance and workers' comp costs, which benefit from the much larger risk sharing pool.

It's the type of benefit that would cost considerably more to provide employees at the 5-10-20 employee level than at the 10,000 or 100,000 employee level. With Paychex PEO surpassing 400,000 covered employees, it creates substantial value for its clients and their employees on benefits costs, a portion of which is then shared with Paychex PEO. This savings can literally mean the difference between an SMB being able to affordably provide healthcare benefits to its employees or not, impacting its ability to hire and retain employees in today's tight labor market as well as the wellbeing of those employees and their families.

We saw this benefit firsthand at Ensemble Capital, advisor to the Fund, when we moved to a PEO service a couple of years ago. As a firm with 15 employees, getting the best rates on health insurance premiums and other benefits wasn't possible. But by switching to a PEO, we saw significant cost savings to both Ensemble Capital as well as to the out-of-pocket costs of our employees that far exceeded the cost of joining the PEO.

The revenue opportunity from PEO services is multiples of the core payroll services revenue and presents a pathway to a larger market and faster growth opportunity since adoption is still low nationally at just over 10% but growing quickly. We believe it will also make switching costs even higher for customers, thereby improving retention.

Paychex's PEO administration service more than doubled in size with the strategic acquisition of Oasis in 2018, its largest deal ever valued at \$1.2 billion. The combination makes Paychex the second largest PEO business after ADP and now represents over 20% of total revenue.

Since the PEO business' economics are tied to scale in risk sharing and resource pooling, Oasis structurally transforms Paychex's opportunity by improving its competitiveness while also expanding its geographic reach across the US. Only about 3.7 million of the 30 million SMB employees nationally are covered by a PEO arrangement leaving a huge opportunity going forward, especially now that consolidation in the industry means only 5 companies control half that market.

Having said that there have been some initial slip ups as Paychex works to integrate Oasis, which has meant that its revenue growth targets (but not profitability targets) have slipped a bit recently. However, given management's long-term operational acumen and experience at running its own sizable PEO business, we believe management will get past the integration hiccups and start to show strong results in the form of higher growth and better margins in the combined PEO business.

Broadridge Financial Solutions, Inc (4.5% weight in portfolio): This is another long-term holding in the Fund. Since the inception of the Fund, this quiet, under the radar company has been one of our best performing and largest holdings. But it isn't a company we talk all that much about simply because there isn't much news flow in this industry and the news that is relevant isn't typically particularly exciting.

Broadridge is the most important financial services company you've never heard of. They are the plumbing behind the financial markets. Their business has two core parts; Investor Communications, which delivers information from their broker-dealer, asset management, corporate issuers and wealth management customers to investors, and Global Technology and Operations, which provides trade processing services to manage the life cycle of a stock or bond transaction.

The crown jewel of their business is their near total control of the process by which companies and investment products complete the process of shareholder voting. When you are a shareholder of a company, or mutual fund, you have the right to vote on key decisions. Companies and funds are required to solicit votes from their shareholders and the SEC has made clear that they view engaging shareholders in the voting process is a key regulatory goal.

In order to vote the proxies of the companies owned in the Ensemble Fund, we use a Broadridge service called ProxyEdge, which organizes and aggregates all of the ballots across all of our holdings and streamlines the process of voting them. It also provides us with information from third parties who offer advice on the various ballot measures. These votes are important to good corporate governance and a responsibility we take very seriously. What's fascinating about this segment of the business, is that Broadridge essentially has a legal monopoly providing this service with no material competition of any note. And it is a regulatory obligation for investment advisors to vote these proxies. Since the company counts 95% of brokerage companies as a client, it is almost as if there is an SEC mandated

regulatory obligation for brokers and advisors to pay Broadridge for their services.

This dynamic, where Broadridge enables their clients to meet SEC regulatory obligations, is a key part of the story. From time to time, some investors have worried that regulation might hurt Broadridge. But while there is no doubt that they operate within a highly regulated industry, we believe that they are not the target of the regulation so much as they are a services provider that enables firms to comply with regulation. Indeed, the company's management has routinely stated on investor calls that there has never been a new regulation that has materially hurt their business. Some investors seem to doubt these claims, but if you understand that regulation is what drives their business, the idea that regulation is a risk doesn't make much sense.

The investor communication segment isn't only about voting. It also includes services that help their clients communicate with investor such as the distribution of marketing, regulatory and transaction related information. The SEC is very focused on increasing investor knowledge, engagement and transparency. So, we believe there is a very long-term tailwind supporting Broadridge's business as the expectations for minimum investor transparency keeps increasing.

The Global Technology and Operations part of what they do is not as unique in the sense that there are meaningful competitors in this segment. However, these services are mission critical to the functioning of their clients. More recently, the company has been building out a set of services for wealth management firms. It might seem odd, but the fact is the wealth management industry is actually relatively young. Prior to 30 years ago, most investors worked with brokers who charged commissions for transacting in stocks and bonds. Today, the industry is moving rapidly towards advisory services such as what we provide at Ensemble Capital to our private wealth clients, where we offer holistic services and advice for a fee without receiving any transaction-based commissions.

Because the industry is relatively young, so are the service providers. So, one of the large opportunities ahead of Broadridge is building out a complete set of services and software for wealth managers. Unlike most of the newer firms in this space that have mostly built best of breed solutions for discreet elements of wealth managers' workflows, Broadridge has done that but also is developing a comprehensive wealth management platform which they hope will streamline all aspects of the wealth management service offering.

And unlike the vast majority of financial software startups, Broadridge has deep, long-term relationships with all of the major brokerage firms that are transitioning to wealth management business models. This is a big part of why they were able to win UBS, the largest wealth management firm in the world, as their initial client for their comprehensive platform.

Every company in our portfolio is unique. But even companies from different industries often benefit from similar dynamics. In the case of Broadridge, the key driver of their long-term competitive advantages is that they provide a mission critical service to clients, but the cost of those services makes up a tiny part of their clients' overall cost structures.

Imagine you are an executive at a large broker and one of your managers suggests switching from Broadridge to a competitor for the service of delivering monthly statements and trade confirms. The first question you might ask is whether the change will make the client happier. The answer is likely to be no. It is important to deliver statements and trade confirmations, and indeed it is a mission critical regulatory obligation. But investors are never going to pick

a brokerage firm because they get monthly statements out more effectively. In fact, it isn't even that clear what that would look like. It is just something that needs to get done without errors. There is no such thing as a premium statement delivery system.

So, as the executive at a large brokerage firm, you might wonder why the manager is even wasting your time bringing up the idea of switching. So, you ask a simple question: "If the new service provider was free, would it save us enough to make a difference?" The answer would be no. These costs are so small relative to the huge cost structure of a broker, that the savings would be rounding error for the overall business.

So faced with a situation where changing to a competitor would provide no better of a service to investors and not save any material amount of money, but doing so would run the risk of errors occurring during the transition process and, in fact, could even cause regulatory issues, there is simply no reason to even consider moving to a competitor. And, this is why Broadridge reports around 98% revenue retention meaning that every year, 98% of their customer base by revenue renews their contract for another year.

Providing mission critical services at a low-cost point in a business-to-business environment is one of our favorite dynamics. It creates a structural competitive advantage that keeps customers from leaving and allows for solid pricing power and stable long-term planning. With Broadridge, we think this dynamic will stay well intact for years to come and so long as the share price remains undervalued in our opinion, we expect to be shareholders for years to come as well.

Definitions

Mean Reversion is the tendency over time for data points in a series that are far from the mean to be followed by data points closer to the mean.

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