Ludo Thomasson:

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

Speaking today will be Sean Stannard-Stockton, chief investment officer of Ensemble Capital.

Sean Stannard-Stockton:

Good afternoon everyone.

The performance of our equity portfolios this quarter was somewhat behind the broader market. While the final calculation of our equity composite will not be available until later this month, our current estimate is that our composite was up 3.27% vs the S&P 500 up 4.48%. After being just ahead of the market in the first half of the year, our estimated performance on a year to date basis is now up 13.19% vs the S&P 500 up 14.24%.

The third quarter was divided into three periods in which our portfolio performed very differently relative to the market. Through July 25th, our portfolio traded broadly in line with the market. From July 25th to August 22nd, we sharply underperformed by about 3.9%, as two stocks in our portfolio sold off. From August 23rd through the end of the quarter, we significantly outperformed the market regaining 2.5% in relative performance.

The drag on our performance in the middle of the quarter was caused by significant declines in L Brands and Now Inc. We've discussed these companies on recent calls and our view has not changed materially. We continue to believe that both stocks are being excessively punished due to what we believe are transitory issues. In both cases, we hope and expect that these transitory headwinds are in the midst of abating and expect the otherwise resilient core business trends to become more evident over the balance of 2017 and in to 2018.

These two holdings are responsible for detracting approximately 4% from our year to date performance. Given that we've underperformed this year be approximately 1.3%, this implies that the rest of our portfolio has collectively outperformed the market by 2.7% this year.

With L Brands and Now, Inc both up over 20% from their recent lows, we're hopefully the worst has passed in these two investments. However, in the short run, the price of any stock in our portfolio is determined by the fear or optimism of other investors, over which we have no control. Our continued ownership of these underperforming stocks is based on our assessment that the underlying businesses are in solid shape and worth much more than the price currently assigned by other investors.

This assessment is not static and we are constantly seeking new information which may change our understanding of the businesses in which we invest. But as you'll hear me describe a little later when I talk about Apple, even big changes in stock market prices are not always accompanied by material changes in the underlying value of the businesses they represent.

On the more positive side, we saw material positive contribution to our performance from our holdings in Mastercard, Landstar Systems and Ferrari.

Mastercard, our largest position, rallied 16% in the quarter, extending a strong year to date rally. As macro headwinds have begun to fade and the headwind from last year's strength in the US dollar reverses, the company's strong secular growth rate has become more visible, a fact the company highlighted when they raise their guidance at their recent analyst day.

Landstar, until recently almost the same size holding for us as Mastercard, rallied 17%. Landstar provides truck brokerage services. With the recent hurricanes triggering a significant need for truckers to support disaster relief, expectations for the near term revenue outlook has surged. In addition, the company would be a big beneficiary of corporate tax reform, with part of the stock's rally being due to increased hope that those benefits may actually become law.

While we certainly didn't predict the hurricanes, nor do we think we can predict what Washington might do with tax reform this year, we have long included in our assessment of Landstar's value our expectation that demand for truck capacity would rebound from recent weakness and we've believed that some form of bipartisan corporate tax relief would benefit the company over time. As the market has come to embrace those views, we cut our position in Landstar from a high of almost 8% to about 5% today.

Ferrari is a company we talked about last quarter, so I won't go into depth on the company again today. The driver of the stock's 28% rally in the quarter was the growing acceptance of the idea that the company has significant excess capacity at their factory, which they can use to produce a new utility vehicle on a very profitable basis. When we bought the stock earlier this year, we believed it was significantly undervalued, but did not yet fully appreciate the untapped profit potential of their underutilized factory.

As this dynamic became clearer to us (and to the market), we materially increased our stake at higher prices. This is a good example of how we do not seek to buy stocks that have declined in value so much as we target stocks that trade at a significant discount to fair value. While it would have been nice to have loaded up immediately when we first finished researching the company, fully understanding a business model takes significant time and our understanding tends to evolve. As long as a stock is trading at a significant discount, we are happy to "average up" as we buy more stock at higher prices.

Lastly, we exited our position in Pepsi, except for a small number of accounts where we still hold it for client specific reasons. While known for its #2 position in the cola market behind Coke, Pepsi is in fact the #1 global snack food business. Their dominant position around the globe and their forward thinking decision to sell what they call "Better for You and "Good for You" snacks in addition to "Fun for You" junk food has made for a good investing recipe and the stock has performed strongly during the time we owned it.

However, over the last year we've become concerned about the extremely limited volume growth the company has been able to generate, forcing them to rely on price increases for growth. For some time, we had chalked the slow volume growth up to macroeconomic trends. But more recently we've come to believe that incumbent consumer branded goods makers are facing a series of challenges that diminish the value of their historically powerful brands. If you'd like to learn more about our thinking on this topic, we encourage you to read our post The Death of (Many) Brands on the Intrinsic Investing blog.

One other aspect I'd like to call out in our portfolio is our growing cash position. Typically, our strategy is to be fully invested. We believe that in most market conditions, we can generally find 20 to 25 high quality companies, whose stocks are undervalued. However, we will not invest our clients' cash unless we can find opportunities to do so that we believe offer an attractive risk/return profile on an absolute basis. While this seems like a common-sense approach to us, we note that the vast majority of equity asset managers are mandated to be fully invested at all times. If they face conditions under which they cannot find attractive investments, their mandate is to own the least overvalued stocks they can find. This is an approach that simply makes no sense to us.

For much of time since the financial crisis, there have been plenty of reasons to feel worried about the market outlook. But because we were able to routinely find plenty of good investment opportunities, we have generally been fully invested. But over the course of 2017, we have found it more and more difficult to find new investment opportunities that meet our quality criteria while still trading at a material discount to our assessment of fair value. At the same time, we have been trimming many of our portfolio holdings as their market values have appreciated and the discount to fair value we had previously identified has contracted. Landstar, which I just discussed, is one example and I'll talk about Apple in a similar light in a moment.

The outcome of finding more to trim and sell than we are finding new opportunities to buy has led to cash levels building. In addition, at the end of August one of our portfolio holdings – Advisory Board Company – agreed to sell itself. While we are pleased that the acquisition price is 60% above where Advisory Board was trading to begin the year, this forced sale has generated additional cash in client portfolios.

We never target a specific level of cash in client accounts. Instead, cash is just the residual of our investment decisions. Often, we have more we want to buy than we can fit in a portfolio and we're forced to choose among stocks that we believe all offer attractive return potential. Today, we find the opposite is true. Without watering down our criteria for the types of companies we want to own or the prices we're willing to pay, we are finding it difficult to put all client cash to work.

The cash levels in individual client accounts is dependent on a number of variables including; the pattern and size of inflows and outflows, the taxability of the portfolio, any restrictions on taking gains that might exist, and the existence of legacy holdings we may maintain in consultation with a client. But as a general statement, taking into account the cash generated from the sale of Advisory Board Company as well as remaining shares in that company that we still hold for tax reasons, but which will be redeemed for cash at an effectively fixed rate later this year, we currently have cash making up about 10% of our equity portfolios.

A superficial analysis might suggest that this high cash weighting implies we are bearish on the market or expecting a short-term decline. However, we would point out that we currently own no stocks that are members of the consumer staples or utilities sectors. Those sectors collectively make up 11% of the S&P 500. Unlike the technology, consumer discretionary and industrial sectors, which trade at valuations that are in line with their long-term averages, the consumer staples and utilities sectors trade near record high valuations. Since our cash levels reached their current levels at the end of August, the consumer staples and utilities sectors have been declining, even as the broader market has rallied.

Now to be clear, we do not make sector calls as part of our investment process. We do bottoms up analysis of individual companies and that process has not yielded any interesting investment opportunities within those sectors. This sector analysis is simply meant to point out that our current cash balances may be temporary and may relate to segments of the market being overvalued, rather than all of the market being unattractive.

This analysis means that we will not necessarily wait for a market pullback to put the cash to work. We are constantly looking for new ideas and even as the market makes new all-time highs, that does not imply that every stock is making an all-time high or is trading above fair value. We will continue diligently looking for investment opportunities in which to deploy our clients cash, but we will not dilute our stringent requirements for investment, even if that means sitting on cash for a period of time.

Now let's turn to our two featured portfolio holdings, Apple and First American Financial.

We've talked about Apple in past calls and it's a stock we've owned for a long time because our research has shown that it's a company with competitive advantages, especially in its iPhone franchise.

Recall that the last time we spoke about the company on one of these calls was a year and a half ago when the stock was trading at about 10x earnings, near a low point, as the market had become disillusioned with its recent iPhone business trends. This had also occurred in 2013 for similar reasons. Our contention had been that Apple's products are sticky with customers because it stirs emotional connections with its technology products and brand while its operating system, ecosystem of apps and services, and integration across product lines make it easy for its users to really integrate technology into their increasingly digital lives.

As a result of its simplification and integration of technology, and its brand, status and ecosystem, Apple has been delivering tremendous value to its customers even as it extracts a great profit. It's the ideal type of business to own; selling a product that customers can't live without, that is differentiated from the competition, and provides so much value to customers that it allows the business to generate high profits while leaving quite a bit of excess "surplus" value for its customers to enjoy as well, leaving them "delighted", as Apple refers to the emotional state they seek to achieve. That emotional word is so associated with Apple's products that it may as well be trademarked by the company!

Having said that, the stock is up over 40% since our call last spring (leaving shareholders "delighted" as well!) and more appropriately reflects the value that we've recognized in the company. While the market tends to have a fair bit of volatility in its assessment of what Apple's stock is worth from one iPhone cycle to another, our assessment of its value has been consistent, with only small changes over the last year as we obtained more information about the company's financial results.

Apple's sales from one iPhone cycle to another tends to have some degree of volatility to it as the overall smartphone market has matured and slowed its growth to a low single digit rate while customers' specific purchasing behaviors when it comes to upgrading has been "peaky", depending on the timing of their need or desire to upgrade to the next iPhone.

As a result, we had a big surge of customers whose first iPhone was the 4S in 2012 followed by a major upgrade cycle in 2015 with the iPhone 6 and now market expectations are that many will find the recently announced iPhone X and 8 models to be compelling enough to upgrade again, causing optimism as to what sales numbers will be.

From our perspective, these peaks and valleys around iPhone cycles represent cyclical, but predictable, sales and profit trends that can be "normalized" across 3-year product cycles so long as we can be confident that Apple will retain the majority its existing customers when they next choose to upgrade their phone. As its base of iPhone customers grows every year, subsequent peak cycles should represent higher sales levels as should the sales valleys and that is the pattern we've historically witnessed and seems to be true today.

Interestingly, the iPhone X represents a more aggressive push for Apple's pricing model, one in which the company is sub-segmenting its already high-end base of customers. We believe the applicable market for $350-$1,000 iPhones represents about 20% of the world's most affluent customers. When Apple released the iPhone Plus models at the end of 2014 with the launch of the iPhone 6 Plus, it increased the price of the larger 5.5" screen model by $120 over the base 4.7" screen model, its first experiment with price segmentation. The larger screen was adopted with enthusiasm, with nary a complaint about pricing and nearly half of the last iPhone 7 cycle comprised the larger, more expensive Plus model.

With the iPhone X, Apple is proposing a $200 price increase over the Plus models on the back of a new form factor that features a new edge to edge higher quality OLED screen and sophisticated 3D Face ID technology replacing the Touch ID fingerprint security system. But really, the iPhone X is all about further sub-segmenting the 600 million base of iPhone users and getting 10-30% of the most affluent, status and technophile centric users among them to pay more for the most advanced iPhone Apple can create today. These are also the users who have the highest "surplus" value accruing to them given their relationship with the brand and the phone. And now Apple is trying to capture a greater portion of that surplus value by delivering a new iPhone at a 25% higher price.

And it's not just the iPhone X that is seeing a higher price and rebalancing of the value share between Apple and its customer. The latest "regular" iPhones, the 8 and the 8Plus also see a $50 and $30 price increase, respectively. The combination of a new iPhone form factor driving more of the existing user base to upgrade their iPhone 6 and 6s' and the higher selling prices has resulted in a dramatic closing of the gap between Apple's share price and our assessment of the company's intrinsic value, since last April.

As many of you may have noticed, that has led us to target a lower weight for our Apple position in client portfolios. Our opinion of the company hasn't changed, and we still believe the company is worth more than the current price, however the discount to our fair value estimate has shrunk significantly as that value has become more widely recognized by the market, which means that the risk/reward trade-off has changed as well, effecting the amount of Apple we want to own for clients.

The old adage "buy low and sell high" is as true as ever, and despite it sounding very simple, practicing it is anything but that. The implementation of that adage often means buying great companies when its uncomfortable in the midst of negative headlines and poor near term trends, while selling high is also just as uncomfortable amid higher market enthusiasm and increasing sales and earnings estimates. We try to accomplish this by keeping our intrinsic value estimates grounded in data, research and analysis, and a long-term understanding of the qualitative business fundamentals to guide our buy, sell, and hold decisions.

While Apple is among our most widely known holdings, I also want to talk about First American Financial, a more under the radar investment of ours. While companies such as Apple generate enormous attention from investors, under the radar companies like First American can generate outstanding returns nonetheless. In fact, so far this year, Apple has returned 35%, while First American has been one of our best performing stocks returning an outstanding 42% year to date.

If you've ever bought a house, you know that one of the many things you need to do is buy title insurance. Unlike most insurance policies, which guard against unpredictable future events, title insurance guards against the risk that the property you are buying may not actually belong to the seller, either because of historical problems with how the title has been recorded or transferred or because there are outstanding liens against the property.

Title insurance is mandatory if you take out a mortgage to buy a house. And even if you pay with cash, the downside to finding out that the property you just bought was not actually owned by the seller or there is some debt collector out there who has a claim on the property you just bought, is so large relative to the small cost of the title insurance policy that very few home buyers go with out it.

In order to sell title insurance, title companies like First American need to assemble what is called a "title plant" in the industry. This title plant is a massive database of records showing all of the maps, deeds, mortgages, tax liens, etc that are associated with a property. Since many homes in the United States have histories going back a hundred years or more, the title histories on even a single property can include hundreds of pages of documents, including hand drawn maps and notes about rights of passage granted by one neighbor to another.

In fact, when I bought a new home last year, one of the houses we looked at had an extremely complex title history. A portion of the property had once been part of the adjoining town until it was transferred to facilitate the electric company's efforts to bring electricity to the neighborhood a long time ago. Earlier in its history, that same odd segment of the property had been allowed a right of way for the neighbor to walk their sheep across. Now given I live in the middle of Silicon Valley, these aren't the sorts of title issues you'd expect to find. But with people living in the same place for well over a hundred years, these are exactly the sort of issues found by title companies.

In my case, I reviewed the title in depth and believe me the records were not a neat and tidy database that your average computer engineer is used to dealing with. Instead, the title history was made up of scanned records of handwritten agreements and notes.

The complexity of title plants and the need to have records on most every piece of property in a given geographic area to be competitive in the market has led to the consolidation of the industry to a small group of large players. Over half of the title business national is controlled by First American and their main competitor Fidelity National. With title insurance premiums representing a relatively stable percentage of home price over time, title insurers enjoy a steadily increasing revenue stream as home prices appreciate. At the same time, while home prices have recovered since the recession, the number of home sales, especially the sale of new homes is still below what we believe are normalized levels. When you see news reports citing a lack of inventory as being the reason for rising home prices, one way to interpret this is to note that there are more willing buyers than there are willing sellers and thus the current volume of transactions is being inhibited by an imbalance in the market.

Like most holdings in our portfolio, First American does a good job optimizing their capital structure and returning excess cash to shareholders. As earnings have grown, so has the company's dividend, which currently represents a 3% yield and which the company has increased by 320% over the last four years.

While First American isn't a particularly sexy company and while they don't show up in the news all that much, they are the sort of very profitable, dependable company, whose products and services make up important elements of the day to day life of their customers. These sorts of stocks are often overlooked by investors who too often prioritize exciting news flow over strong cash flow generation. In the case of First American, investors who saw through the boring business story could see a rather exciting profit machine, one which the market has spent the year steadily bidding higher.

So, thank you all for joining our call today. During this call, we referred to the portfolio holdings of Ensemble Capital Management. If you 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.

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

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As of the date of the conference call, Clients of Ensemble Capital owned shares of Now, Inc (DNOW), First American Financial (FAF), Landstar (LSTR), Ferrari (RACE), Apple (AAPL), L Brands (LB) and MasterCard (MA).

As of the date of the conference call, Clients of Ensemble Capital did not own shares of Coke (KO), Pepsi (PEP) or Advisory Board Company (ABCO).

Each quarter we file a 13F report of holdings, which discloses all of our reportable client holdings. Please refer to our current 13F filing or contact us for a current or past copy of such filing.

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