Conference Call Transcript: April 18, 2016

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

Thank you for joining us for our second quarter client conference call. going forward we will be scheduling these calls on the third business day after each quarter end. They do not replace individual client service calls or meetings but are intended to supplement individual portfolio discussions with discussions about current topics we feel all of our clients will benefit from. As always, we encourage you to reach out to any member of our Ensemble team with questions about your personal financial situation at any time.

First of all, I hope that all of you have completed your taxes or at least filed an extension. For those who haven't, the deadline to file is midnight tonight. We received an extension this year from the 15th to the 18th due to Emancipation Day, a holiday that is celebrated only in Washington DC to mark the anniversary of the signing of the Emancipation Act, which President Abraham Lincoln signed on April 16, 1862. So now, you know!

But, enough about taxes! Today we are discussing something far more exciting, insurance. At Ensemble, we do not offer or sell any insurance products, but we want to ensure that our clients have the right coverage and are happy to refer you to third party agents or brokers to purchase insurance.

Our focus today isn't related to wealth transfer strategies for multigenerational wealth, or to discuss tax efficiency strategies, but we want discuss about the protection of either your ability to generate an income or to protect existing assets against a major depletion.

For most people in the wealth-accumulating phase of their lives, the most valuable asset that they have is not their home or their portfolio, but their ability to generate an income. For example, if a 40 year old person is making $300k per year, her or his income loss due to an injury or death is worth about $7.5m if she or he was planning to work until 65 year old That's why it is critical for anyone in that situation to have adequate life and disability insurance.

For life insurance, calculating the right amount is key to make sure your family is protected. There are different ways to structure your life insurance; I like the idea of laddering policies with different maturities. It provides the largest amount insurance when you need it the most and helps reduce your premium costs.

Disability insurance is sometime overlooked or not properly covered, but the likelihood of being injured is much higher than death and could have a big toll on your wealth. For example, an accident resulting a 2 or 3-year disability could deplete your portfolio very rapidly. For disability insurance, having a private policy on top of the policy offered by your work is generally a good idea.

For older people, the cost of long-term care is a major expense as well. It may not deplete all your assets but could potentially decrease your overall wealth for inheritance purposes. With so many policies available now, it is easier to make a choice that fit your goals and your health.

An important but sometimes overlooked insurance is umbrella insurance. Also called Excess liability insurance, a relatively cheap insurance protects you against a host of extreme circumstances that could wipe out your current and future portfolio. A simple example of how umbrella insurance protects you: Your son or daughter borrows a friend's car, and wrecks the car or injures someone; the insurance will help with medical fees as well as legal fees. The rule of thumb or starting point to determine how much umbrella insurance coverage you should get is to purchase a policy that would pay out an amount to equal your net worth. However, you should consider a higher policy if you have a high wage job.

A good insurance broker could help you with a large number of insurance options to protect pretty much everything that you own. The main objective is ensure all of your policies are in sync with one another and complement your umbrella insurance.

No matter your circumstances, having an appropriate insurance will give you a peace of mind. And, here is Sean to discuss investments.

Good afternoon. Thanks so much for taking the time to join us today. One quick reminder before we get started, we've had a great response to the invitations for our first annual client day next month. If you'd like to attend, please be sure to send back your RSVP soon. There will be some additional space available for those clients who would like to bring a friend or family member who might be interested in learning more about Ensemble Capital.

Also, later in the call you'll be hearing from our senior investment analyst Arif Karim who will be talking about our position in Apple. And now let's get to the market, our portfolios and what's going on in the global economy.

On the date of our last call in mid-January, the S&P 500 had already tumbled 7.5% for the year. By February 11th, the market had declined 10.3% for the year or almost exactly 15% from its 2015 high. But it then embarked on a very strong rally, reversing all of the year's losses and finishing the quarter up 1.3%.

Our equity performance was relatively weak during the quarter. After strong performance in 2015, our equity accounts have generally trailed the market by around 3% so far this year. The major culprits of this short term underperformance has been 1) a weak earnings report from Advisory Board company, one of our larger holdings, 2) underperformance by smaller companies, which at this time are overrepresented in our portfolios compared to the larger companies that make up the S&P 500, and 3) the fact that our portfolios entered the year with relatively more exposure to economically sensitive stocks than to more defensive stocks. This last item isn't due to a particularly bullish view on the economy but rather us finding more value in these types of stocks given market participants being generally wary of the global economy.

As recession fears waned in March, our portfolios generally outperformed the market as it rebounded, but not by enough to offset the early quarter underperformance. While we are not satisfied with our performance during the quarter, we do note that we've experienced quarters with similar levels of underperformance in the past, even as we've built a long term track record of outperformance.

Suring the quarter, markets around the world worried intensely that the globe may be tipping into recession. Chinese economic volatility and the negative impact on many emerging markets from falling oil prices put investors on edge. Despite the worries, US economic performance was resilient. The economy created 628,000 new jobs during the quarter and the number of new people claiming unemployment benefits fell to levels not seen since 1973.

This isn't to say that the US economy is robust. Energy related industries are essentially in depression due to the price of natural gas and oil still being down significantly, even as oil has rallied by over 50% since the recent market low. The closely related industrial economy is in a recession with demand declining. But many other sectors continue to grow.

Now that we are over six years into the current economic expansion, it is natural for people to be on the lookout for the next recession. Expansions do not go on forever. On the other hand, the Great Recession was the deepest in almost 100 years and this expansion has been characterized by being much slower than normal. It may be that far from being long in the tooth, this expansion could see an acceleration.

Certainly, that's the view of the Federal Reserve, whose members agree that they should be focused on raising rates in order to prevent a potential overheating of the economy in the years ahead, not lowering rates to stimulate it further.

While the Federal Reserve, like all economists, do not have a strong track record of predicting the future course of the economy, it is good for investors to remember that when they are gripped by fears of an economic meltdown or feel carried away by economic optimism, there is usually a strong case to be made not just that they are wrong, but that the economy may be headed in the opposite direction as they expect.

Now, I'd like to introduce Arif Karim, our senior investment analyst. Arif holds the chartered financial analyst designation, a degree from MIT and has almost 20 years of experience in equity research. Arif works closely with me as we research new investment ideas and our current portfolio companies.

Arif is going to talk about our holding in Apple. We've owned Apple to various degrees for over seven years. During that time the company has transformed itself from a niche computer company into the largest company in the world. While Arif joined us in 2015, he has followed and owned the stock at previous firms for a similar length of time.

So let's hear from Arif,

Hi everyone, I'm glad to be joining the call and appreciate that so many clients have taken the time to listen in. While Apple is one of the most well-known companies in the world, we think most people still don't fully appreciate the scale and scope of the company's achievements and opportunities ahead.

Simply stated, Apple has been the most successful company in bringing technology to the consumer in an elegantly designed, intuitive, and easy to use interface. It has a history of creating technology products that consumers desire, rather than simply filling a utilitarian need as most other technology companies typically address. You might still remember that chunky PC you have in a closet somewhere that you have been in no hurry to upgrade in the last decade!

Across industries, the evidence shows that companies, which address wants and desires, as opposed simply to consumer's needs, end up with much stronger profit trajectories and returns. Fundamentally, we believe that the market values Apple as if it is the traditional type of technology company that addresses needs when, in fact, it is in the far more lucrative business of fulfilling desires and aspirations.

It is not that dissimilar to luxury brands such as Louis Vuitton, Tiffany, Porsche, BMW, or Rolex. Their customers pay large premiums for aspects of the products that go beyond basic utilitarian needs of the products they sell. Smartphones, mobile devices, and computers are the biggest technology markets around the globe and Apple has the best-branded, easiest to use and highest quality products, all integrated into a sticky services ecosystem. This has resulted in very high customer satisfaction and retention rates of over 90%, rates that are significantly higher than its competitor's products and highest rates across all product categories beyond just technology. I would guess that most listeners on this call own iPhones. Further, I bet most of your friends and family members own iPhones as well. While consumers of most other technology products are willing to switch brands when it comes time to upgrade, once someone becomes an iPhone or Mac user, they rarely switch to a competing brand. This behavior is entirely different from the behavior of customers of products made by Apple's competitors.

IPhones, while expensive at a face value of $600-700, are the most important and personal discretionary device the consumer owns. They have replaced multiple discrete devices over time. You use it not only as your phone, but also as your camera, 4K video camcorder, PDA, your book/newspaper/email reader, portable television, remote control for other devices, your wallet, for navigating, for "Facebooking", Tweeting, as your virtual, much more capable shopping mall, and even to track your children and much more. It is the gateway to your entire digital life that has grown to be a very important part of yourself. Soon, it will be the only thing you need to take with you when you walk out the door.

It is your most used device and only increasing in importance.And, with a life span of 2-3 years, the cost of the average iPhone translates to less than $1 a day. This is an incredible value per hour of usage and utility for the user. The combination of these qualities make Apple a phenomenal annuity-like business with repeated sales to its customers and delivering tremendous value to the user, while its differentiation allows it also to earn significant profits on every device it sells. When multiplied by 300MM devices sold every year, Apple becomes a tremendous cash-generating machine. The business generated an average of almost

$60 billion per year in cash over the last two years. It is the most profitable business in the history of the world, and yet still has the opportunity to materially grow. We believe Apple's competitive advantages will persist and Apple will continue to grow its market share even as it continues to generate strong profits and cash flow. While high-income consumers in the US might look at the fact that most of their peers already own an iPhone and wonder how the company can grow, the fact is that Apple still has less than 20% of global smart phone market share. This is due to the fact that, while the iPhone may be a great value, it is still out of reach of lower income consumers in developed markets and all but the wealthiest consumers in emerging markets.

With the launch of the new iPhone SE, Apple is broadening the affordability of its flagship product to even more people around the world and opening a large segment of the market that it didn't even address before. With the stock currently valued at a PE ratio of about 10x, which is about half the valuation that the market currently applies to the average US company, we believe that the market under appreciates the value of Apple's extraordinary business. Back to you Sean.

Thanks Arif.

The other company we'd like to discuss is MasterCard. Like with Apple, everyone on this call is familiar with MasterCard and most of you likely have one in your pocket. But what many people don't realize is that MasterCard does not provide credit of any kind. That's why your credit card bears both the name of MasterCard or Visa as well as the name of a bank.

While the bank is the one extending credit to the user (and trying to collect bad debts when they occur) MasterCard gets paid to process the transaction over its global network. When you step back and think about it, it is rather incredible that you can arrive at your local grocery store or at a small shop in Asia, Africa or Europe and within seconds the shopkeeper will confidently let you walk out the door with their goods based on simply swiping a piece of plastic you hand them through their register.

It is this validation process, this process of creating a level of trust that allows global commerce to flow. Today, after years of building their networks, Visa and MasterCard dominate their field. These companies benefit from what's called a Network Effect. Each new merchant that decides to accept MasterCard makes the network more valuable to consumers who use the card. Each new consumer who starts using MasterCard, makes the network more valuable to merchants.

With both companies earning profit margins of over 50%, many new companies would love to get into this business. The fact is many have tried, but they have virtually all failed. PayPal may be the most well-known attempt to create an alternative network, but after 20 years of trying, most PayPal transactions today are simply an online transaction using a MasterCard or Visa account.

Other attempts have been made with even less success. A number of years ago, a group of large telecom companies got together to tried to build their own payment network. They never gained much traction, and last year had to change their name to Softcard, as their previous name, ISIS, became better known as a terrorist network.

When we first started buying MasterCard years ago, there was a clear worry in the market that smartphone based payments represented a new threat to the credit card companies. But strong networks are very hard to displace. Who would choose to carry a new card if no merchants accepted it? And which merchants would go to the trouble of setting up acceptance for a new card if few consumers carried it?

So after years of trying to leverage smartphones as new payment devices, Apple's Apple Pay mechanism, the most successful effort at smartphone based payments, simply allows consumers to add their MasterCard or Visa to a virtual "wallet". Whether you wave your Smartphone, lift your Apple Watch, swipe your credit card or check out of an online store, it remains almost a given that the transaction will be processed by MasterCard or Visa.

Last quarter on this call we discussed the bit of market trivia going around at the time that noted that "the first week of January this year was the worst first week of the year for the market going back to 1928." At the time, we dismissed this dire comment and pointed to statistics that showed difficult first weeks of January had led to both strong full year results as well as weak ones.

The newest bit of market trivia making the rounds is that the huge reversal during the quarter, with the market declining over 10% and yet finishing the quarter in the positive, makes it one of the strongest intraquarter reversals of this century with the only bigger intraquarter reversals having occurred at the market bottoms of 2002-03 and 2008-09. Yet, just as we dismissed the sky is falling trivia from earlier this year noting its lack of meaning for the future, we urge listeners to dismiss this more bullish trivia as well. The fact is that if you look at the forward performance of the market after intraquarter reversals of over 10%, you find no statistical difference between the performance experienced during random time periods.

Unfortunately, short term market performance is simply unpredictable. This is why at Ensemble we spend so much time focused on the fundamentals of specific companies and little time trying to guess which way the market will move next.

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

If you have any questions about your individual portfolio, please give us a call or shoot us an email. We are always ready to review your plan and make sure that you continue to be positioned as well as possible to meet your goals. During this call we made reference to our portfolio holdings and performance. If you would like a copy of our historical equity composite performance or our 13F holdings disclosures, please send an email request to info@ensemblecapital.com.

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