Conference Call Transcript: April 7, 2017

Ludo Thomasson:

Hello everyone, I am Ludo Thomasson, director of wealth management at Ensemble Capital. Thank you for joining us for our Spring 2017 conference call. Today, the focus will be on the current market and economic situation, and two of our portfolio companies, L Brands and Oracle.

Speaking today will be Sean Stannard-Stockton, chief investment officer of Ensemble Capital and portfolio manager of the Ensemble Fund, and Arif Karim, senior investment analyst.

Sean Stannard-Stockton:

Good afternoon everyone. Ensemble Capital Management offers separately managed accounts as well as a publicly traded mutual fund called the Ensemble Fund (ENSBX). On our call today, I'll be speaking about our general view of the market and economy as well as specific portfolio companies that are held by both our separate account clients and by the Ensemble Fund.

Individual client account performance varies based on a variety of factors including asset allocation and client specific portfolio customization. The Ensemble Fund – which is a pure expression of the equity investment strategy we use across our client base – was up 3.73% in the first quarter vs the S&P 500 up 6.07%.**

Quarterly Returns as of March 31, 2017

	1Q17	1 Year	Since Inception*
Ensemble Fund	3.73%	18.89%	9.02%
S&P 500	6.07%	17.17%	11.00%

**Inception Date: November 2, 2015*

***Performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. You may obtain performance data current to the most recent month-end by visiting www.EnsembleFund.com.*

The underperformance this quarter was idiosyncratic and concentrated in the second half of the quarter after we outperformed during the first six weeks of the year. Periods of under or over performance are frequently related to broad market trends with the drivers being shifts in industry performance, changes in macroeconomic trends or other events that impact a broad range of holdings. But this past quarter, our underperformance was due to three specific stocks that declined for entirely separate reasons.

L Brands (6.7%) was the largest detractor. Given its large position size in our portfolio and its 28% decline in the quarter, its negative impact on returns made up more than 100% of our underperformance. Later in the call, Arif will discuss this stock in depth.

TransDigm Group (7.2%) declined 12% due to accusations from a short seller that the company, which sells spare parts to airlines and the military, has been overcharging the department of defense. We are following this controversy closely, but we do not believe these accusations have merit.

DistributionNow (4.9%), which we talked about last quarter, supplies products needed by oil and gas drilling operators. As the number of active drilling rigs increased dramatically since last year, the stock did very well. But when the price of oil faded from its recent highs, investors began to worry that the rig count would decline. Despite the fact that the rig count has continued to move higher and is now 25% above where it was at the beginning of the year, DistributionNow's stock fell almost 30% from its January highs to its March lows. While it is back up more than 10% from the low, we think this decline was unwarranted and expect the stock to continue to climb back towards it old highs.

On the positive side, Advisory Board Company (4.4%) was a top performer as an activist investor took a large stake in the company triggering them to evaluate the potential of selling part or all of the business. Apple (4.6%), which we believe will post strong iPhone sales numbers this fall, and MasterCard (7.2%), which continues to report solid results, rounded out our top three positive contributors to performance.

For the last two quarterly conference calls, which bracketed the presidential election, we've commented extensively on the intersection of politics, the economy and financial markets. Our message has been that while investors need to recognize the ways that public policy can impact the business prospects of individual companies, there is little evidence of any reliable way to predict how politics will impact the stock market. Indeed, investors have been best served historically by ignoring politics. Letting politics sway your investing can be harmful to your financial health.

So while the mainstream and financial news media are covering politics around the clock, we'd argue that the most important drivers of financial markets this past quarter have been basic economic trends.

The fact is, the US economy continues to improve. Almost a quarter million jobs were added to the US economy in both January and February and the three month moving average for the first quarter was in line with the job creation levels we've seen throughout the recovery. Importantly, over the last year people have been coming back into the workforce and the percentage of Americans who are employed or actively seeking employment has started to rise. While this metric fluctuates, the 12-month average participation rate is now increasing after being in continual decline since 2008. Today, there are 8 million more jobs in America than there were just prior to the financial crisis.

Unemployment claims are exploring new lows this week. The number of people who reported filing for unemployment benefits this past week registered at the lowest level of the recovery and indeed is the smallest number of people to file for unemployment in any week since the early 1970's when the US workforce was literally half the size it is today. As a percentage of the workforce, there has never been a time when so few people have been reporting the loss of a job. And in addition to new jobs, wages have been growing recently at the fastest rate since the end of the financial crisis.

Interest rates are moving up. The 10-year treasury yield averaged 2.4% in the first quarter. While this is still well below the long term average, it is the highest average quarterly yield in over two years. The last time we saw as big of a move up in interest rates was in 2013 when the stock market raced higher by 32%.

But higher interest rates seem like a bad thing to most people. So why have rising interest rates generally been associated with a strong stock market since the Financial Recession?

Over the longer term, the yield on the 10-year treasury bond has tended to approximate the rate of growth of the economy. So while low rates might spur borrowing to finance investments and large consumer purchases, if the economy is indeed going to eventually return to the rates of growth we were accustomed to for the 50 years prior to the financial crisis, interest rates should move higher. While the bond market is not that great at predicating the future, its behavior is supportive of the idea that the economy is improving.

In general, the stock market has rallied during period of low rates increasing back towards average levels as the economy recovers from weak growth. While the stock market generally does poorly when interest rates increase to above average levels at the tail end of a robust economic boom. So for the time being, we would expect ongoing increases in long term interest rates to coincide with solid stock market performance, as it has recently.

Inflation has also been picking up. Like with rising interest rates, most people perceive rising inflation as a bad thing. But economists generally believe that a low, but positive rate of inflation is good for the economy. Historically, market PE ratios have been highest when the rate of inflation is between 2%-3%. This is in fact where inflation expectations were during much of the initial market rally from the great recession lows during the 2010 to 2014 timeframe. But starting in 2015, inflation expectations began to decline, falling as low as 1.2% as the market bottomed last year. But since mid last year, inflation expectations have been increasing in a positive sign for economic growth. As we moved into the first quarter, inflation expectations once against moved back into the 2%-3% sweet spot for market performance.

One more counterintuitive sign of the improving economy has been the increase in oil prices. The price of oil traded above $50 for much of the first quarter, the first time it has traded that high since mid-2015. A stronger economy demands more energy and while too high oil prices, too high inflation and too high interest rates can all crimp a robust economy, when they occur in the context of an economic recovery they are signs of economic strength.

So when we take a step back, what begins to emerge is a picture of an economy that recovered at a slower than average pace from 2010 to 2014. Then during 2015 and the first half of 2016, economic conditions seemed to deteriorate, with worries about a potential recession triggering the 15% correction in the stock market from December 2015 through February 2016. Since then, economic conditions have been improving again and the stock market has responded in kind.

Now don't for a minute think any of this tells us what is going to happen next. These observations about the economy and market offer context for where we've been. Too many investors fret that the recent market rally is related strictly to possibly misplaced hopes about lower taxes and regulations coming out of Washington. But they are missing the fact that while politics has dominated the news cycle for the last year, the US economy has been in the midst of posting steady improvement.

At Ensemble, we focus on understanding what is going on in the economy, rather than trying to predict the future. Most of our time is spent working to understand individual companies. Even here, our work is less about predicting the future and more about trying to understand the state of our portfolio holdings' competitive advantages as these are the elements that allow companies to thrive. Rather than trying to predict the future, we seek to own hardy and robust companies that we think can soar when times are good and survive to fight another day when times are bad.

One company in our portfolio facing difficult industry conditions is L Brands, a specialty retailer whose mall based stores are experiencing headwinds from weak mall foot traffic trends. But like all the companies we own, we believe L Brands exhibits unique competitive characteristics that make it an attractive investment.

Arif, tell us about L Brands.

Arif Karim:

L Brands is one of the newer names in our portfolio. It is the parent company of specialty retailers Victoria's Secret and Bath and Body Works. Last year, Victoria's Secret did nearly $8 billion in sales, virtually all of it in the US while Bath and Body Works did nearly $4 billion.

The stock has been under pressure over the last year due to changing consumer behavior in the mall-based retail business, and we initially started buying when the stock had already declined about 30% from its high. Shifting consumption patterns and increasing ecommerce purchasing behaviors have led to significant declines in mall traffic and pressured most if not all mall-based retailers, especially since the promotionsheavy holiday season last year. Despite making our initial purchases at levels that we felt were a discount to intrinsic value, the stock has continued to decline and as Sean noted, it was our weakest holding this past quarter.

In addition, Victoria's Secret has been in the process of discontinuing and clearing out less differentiated apparel and swim wear, which have distorted mostly stable underlying financial results for the continuing business. These two factors combined to create a lot of noise around the stock while fundamentals have been mostly stable in the underlying business. Once we get past these factors, we believe healthy trends will reemerge in the go-forward business in the US while traction in their new China strategy will refocus investors on the very profitable and large growth opportunity offered in the global market place as I'll explain shortly.

So, the industry pressure in the near-term has given us the opportunity to invest in a very rare type of company in the consumer discretionary space; one that has a strong moat and global opportunity. After all, underlying demand for underwear is not being disrupted and neither are soaps, lotions, and candles. In addition, the branded experience is not being disrupted either as we'll discuss.

L Brands is just really beginning to tap the global opportunity, beginning with China, a market as large as the US, where the company launched the first two Victoria's Secret stores last month to great fanfare and long lines of customers. In fact, Victoria's Secret's annual fashion show, a spectacle viewed around the world, is watched by 400 million people…. In China alone! The brand is indeed a global one with 800 million people watching the annual fashion show each year, highlighting the power of the brand and the experience.

In China, it is launching with strong brand recognition into a large, highly fragmented market with no strong incumbent leader and a middle and upper class that seeks out branded goods and experiences. After all, the Chinese middle class buy 1/3 of luxury goods globally. We expect strong growth to follow over the next decade as stores are rolled out with strong complementary ecommerce sales. Other parts of the globe are being served by select franchise partners and also have tremendous sales growth opportunity ahead.

As a result, we believe the market is significantly undervaluing the brand, product moat, and global expansion opportunity because of near-term changes in consumer purchasing patterns in the US. An indication of this is its 5% dividend yield, which in today's rate environment would only be justified by a permanently declining business or unsustainable dividend, neither of which we believe to be the case.

Ultimately, we believe that L Brands will be able to successfully navigate changes in retail shopping trends under the leadership of its founder and retailing genius Les Wexner, as he's done for 50 years. The company's robust and faster growing ecommerce business at 17% of sales demonstrates this, and it's more profitable to boot!

So a little background -- L Brands was founded by Les Wexner, literally the inventor of what's known as specialty retail in the 1960's, an era when one-stop shop department stores selling everything were the norm. His insight was to optimize return on capital by focusing on specific niche products that catered to customer's needs but also had a high turnover rate on the racks while carrying healthy margins. His first store was the women's apparel shop called The Limited, started in 1963.

Since then he created or acquired new concepts and developed them under the Limited Brands umbrella including Express, Structure, Abercrombie & Fitch, Victoria's Secret, Bath and Body Works, Lerners, and White Barn Candle Co. If store recognition is an element of success, many of you will probably recognize a few of these names from your visits to your local mall, a testament to Wexner's knack for retailing. He is regarded as one of the greatest retailers ever.

Over time, Wexner has spun out or sold a lot of these store concepts as L Brands has evolved with the market. Today, L Brands is predominantly comprised of the two retail brands with solid competitive moats and business models -- Victoria's Secret and Bath and Body Works. We believe these to be highly resistant to the kind of commoditization that internet retailers like Amazon are driving in the traditional retail world. Both businesses are vertically integrated – meaning they make their own branded products, which they sell through their own branded stores and websites, with strong product and brand loyalty, that deliver emotional experiences beyond the products alone. It's the differentiated, experiential nature of the products that make them highly resistant to the permanent disruption we see across the retail space.

Diving into the business, Victoria's Secret (and its younger PINK subsidiary) sells women's underwear in a store experience that provides a specialized one for the women it targets, generally in the 16-35 age range. It has 35% market share, nearly 10 times its closest competitor, and sells 6 out of every 10 bras in the US. The stores serve as galleries for these high turnover products while the brand's appeal allows it to earn a high margin, driving strong returns on capital and making the business very valuable.

Its consumers shop there because fit, comfort, and style are very personal and individualized aspects of the product and the well-trained service staff are available to help customers figure out the products that would be best for them in a comfortable environment. In addition, it's a category in which price is a lower priority for a significant segment of customers, indicating that these customers are willing to pay a premium for the product when it meets their higher priorities. The products are highly designed to meet the paradoxical priorities of durability for everyday use while also being composed of seemingly delicate materials and providing the right fit for various body types.

Bath and Body Works (and its subsidiary White Barn Candle) focuses on fragrance products such as soaps, lotions, and candles. It is the leader in this segment as a focused specialty shop with a strong following among its customers.

Again, this is the kind of product that is highly experiential (as of yet, there's no way to smell scents online!). This makes the store an important aspect of the shopping experience. It is also a consumable product business that caters to a fundamental building block of every human experience. Whether it's a scent to use on yourself or to create a certain atmosphere in your home, Bath and Bodywork's products help customers do just that. For many of their customers, the scents they've been buying for years are an important part of their everyday routine. Any time the company discontinues a scent it triggers panicked buying as customers stockpile scents that they've used for years and don't want to lose access to.

From an ecommerce perspective, companies like Amazon are generally distributors of products. They make it difficult for other undifferentiated retail distributors such as Macy's, JC Penny's and Target to compete effectively because they all have access to the same branded or unbranded products, and Amazon generally has a much better and more convenient customer experience and a lower cost model to boot. The staff of Ensemble are all Amazon Prime members and we fully believe in the distribution dominance of Amazon over traditional retailers.

However, companies with differentiated products, durable brand appeal, and strong customer service or experiences such as Victoria's Secret, Bath and Body Works or companies like Apple, Nike (1.9%), and Tiffany (2.1%), can largely retain control of the distribution and profitability of their products. Their branded products are sought after by customers who will leave the online mall called Amazon and go to the branded sites in order to purchase these differentiated products. At the same time, these types of retailers can sell through Amazon if it suits their interests.

This is exactly the type of companies that we can have confidence in the future of even as customer buying patterns change. They may buy differently, and sales may be lumpy in the near term as channels shift, but as long as they keep buying the products our portfolio companies make, we believe shareholders will be rewarded over the long term.

Back to you Sean.

Sean Stannard-Stockton:

Thanks, Arif. While L Brands has strong competitive advantages to protect their business as shoppers shift their shopping habits, we also want to talk about Oracle (3.0%), a mature technology company that we believe is in the early innings of experiencing a dramatically positive impact from the shift to cloud computing.

Oracle went public back in 1986, the day before Microsoft went public. During the quarter century leading up to 2012, these two companies generated very similar total returns for investors of approximately 6000%, making them both major blue chip companies.

But since 2012, Microsoft has almost tripled again (much better than the market overall) while Oracle has generated a total return of 40% or about half of the appreciation of the S&P 500 during that time.

We believe that rather than facing a permanently weaker future, Oracle is simply a couple of years behind Microsoft on fully transitioning to the reality of cloud computing and we believe that the market is only just starting to appreciate the degree to which this successful transition should lead to a much higher stock price for Oracle.

But before we delve into this transition, some background on Oracle. The company was founded by Larry Ellison. While Ellison is notorious in some circles, he is also unequivocally one of the great geniuses of the technology industry. While his best friend Steve Jobs owned less than 1% of Apple at his death, today Larry Ellison owns 27% of Oracle, ranking him as the largest individual holder of a company with a market capitalization of over $100 billion. Only Warren Buffett's 18% ownership of Berkshire Hathaway and Jeff Bezos's 16% stake in Amazon comes close. As an aside, many of the companies in our portfolio are managed by owners with large personal stakes in the business. L Brands' Les Wexner for instance, owns 16% of the company.

The Oracle offering is complicated and the breadth of what they do is beyond the scope of this call. But at its heart, Oracle offers two platforms, a database that acts as the infrastructure for a myriad of critical corporate software applications, and a software suite known as Enterprise Resource Planning that allows companies to manage their business across planning, purchasing, inventory, sales, marketing, finance and human resources. For global companies coordinating employees, resources and activities around the world, ERP software is a must.

100% of the Fortune 500 use some of Oracle's offerings, and their database, which powers not only Oracle's ERP software, but much of the software offered by their direct ERP competitor SAP, is THE market leader. Their software is so important to other companies that it is one of the few technology implementation projects that is enough of a needle mover to be discussed on quarterly earnings conference calls.

The cost of switching ERP systems is massive, creating huge "switching costs", an important competitive advantage that makes Oracle's customer relationships very sticky. It isn't just the cost of paying for new software, to switch ERP systems a company needs to spend vast resources retraining employees, rebuilding internal processes and changing how they work, while still operating their business. Remember, this software is used across entire organizations to coordinate activity in most business groups. Implementing a new ERP system takes <u>years</u> to complete and the cost is high enough that companies often measure their ROI on time periods of a decade or more.

But like all industries, the huge profits that Oracle earns have drawn competition. Remember, Oracle went public in 1986, but it was founded 40 years ago in 1977. Technology changes fast and over the past 15 years one of the most important changes to impact Oracle has been the shift from on-premise computing to cloud computing. Both Workday and Salesforce are cloud-based technology companies founded by ex-Oracle employees who have sought to use a modern cloud-based operating structure to compete against Oracle's historically on-premise technology structure.

But Oracle hasn't been sitting still. And those huge switching costs have afforded them strong competitive protection while they spent years rebuilding their software from the ground up to become a cloud first technology business and preparing themselves to eliminate the relatively short-term technology advantage that cloud-based competitors have had against them.

So let's pause and go back to my earlier comparison to Microsoft. After seeing its share price go nowhere for a decade between 2002 and 2012, Microsoft got religion on transforming their software into a cloud first offering and the stock spent the next five years in a continuous rally that has led the stock to almost triple.

Beginning a year ago, Oracle's cloud-based sales began to accelerate quickly. And on their earnings call in December, with their technology transformation to a cloud first business complete, their co-CEO Mark Hurd announced that they had actually stopped compensating their salespeople in their applications business for selling on-premise software.

We've seen with Microsoft, as well as other software businesses, that companies that successfully make the transition to the cloud are often well rewarded by investors. We believe that as this transition takes hold, the headwinds to revenue growth that have plagued the company in recent years will abate and profit margins will move materially higher, a pattern that is common to companies transitioning to cloud-based business models. The results from their most recent quarter announced in March support this thesis and we think the company and the stock have a bright future.

Thank you all for joining our call today. During this call, we made reference to the Ensemble Fund (ENSBX) and to the portfolio holdings of Ensemble Capital Management. If you would like to receive a prospectus or fact sheet for the Ensemble Fund, or would like to request a copy of Ensemble Capital's historical equity composite performance or our 13F holdings disclosure, please send an email request to info@ensemblecapital.com.

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

See relevant disclosures below. Please contact us if you would like a comprehensive report on the performance of the Ensemble Fund. In addition, Ensemble Capital publishes a composite of our client account investment performance each quarter. Please contact us if you'd like a copy sent to you.

Total returns presented for periods less than one year are cumulative, returns for periods greater than one year are annualized.

All returns include changes in share price, and reinvestment of any dividends and capital gains distributions. Indices shown are broad-based, unmanaged indices commonly used to measure performance of US stocks. These indices do not incur expenses and are not available for investment. The fund's expense ratio is 1.00%.

Short-term performance, in particular, is not a good indication of the fund's future performance, and an investment should not be made based solely on returns.

Investors should consider the investment objectives, risks, and charges and expenses of the Fund carefully before investing. The prospectus contains this and other information about the Fund. You may obtain a prospectus by calling the transfer agent at 1-800-785-8165. The prospectus should be read carefully before investing.

An investment in the Fund is subject to investment risks, including the possible loss of the principal amount invested. There can be no assurance that the Fund will be successful in meeting its objectives. The Fund invests in common stocks which subjects investors to market risk. The Fund invests in small and mid-cap companies, which involve additional risks such as limited liquidity and greater volatility. The Fund invests in undervalued securities. Undervalued securities are, by definition, out of favor with investors, and there is no way to predict when, if ever, the securities may return to favor. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. More information about these risks and other risks can be found in the Fund's prospectus. The Fund is a non-diversified fund and therefore may be subject to greater volatility than a more diversified investment.

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Glossary of Financial Terms

- P/E Ratio: The price-earnings ratio (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.
- M&A: Mergers and acquisitions (M&A) is a general term that refers to the consolidation of companies or assets. While there are several types of transactions classified under the notion of M&A, a merger means a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.