Conference Call Transcript: Occtober 14, 2015

Good afternoon. I am Ludo Thomasson, director of the wealth management here at Ensemble Capital. Thank you for joining us for our third quarter client conference call. As a reminder, these calls will be scheduled every quarter for about two weeks after the quarter ends. They do not replace a client service call or meeting so we encourage you to ask any questions you might have privately at any time.

Sean will discuss in more detail the recent market volatility and our portfolio, but I wanted to take a few minutes first to remind you of a couple of important year-end planning suggestions.

1. First- If you plan to do any charitable gifting this year, we suggest processing your gifts before December. Even if you have a Donor Advised Fund, December is a busy month and it's better to start the process early to avoid any last minute glitches.
2. Second- Check with your CPA if you need to harvest some gains or losses in your portfolio. We had a volatile year, therefore for many clients both unrealized losses and gains are available to be harvested this year. We always look to minimize your gains when possible and take into account any carry forward loses that you have communicated to us. But only your CPA has a full picture of your tax situations and so they may be aware of information that we are not that can help us optimize the management of your portfolio.
3. Third, talk to your CPA about your AMT situation and ask if you should accelerate or defer some of your deductions, such as property taxes, for example.
4. And lastly, take advantage of the annual gift tax exclusion. This is a very powerful tool if you plan to gift assets over time as these yearly gifts don't count toward your lifetime gift tax exemption. This year, the maximum amount is $14,000 per person. For example, a husband and wife can each make $14,000 gifts. So for example, a couple could make $28,000 gifts to each of their four grandchildren, for a total of $112,000 tax free. With a 40% estate tax, that's a saving of almost $45k per year. Keep in mind that grandparents can also pay their grandchildrens' qualified education tuition without the payments utilizing any part of their annual exclusion or lifetime gift tax exclusion.

Feel free to call me if you would like to discuss any financial planning topics in more detail. Sean will now be discussing investments.

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Good afternoon. Thanks so much for taking the time to join us today. We had wonderful feedback on our last call, with many clients who did not dial in for the live call telling us they listened to a replay later. I think my favorite was a client who said they listened to a replay of the call from their iPhone during a drive to Tahoe. I assume they must have lost all radio signals up in the mountains before deciding to listen to our investment update!

A quick update on Ensemble Capital. Much of the heavy lifting we did earlier this year to bring on additional staff and implement our new reporting system is complete. We're very pleased with the talented people who have joined us this year and our new reporting package seems to have brought additional clarity to our clients on what they own and how their accounts are doing. While much of the client facing updates are finished for the time being, we continue to work on enhancing our portfolio management tools that operate behind the scenes. These include a more robust system to coordinate trades across multiple portfolios owned by a single client, become even more tax efficient in our portfolio management, and leveraging new trade management tools that we believe are helping us achieve better price execution on our trades.

So now let's talk about the market, our portfolios and what's going on in the global economy.

During the third quarter, the market declined by over 10% for the first time since 2011. In fact, on the morning of Monday, August 24, the Dow Jones Industrial average fell 1,090 points or -7% at the opening bell. Individual stocks were down even more with a number of large, global companies seeing their stocks trade down 20% or more for a few minutes before rebounding.

I'll talk in a minute about some of the issues driving the market volatility, but first I just want to make note of the fact that these sorts of "flash crashes" have become more common in recent years. A big driver of the volatility has been the growth of ETFs, index funds and high frequency traders.

When we think about people trading stocks, many of us still imagine a financial analyst considering the pros and cons of a given investment and trying to determine what the fair price is for a given security. That's how we approach trade decisions here at Ensemble. But the reality is that today, the majority of trades are executed based on short term supply and demand and the need for index funds and ETFs to sell their holdings when their investors want out and add to their holdings, when investors want in, without any regard for the actual intrinsic value of the stocks being traded.

These flash crashes and market machinations get a lot of bad press and certainly the way they push the market around can be stressful for owners of stocks. But at Ensemble Capital, our job is to identify times when markets are acting irrationally and mispricing stocks. So while the volatility is honestly no fun, it is also a key source of potential outperformance.

The move towards passive, or index investing has picked up steam in recent years. While we think passive investing is a reasonable approach, we also think that the popularity of indexing may lead it to be less effective in the future. It is a market truism that investment strategies lose their efficacy once they become highly popular. It becomes a simple question of too many assets chasing too few returns.

A recent New York Times article titled The Ease of Index Funds Comes With Risk discussed the way in which the popularity of indexing has led to stocks in major market indexes to become much more highly valued compared to non-index peers. A decade ago, index stocks traded with a 12% valuation premium to non-index stocks. Today, after 10 years of investors embracing indexing, index stocks trade at a 62% valuation premium.

At Ensemble, we are agnostic to whether the stocks we own are part of an index or not. Instead, we simply search for outstanding companies trading at inexpensive valuations, no matter where we find them.

Our focused and unconstrained approach has led to strong returns so far this year. The market finished the quarter down over 5% year to date. Our unrestricted equity accounts on the other hand were down just a couple of percentage points on average. This was mostly the result of the market decline being harshest towards low quality or highly valued speculative stocks, while the high quality, modestly valued stocks that we focus our portfolios around held up better.

As we discussed in our quarterly statement commentary, the driving force behind the market decline was increasing concerns that the Chinese economy is slowing. Chinese related transactions make up less than 5% of the US economy. However, the prospect of declining Chinese demand caused market participants to worry that just as the US Federal Reserve has finally gotten to the point where they believe the US economy is strong enough to handle some interest rate increases, Chinese economic issues might trip up the global economy.

However, it is important to understand that there are really two different Chinese economies operating in parallel. In the US, 70% of GDP growth comes from consumer spending. While in China, only 30% is from consumer spending with government spending on infrastructure and investment making up an amazing 65%. The slowdown in the Chinese economy of late has primarily be driven by a slowdown in government investment spending as they intentionally work to transition the economy towards more consumer leadership.

While it is true that reducing investment spending will slow the overall economy in the near term and result in relatively lower job opportunities and income for consumers overall, it is important to note that affluent Chinese consumers continue to spend. We don’t need to look at undependable, official Chinese government economic statistics to know this is true. The fact is that US companies continue to see strong demand from affluent Chinese consumers.

Tiffany's, the high end jewelry retailer, reported same store sales in China grew at a double digit pace during the quarter ending in July. Airlines are reporting continued, robust outbound tourist travel from China. And revenue growth in Apple’s China segment was up an astounding 112% this summer.

This isn’t to say that the Chinese economy is problem free. But when you own a focused portfolio of companies as we do on behalf of our clients, it is important to examine the nuances under the surface, rather than relying on the headlines.

Taking a step back, it is also important to recognize how quickly the market worries blazing across websites and newspaper headlines can fade away. It was just on our last call of this sort that we discussed issues in Greece and yet those issues seem largely forgotten by the market. Unfortunately, more often than not the issues that everyone is talking about are not the ones that investors need to worry about. Instead, real risk often emanates from unpredictable and unknown events that are far off everyone’s radar until suddenly they are the center of attention.

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The other major news during the quarter was the Federal Reserve's decision to once again postpone raising interest rates, at least in part due to uncertainly around emerging market economies. The Fed now says that it is more likely than not that they will begin raising interest by the end of this year, but they also think there is a material chance that they will continue to defer into 2016.

The fact is that even once the Fed begins raising rates, their policy will be highly simulative. After so many years of zero interest rates, it is hard to remember that historically the average Federal Reserve interest rate has been about 4.5%. So even at 1% or 2%, Federal Reserve policy will continue to be a simulative tailwind to economic growth.

That being said, should the Federal Reserve continues to march rates higher towards their historical average, the value of long term bonds will become severely impaired. A 30-year treasury bond for instance, would fall in value by approximately 25% in the event that 30-year interest rates moved up by just 1%. This is why at Ensemble Capital, we primarily hold short term bonds in our client accounts. We'd much rather collect a percent or two less in interest in exchange for greatly reducing risk and giving our clients the opportunity to reinvest at higher rates in the future, should those higher rates eventually come to pass.

Our risk reducing approach to bonds has led our fixed income portfolios to generally underperform the broader bond market in recent years as interest rates have stayed persistently low. But given the role of bonds as offering stability during stock market volatility, the last thing we want to do is expose our clients' bond holdings to material risk in the event that interest rates eventually move higher.

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With the market selloff has come some opportunities for us to add to existing holdings at cheaper prices and buy some new holdings in our portfolios. Historically, we have held stocks for 3 to 5 years on average, implying that we "turnover" between 20% to 30% of our portfolio each year.

In recent years, with the market consistently marching higher and giving us fewer opportunities to pick up new positions at bargain prices, our turnover has trended toward the low end of our average range. This year we are seeing somewhat more activity. This activity is designed to protect gains and better position our client portfolios for the future. But the combination of higher turnover paired with portfolios made up of appreciated stocks bought in years past means that in some cases, taxable realized gains may be higher than in years past.

Our investment strategy is very tax efficient because our multiyear average holding period defers taxable gains and qualifies for preferential long term gain tax rates. But over time, if we are to continually replace stocks that we believe no longer offer as much upside as they once did with stocks we think are better positioned for the future, we must realize taxable gains.

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Finally, I want to discuss two specific stocks that are widely owned in our client accounts.

One of our under performing positions during the quarter was Sensata Technologies, down 15%. Sensata provides sensors that go into cars and trucks to make them more fuel efficient, safer and emit less emissions. While the number of cars and trucks around the globe is not expected to grow much, the amount of sensor content per car is expected to grow at 7%-10% per year.

Sensata is a good example of the sort of competitively entrenched companies that we seek to own. They work with every major automaker. Their engineers literally work at the automakers design centers where they help drive fuel efficiency, safety and lower emissions through designing Senata sensors into the automakers' new car designs. Once an automaker designs a model platform, think of the Honda Civic for example, that platform can live for decades during which time the automaker continual buys Sensata's custom built sensors.

However, during the third quarter, the Volkswagen emissions scandal knocked down the stocks of major auto suppliers. This scandal had nothing to do with Sensata sensors. In fact, VW utilized software to cheat on emissions tests specifically so they could avoid the costs of installing additional emissions control systems.

We think the Volkswagen scandal, far from being a problem for Sensata is actually a long term positive. While auto production and orders for Sensata's sensors might be disrupted in the very near term, it seems clear to us that the scandal will catalyze global governments to enhance their emissions control mandates and strengthen their enforcement of existing requirement. Since Sensata's sensors are a key input for reducing emissions (such as sensors that temporarily shut down the engine while waiting at a red light or monitoring tire pressure, which is a key driver of fuel efficiency), meeting enhance mandates and more stringent compliance requirements is going to mean automakers ordering more Sensata sensors.

We can see this dynamic at work right now with Sensata attributing up to $100 million of their revenue growth to the Euro6 emissions standards phasing in this year (which are unrelated to the Volkswagen issue). The situation at Sensata is an example of a primary source of opportunity for us. Frequently the market focuses on the next couple quarters of company results, despite the fact that it is the multiyear future of each company that generates most of the value for a given stock. Just yesterday VW announced their planned fix for their emissions problem and the new emissions control system is one that Sensata builds sensors for. So by focusing on the medium to long term, we open up the possibility of outperforming the market when its excessive focus on the short term depresses stock prices.

One of the bright spots in our portfolio was Broadridge Financial, which rallied over 10% in spite of the market decline. Broadridge is an example of the sort of business we love. It produces a highly dependable stream of free cash flow, which the company does an excellent job of allocating in part to a dividend, in part to buying back significant amounts of stock and in part to investing in growing their business.

While it is unlikely you've heard of Broadridge, you interact with them regularly since the company processes investor communications, such as statement delivery, trade confirms and corporate proxy voting, on behalf of many of the top brokerage companies including Schwab where our client accounts are held. In proxy voting, the process by which shareholders have an opportunity to vote for the board of directors and other corporate matters, Broadridge has a virtual monopoly processing 98% of all votes.

The company was spun out of ADP, the large payroll company just before the financial crisis and like many spinoffs the stock was discarded and ignored by investors. The word "Financials" in their name and the fact that their customers are a who's who of the country's largest banks and brokerage firms probably scared off a lot of investors. But in recent years the market has come to appreciate that Broadridge's business is far steadier than the business of its customers. In addition, once a customer is using their services, Broadridge gets baked into the core processes that run their firm and so switching to a competitor becomes a costly and difficult process.

In business to business companies like Broadridge, we look for companies whose offering is mission critical to their customers, but where the cost of their offering makes up a small portion of their customers' expense budget. In these situations, there is little cost savings available to incentivize a customer to switch to a competitor, while doing so can be very disruptive and time consuming.

Incidentally, this dynamic is true for Sensata as well. The average car has less than $100 worth of sensor content from Sensata and so even if a competitor where to offer cheaper sensors, it would only save the automakers a couple of dollars per car. Given the multiple decades of experience that automakers have been working with Sensata and gaining trust in the quality of their product, there is little reason for them to consider alternatives.

So in closing, we'd just note that while the market is down for the year, it is up 70% in the past five years. We believe that the occasional selloff is a healthy part of an overall bull market and welcome the opportunity to find new bargains. But there's no doubt the process is stressful and we work hard to allocate our client accounts with a mix of stocks and bonds that fit each client's ability and willingness to accept downside volatility.

And with that we'll bring this to a close. Last quarter we opened the line to questions, but we're very aware of the private nature of wealth management and given the lack of questions last time, we won't be taking questions going forward. That being said, we strongly encourage anyone on the line to reach out to us directly via phone or email with any questions you might have.

Talk to you next time and thanks for listening.

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