February 2021

Dear Client,

Enclosed are the return calculations for your account(s). Where applicable, three, five, ten year and returns since inception are included as well. The S&P 500 returned 18.34% including dividends in 2020. Our composite returned 7.34% (individual results may vary). Since inception on 01/01/2000, our composite has returned 385% vs. 284% for the S&P 500. That represents a compound annual return of 7.81% for the composite vs. 6.61% for the S&P 500 with dividends.

Last year was yet another example of why it is never a good idea to sell during market corrections with the expectation of buying back in when the market conditions are less volatile. From its high in mid-February 2020, the S&P 500 fell more than 30% through the end of March. By early June of 2020, the S&P 500 had recovered most of the losses and was unchanged for the year. No one could have forecast the ferocity of the selling or the rapidity of the rebound. We wrote last year's letter in late February while the correction was underway with prices already down approximately 15%. We suggested that the decline made no sense since purchasing shares in a company was really the same as purchasing a stake in all future cash-flows and profits; a one or two quarter slowdown would not affect long-term business value. Although we were wrong about the duration of the pandemic and the uneven impact (some businesses accelerated their growth rates), we were correct in buying some high-quality companies at attractive levels. Among the names purchased last March were Home Depot, Facebook, Chemours, Discovery Communications and Evoqua Water Technologies. The later, Evoqua Water Technologies, was a company we were very familiar with as it was highlighted in our 2018 letter. Despite being engaged in the stable water treatment business the shares lost an astonishing 70% of their value in the February- March period. We had sold some of our initial position in January and once again established a full position at the bargain prices that presented themselves in March. With respect to the rest of the companies purchased, the fire-sale prices paid provided a margin of safety and good capital appreciation prospects in any normal operating environment.

In preparation for this year's letter, I re-read not only last year's letter but one I wrote to clients 21 years ago. Although no pandemic was present, it was a period of lively public participation in the stock market and frenzied speculation, popularly known as the dotcom boom. Out went conventional methods for valuing companies like earnings, cash-flows, asset values, etc. and in came new metrics such as page views, eyeballs and new users. Absent the need for earnings, or in some cases even a saleable product, these enterprises would piggy-back these new metrics into large market capitalizations. As with earlier manias, these "story" stocks garnered a very vocal following, positive price action (momentum) and concomitant media attention. This virtuous circle continued for some time, defying skeptics and naysayers, until the bubble finally burst in

March 2000. From peak to trough the NASDAQ Composite Index fell 78% and many of the formerly highly valued companies failed.

Perhaps more interesting than the plight of companies that failed, may be the highly valued ones that succeeded and are with us today. To illustrate why price matters, one need look no further than Cisco Systems. Cisco was a rapidly growing technology firm and, in March 2000, the most valuable company in America with a stock market capitalization of $450 billion. Revenues for FY 2000 were $18.9 billion and net income was $2.66 billion or 39 cents per share. At the March 2000 high, investors were willing to pay over 200x earnings for this rapidly growing tech behemoth. Fast forward 20 years and Cisco had FY 2020 revenues of $49.3 billion, net income of $11.2 billion and per share earnings of $2.65. Clearly the company experienced respectable growth over the period examined. Unfortunately for shareholders, the growth and profitability were nowhere near high enough to overcome the expectations imbedded in the March 2000 share price. From their high, Cisco shares fell 86% when the NASDAQ bubble popped and have yet to approach their previous price 20 years later.

The forgoing example is by no means unique. It is illustrative of a common investing error that is often ignored; overpaying for even a rapidly growing businesses can result in poor overall returns. Although the current environment differs in many ways from the excesses of the dotcom era, there are alarming similarities that augur poorly for a broad swath of current "story" stocks. These are often the ones the highlighted frequently by the media and the ones individual investors own in disproportionate amounts in their accounts. We would not be surprised to see many of today's highly valued companies trading at sizable multiples to earnings/sales share the same fate as Cisco. This would have a major impact on the future returns of indexes like the S&P 500 (since they are market cap weighted) and by default, passive investing. More on this subject later.

We have referenced the term margin of safety in earlier letters and though it may seem quaint or outdated in today's world, it is still central to our thinking as we analyze investment candidates for inclusion in our portfolios. When we decide to invest in a business, we look for a few simple attributes; among the most important are a shareholder friendly management with good capital allocation skills and a share price that under any reasonable set of expectations offers an attractive earnings/cash-flow yield.

Keynes defined speculation as "… the activity of forecasting the psychology of the market and investment as forecasting the prospective yield of an asset over time." Although the terms are widely used interchangeably, they are radically different. Speculators are interested in profiting off short-term market fluctuations and price movement. The investor, whose holding period is often years, is concerned with price fluctuations insofar as they offer him or her attractive entry or exit point for an investment. The advent of commission-free trading and online brokers such as Robinhood whose app- according to an administrative complaint filed by securities regulators in Massachusetts- "…was designed to incentivize continuous and repeated engagement…" has almost certainly contributed to rampant speculation. As was the case with previous manias, it will end poorly for many.

Much like the early 2000’s, a large component of the S&P 500 is characterized by high multiple technology companies. The top 5 companies (AAPL, MSFT, AMZN, FB, TSLA) make up more than 20% of the index. At the end of the first decade of the new millennium, the S&P 500 index produced an overall 10-year return of 4.56%, or .41% per annum including dividends. This mediocre return was due in large part to the big tech companies’ inability to live up to the extremely high expectations priced into the stocks at the beginning of that decade. Given the current high multiples, we think multiple compression, rather than expansion, is probable for the current crop of market leaders. This suggests that passive returns will lag and, as a corollary, active managers owning attractively priced securities other than the current leaders will perform better.

Please feel free to contact us with any questions or comments. As always, we thank you for your trust and patience.

Very truly yours,

Eckart A. Weeck

Senior Managing Director