Conference Call Transcript: January 14, 2016

Good afternoon. I am Ludo Thomasson, director of the wealth management here at Ensemble Capital.

Thank you for joining us for our first 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.

The beginning of the year has been quite challenging for the global markets and we will be focusing the majority of this call on the current market and economic conditions, but this is also great time to focus on the importance of having an appropriate asset allocation across your portfolio.

As most of you may know, the asset allocation in its most basic form, is the decision of how to weight stocks, bonds and cash in a portfolio, in a way that provides the potential for the best investment return for the amount of risk you are willing to take. And more importantly than just the risk factor, the asset allocation is based on the financial goals you have set with us for you and your family.

Whether you are living out of your portfolio or you are still in the accumulating phase and have a longer term horizon, this recent market volatility shouldn't alter your ultimate goals and financial projections.

It has been true that from a yield point of view, bonds haven't been that attractive in recent years, but they still play an important role in portfolios by providing stability during times of market volatility…. The allocation to bonds, in general, is determined by each portfolio's time horizon, with specific bonds set up to coordinate with cash needs….. For people living out of their portfolios, this allocation provides short and medium-term liquidity, allowing enough time for stocks to recover when there is a sell off.

For example, if you are retired and withdrawing about 3% of the total value of your portfolio annually, having a 30% allocation in bonds will give you approximately 10 years of secure money in the event of a large market selloff. 10 years is not just a random number; there have been only a small handful of 10 year rolling periods when the S&P 500 return was negative. That means that it is very likely that your equity allocation will be able to recover most of their losses by the time you use your bond allocation if a large market selloff happens.

This topic shouldn't come as a surprise as we have made sure that each of our clients have the appropriate asset allocation in their portfolio, but if you feel that you need to review or discuss your asset allocation in more detail, please contact us at any time. Here is Sean.

The fourth quarter saw a strong rally in the stock market. We'll get to the recent selloff shortly, but it is worth talking briefly about what happened in Q4 and the context it offers to the action so far in January.

In the fourth quarter, the S&P 500 rallied 7%. Far from being a sign that the outlook for corporate fundamentals was looking bright, the rally was primarily fueled by the fact that when the market ended September, the conventional wisdom had become overly pessimistic about the outlook for China. In other words, the seeds of the Q4 rally were sown by the market pessimism of the third quarter.

Now 2016 has started off with another sharp correction. Through last night, the S&P 500 had declined 7.5% year to date. The fact that last summer's market correction turned out to be the best buying opportunity since 2011 does not mean that this correction will work out the same way. But it also should give pause to anyone who thinks that a deeper selloff is inevitable.

There are a number of reasons for the decline in the stock market, but in all honestly no one can point to any one issue as being the primary culprit. The weakness in the Chinese economy is certainly a worry, but the US generates very little of our economic growth from exports to China and most US companies, certainly most of the companies in our client portfolios, generate a relatively small portion of their revenue from China.

The decline in oil and commodities more generally is certainly a major fundamental negative for energy and commodity companies. We expect that there will be numerous bankruptcies among financially weak energy companies during 2016. But for 90% of the companies in the country, energy is a cost that is falling, not a source of earnings. And lower energy costs are a significant tailwind for consumer spending. For the average consumer, paying less for gasoline is like getting a meaningful tax break with those savings going to more spending, reducing debt, increasing savings and generally strengthening the consumer balance sheet. With oil at todays prices, so people are predicting gasoline selling here in the SF bay area for under $2 a gallon.

The rising cost of corporate borrowing is a risk that deserves close examination. Even though the Federal Reserve increased interest rates in December and says they expect to raise rates four times for a total of an additional 1% increase during 2016, longer term treasury bonds have seen yields go down. Yet lower rated corporate bonds (otherwise known as junk bonds) have seen rates go up.

At Ensemble, we do a detailed analysis of every company's financing needs before adding it to our portfolio. Many of our companies utilize debt. But we look hard at how much they need debt to run their business versus the degree to which they take advantage of debt to increase shareholder value. Given how cheap debt is, smart companies with stable earnings are able to utilize debt to buy back their own stock or finance attractive acquisitions. These sort of companies would not have a financing crisis even if debt markets were to close. That being said, as worries mount around lower rated corporate bonds, we continue to examine closely our portfolio holdings' financing needs.

While the Fed says they expect to raise rates four times this year, the bond market implies that there is only even odds that they raise rates more than once. This discrepancy points to the Fed having a good deal more bullish outlook on the economy than the market. On the one hand, we know that the Fed has been overly optimistic about the speed of the recovery for a long time. However, we also know that the market tends to predict recessions more often than the actually occur. The fact is that even the best economist with access to the best economic information have shown almost no ability to accurately forecast economic performance.

This lack of evidence for economic forecast ability is the main reason that at Ensemble we focus our efforts on analyzing companies rather than trying to predict the economy. But that does not mean we ignore the economy.

During periods like the current selloff, we review our portfolio holdings over and over again looking for assumptions we've made that the market appears to be questioning and asking ourselves if the facts have changed. Being a long term investor does not mean that you make investments and then stop paying attention. It means you review and analyze your portfolio all day, every day, but that you make decisions to buy and sell your holdings not based around what might happen to them in the next couple months (which is generally unpredictable) but instead focus on what the evidence says about the next three to five years.

When you are in the business of trying to generate returns that are better than the market, you have to ask yourself what you do that you think might lead to outperformance. In a world where information is freely and quickly disseminated, there appears to be little value to trying to move faster than other market participants. Instead, many successful investors with the best returns over the long term generate those returns by being willing to take short term pain in exchange for long term gain. It sounds cliché, but the fact is that most investors hold stocks for just months at a time and in doing so the market often loses sight of what the medium to long term holds.

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

The first is Charles Schwab & Co, which has declined 16% since the beginning of the year. Schwab is the brokerage company that custodies virtually all of Ensemble Capital's client accounts. While the company is popularly known as a "discount broker", the days when trading commissions were the lead business have long passed. Today, Schwab makes the majority of their money from two sources 1) asset management fees and 2) net interest income they earn from the rather large bank they control. Trading commission makes up just 14% of their revenue and will be an even smaller contributor if the Fed keeps raising interest rates as I'll explain.

On the asset management side, investors have entrusted Schwab to hold an amazing two and half trillion dollars worth of assets. When those assets are invested in mutual funds Schwab gets a significant share of the revenue earned by the mutual fund managers. These mutual fund managers are paying Schwab for the privilege of making their funds available to Schwab clients. When you have

$2.5 trillion in assets, you get to dictate the terms around which funds get to be on your brokerage platform. Schwab often takes as much as 40% of the fees that the mutual fund manager makes.

When client assets are held in money market funds, the funds are managed by Schwab themselves. Historically Schwab has earned good money managing money market funds. But with interest rates so low, they've had to waive their fees for the last several years. When money market funds are earning 3%, it is no problem for Schwab to charge half a percent to manage them. But when money market funds earn next to nothing, Schwab has to waive their fee to avoid having the funds earn a negative rate of return.

If the Fed does indeed raise rates this year and next, Schwab will once again be able to charge fees for money market fund management and those new revenues will fall right to the bottom line. To give you a sense of the scope of this earnings potential, Schwab waived approximately $700 million in money market fees in 2015. Eliminating the fee waivers could add as much as 30% to the company's earnings.

Over the years, Schwab has also built a very large bank. By not needing to open branches and instead piggybacking on their established brokerage offices and infrastructure, Schwab has been able to run this big bank very cheaply. Yet, the low interest rate environment also minimizes the amount that the bank earns on the assets customers deposit with the company. Today Schwab earns just a little over one a half percent on the assets of the bank. But back when interest rates were higher, Schwab was able to earn 3% or twice as much. If rates were to move higher to those historical levels, it could add as much as 40% to the company's earnings.

So while rising interest rates might be a negative for many companies, for Schwab, they are anxious to see the Fed get on with it.

Pepsi is another company we own. This defensive stock is meant to play the role of a stable actor in our portfolios. And as we would expect, it is down only 3.5% this year. But in addition to playing defense, we also think Pepsi can offer material upside for investors over time.

While the company name is that of their flagship soda, in truth Pepsi is a global snack food business with only about a fifth of their revenue coming from soda. Across its portfolio the company controls 22 separate brands that each generate over a billion dollars a year in revenue. Their brands cover a range of products that Pepsi categorizes as Fun for You (treats or what you would honestly call junk food), Better for You (healthier versions of their Fun for You products) and Good for You (products like Sabra Hummus, Quaker Oats, Naked Juice and other food products that consumers think are delicious but are also healthy snack options).

What makes Pepsi so unique is the scale of their global snack business. While many industries see market leaders that are 10% or 20% larger than their next largest competitor, Pepsi is larger than a significant number of their next largest snack food competitors combined. While people often think of the Pepsi vs Coke competition, this only represents a small part of their overall business. Far more important is the fact that when you walk into a Walmart in the US, a pub in the UK, a bodega in

Brazil, a hypermart in South Korea or a Kirana in India, the odds are very high that you'll find Pepsi owned snack food products.

While Pepsi isn't the most exciting company we own, we think it offers compelling long term return potential with limited risk.

Before we wrap up I want to offer you a piece of market trivia. I use the word trivia on purpose, for a reason I'll explain in a moment. Here's the stat, "the first week of January this year was the worst first week of the year for the market going back to 1928." Wow. That sounds seriously dire. But unfortunately (or fortunately as the case may be), that data point gives us absolutely no insight into what is going to come next. It could be that this year will shape up like 2008, when an awful first week of the year was followed by a subsequent decline during the rest of the year of 35%. But it could also signal a year like 1991, when a terrible first week of the year was followed by a 32% rally into December. Or it could be like 1978 and 1969 when, after steep opening week selloffs, the market finished the year within 10% of where it closed the first week of January.

So when we use the term "trivia" to describe the fact that the first week of this year was the worst since 1928, what we mean is that it is a unique and interesting fact that sticks out to people. But it isn't a fact that tells us anything about what the future holds.

Instead the evidence shows that short term market action tells us next to nothing about subsequent performance. The market has historically returned about 8%-9% a year on average and how it does over short term time periods doesn't tend to influence how it performs over the following year.

So in closing, we want to acknowledge that the last couple weeks have been really rough ones. We think that this sort of downside volatility is the price that investors pay to earn the 8%-9% rates of returns that equities have historically offered rather than the much lower rates offered by investments with little volatility. But that doesn't diminish the fact that selloffs like this are no fun. That 8%-9% is earned, not given away.

Rest assured that while we can't predict where the market will go over the short term, we do know that there is tremendous evidence supporting the long term returns accrue to investors who focus on owning high quality companies at reasonable valuations.

If you have any questions or concerns about your individual portfolio, please give us a call or shoot us an email. We're always ready to review your plan and make sure that you continue to be positioned as well as possible to meet your goals.

I look forward to speaking with you next time and thanks for listening.

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