Fourth Quarter 2022

The performance of securities mentioned within this letter refers to how the security performed in the market and does not reflect the performance attributed to the core equity portfolio. Please see the chart at the end of letter, which reflects the full list of contributors and detractors based on each security's weighting within the core equity portfolio.

For a copy of Ensemble Capital's equity strategy performance track record, please email a request to info@ensemblecapital.com.

2022 was not a good year for the Ensemble equity investment strategy. Not only was our strategy down 28.60% for the year, but we underperformed the S&P 500 by 10.47%. However, most of the damage was experienced during the first few months of the year, with our strategy returning to outperformance in mid-May, generating a 4% gain while the S&P 500 has declined by 1% since then. After our strategy outperformed by 2.25% while the market fell 4.88% in the third quarter, our strategy finished the fourth quarter up 9.12% while the S&P 500 rallied 7.55%. This means that in the second half of 2022, our strategy was up 6.3% while the S&P 500 was up 2.3%.

The three quarter period from the fourth quarter of 2021 to the second quarter of 2022 represents the fifth time since our strategy's inception in 2004 that we have underperformed the market by a cumulative 5% or more. Over the subsequent year following the first four instances, our strategy outperformed our benchmark by an average of 5.88%. Over the first six months following our most recent period of sharp underperformance, we have outperformed the S&P 500 by 3.95%, which annualizes to nearly 8%, putting us well ahead of the sort of relative performance recovery that we have seen after past periods of underperformance.

So what went wrong and what do we expect in 2023 and beyond? Diagnosing the drivers of our underperformance this year is critical to informing whether our strategy needs to change or, as during past periods of underperformance, the types of companies we invest in have temporarily fallen out of favor and we should stay the course.

Importantly, the large majority of our portfolio companies grew revenue and earnings in 2022. Many of them substantially. With our portfolio growing revenue, earnings, and cash flow in the aggregate during the year, more than 100% of the decline in the market value of our portfolio is explained by lower valuations placed on our holdings by other investors. The question is whether this decline is a reflection of our portfolio having been previously overvalued, or whether some catalyst has triggered a compression in valuations that have brought them down to unsustainably cheap levels.

We have discussed our take on this issue repeatedly this year, starting in early March when we wrote about the "stagflation panic" gripping the market. In May, one day before our relative performance bottomed, we wrote about the "disconnect between corporate fundamentals and stock prices," which we believed was being driven by the stagflation panic. In September, we released an analysis of equity market performance during the stagflationary 1970s and demonstrated that the acute underperformance experienced by the types of growth stocks that have hurt our performance this year was fully reversed after the 1970s stagflationary concerns came to an end.

Stagflation is the name for economic conditions that combine high inflation and weak real growth at the same time. If stagflationary concerns were the major driver of our underperformance, then we should be able to observe a correlation between our underperformance and stagflationary indicators, and in fact this is exactly what we see. Market based expectations of future inflation peaked this past spring, less than a month before our strategy flipped back to outperformance. Actual observed inflation peaked in June, just a month after our underperformance came to an end. Real GDP growth was strong in 2021, but reported as being in contraction in the first half of 2022, during our period of steep underperformance, before flipping to nicely positive real GDP growth in the 3rd quarter with most indicators pointing to another quarter of strong real GDP growth in the just finished 4th quarter.

We can also see clearly that as of today, many of the stocks that have most hurt our performance this year now trade at valuations well below their long term average. For instance:

- Netflix trades at price to earnings and price to sales ratios that are about half or less than its 10 year average. The stock now trades at valuation levels last seen in 2014, prior to the company emerging as a credible threat to legacy media.
- Illumina, a highly profitable business whose earnings and cash flow are currently being negatively impacted by their early stage GRAIL cancer detection business, which they will likely be spinning off in 2023, now trades at a price to sales ratio of about half its 10 year average. The last time the stock traded at this low of a multiple of revenue was in 2013, prior to the company coming to dominant the genetic sequencing industry.
- First Republic trades at a PE ratio of under 15x, 25% below its 10 year average at levels seen only at the bottom of the initial COVID selloff in March of 2020 and a decade ago back in 2013.
- Google, even including the money they are spending on pre-revenue activities such as their self-driving car unit Waymo, sells at price to sales, price to earnings and price to cash flow multiples that are a third less than their 10-year average. Today, the stock trades at or below valuation multiples seen in 2009 at the bottom of the Financial Crisis stock market crash.

But while we believe that our portfolio holdings were not overvalued at the end of 2021, this is not to say that we don't think there was any excessive speculation in financial markets. In this letter two years ago, in early 2021, we called out what we argued were obviously bubble-like valuations in some corners of the stock market.

We wrote, "there appears to be clear signs of speculative activity in some parts of the market. Stories of new investors gambling their stimulus checks on cryptocurrency, electric vehicle SPACs and Software as a Service stocks are everywhere…" And we pointed to the Goldman Sachs Unprofitable Tech Company Index as one measure of the speculation.

In the chart below, we show the five year track record of the Unprofitable Tech Company Index, the S&P 500, and a representative account from within our equity composite. After rallying an absurd 420% from the COVID bottom in March 2020 to its high in February 2021, the Unprofitable Tech Company Index has lost

nearly all of its gains and has now lost money over the past five years. On the other hand, while the Ensemble strategy has given up the outperformance we achieved earlier, the five year returns to our strategy have been approximately the same as the S&P 500 while generating absolute returns of about 9% a year despite our sharp drawdown in 2022.

(Source: Bloomberg, Ensemble performance based on a representative account from within our equity composite)

As we turn to 2023, we intend to remain laser focused on owning competitively advantaged companies, that have solid growth opportunities, outstanding management, and whose stocks trade at values less than we expect the company to generate in distributable cash flow over the long term. Should any company in our portfolio cease to meet those requirements, we will not hesitate to sell their stock, just as we did with a few positions in 2022. And we will remain on the lookout for new companies that meet our demanding criteria and whose stocks trade at attractive valuations. And indeed, we added a couple of new positions in 2022.

But what we won't do is we won't abandon great companies we own, whose stocks trade at attractive valuations, to chase what seems to be "working" right now. Indeed, the recovery that we have seen in our

relative performance since mid-May has been driven by many of the same stocks that hurt us on the way down. For instance, while the S&P 500 is down 1% since mid-May, Netflix is up 77%, Masimo is up 21%. Home Depot is up 14% and NVR is up 12% with approximately 2/3rds of our portfolio outperforming.

The nature of a long term investment approach is that it requires owning stocks for a long time. Ideally, investors could know not just which stocks will do well over the long term, but also which will do best over each short time frame. They could then jump between stocks to always own the ones that are working well. But all of the evidence points to investors who attempt to do this chase the wrong stocks at the wrong time. While the evidence is also strong that talented long term oriented stock pickers can indeed outperform over the long term despite having to accept periods of short term underperformance.

Today, of the 21 stocks we own in our portfolio, all but five were purchased prior to COVID. We've owned 12 of those companies for over five years and 8 of them for over a decade. What this means is that our long term track record has been built using a process that only adds about two new companies a year to our strategy. This implies an average holding period for a company in our portfolio of a little over a decade. A decade is about the length of the average economic cycle, from recession, to recovery, to expansion, to overheating, to recession, etc. Thus, our long term track record has been built not by jumping in and out of stocks based on near term economic trends, but rather by owning superior companies across the full economic cycle.

So, what should our clients expect in 2023? We know that historically our portfolio performed similarly or better than the market during the two recessions we have experienced in 2008-2009, and in 2020. And we know that our portfolio performed similarly to the market as inflation rose from below 2% in early 2021 to nearly 7% in November of 2021. And our strategy outperformed in the second half of 2022, while inflation averaged 8% and the real economy expanded. Based on our historical track record and the nature of the companies we invest in; we believe our investment strategy is generally resilient to both inflation and recession risks.

But the economic environment from the tail end of 2021 through the first half of 2022 was characterized by both a reported contraction in real growth and elevated inflation, otherwise known as stagflation. And it is this unique set of macroeconomic conditions that have led to the steep underperformance of the growth stocks within our portfolio, just as stagflationary economic conditions led to these types of stocks to underperform during the stagflationary periods seen during the 1970s.

So how are we thinking about the economic environment in 2023 and beyond? On the one hand, we know that accurately predicting short term economic outcomes is extremely difficult. On the other hand, we think it is incumbent on investors to have an explicit view on longer term economic variables.

The root cause of the current economic slowdown has been a combination of two factors, 1) a rapid rotation away from consumer goods towards services as COVID came to an end, leading to excess inventories at

retailers and an abrupt contraction in ordering new goods and 2) the Fed's intentional slowing of the economy via rapidly raising interest rates in their attempt to limit inflation.

The root cause of the inflation that surged all around the world is multifaceted, but we believe that the majority of inflation has been caused by various COVID driven constraints to growth, namely snarled supply chains and a limit on the number of people willing and able to work, as well as the surge in energy and commodity prices that occurred earlier this year in reaction to Russia's invasion of Ukraine. While there are other drivers of inflation in the US, such as a likely excessive level of stimulus spending relative to the amount of output capacity of the US economy, it is important to note that inflation is high all around the world with inflation in the US actually at the lower end of what is seen elsewhere. Given inflation surged all around the globe, the root cause is likely something that happened all around the globe. Namely COVID and the surge in energy and commodity prices due to the Russian invasion of Ukraine.

Inflation in the US has clearly begun to ease. Inflation in the price of goods, has already gone negative into outright deflation, as retailers with excess inventory have been liquidating via sales and the cost of moving goods around the world has fallen dramatically from COVID highs. Inflation in the cost of shelter, namely home prices and rents, has also stalled out, with home prices now falling and rents having slowed their growth dramatically and tipped into outright declines in some parts of the country.

This leaves the so called "sticky" inflation that is driven by services, excluding shelter. These prices rarely fall because the cost input to delivering them is mainly wages and wages are rarely adjusted lower. And yet, deflation is not the goal, simply reducing the rate of price increases back towards the Fed's target of 2% would represent a triumph over inflation. Today, it is clear that labor market pressures which have driven up wages and the price of services, has begun to abate.

The total number of people on unemployment has risen by 24% over the last three months. Although it is still near the lowest level in half a century. The "quit rate" or percentage of employees who quit their job has declined this year, although it is still higher than at any point in at least the last quarter century. The net new number of jobs in the US has grown every month this year, but the rate of growth has slowed considerably from 600,000 new jobs a month at the beginning of the year to less than 300,000 a month to end the year.

The fact is that over the last three months, both reported headline inflation and the Fed's preferred inflation measure of core PCE, have risen at rates under 4%. While there is more progress to be made to get the Fed's 2% target, or even just down to the 3% inflation rate that was experienced during the booming economic and stock market environment of the 1990s, it is clear that much progress has been made.

It seems likely that even if inflation improves over the next few months and the Fed is able to stop hiking interest rates, it is already too late to avoid a recession. But we've managed our strategy through two recessions and as we've explained in past letters, we believe that the stock market has already discounted a mild recession, with only a far rarer severe recession being a risk to drive stock prices materially below their 2022 lows.

Having the stock market rally in a year when earnings decline is not atypical. Since 1955, there have been 17 calendar years in which S&P 500 earnings have declined. Yet the S&P 500 has rallied in 11 of those years. This is because the stock market is forward looking. While corporate earnings rose in 2022, the stock market declined in part due to worries about falling earnings in 2023. By the time corporate earnings do start falling, it may well be that the stock market rallies as it anticipates a recovery on the other side of the recession.

It is only during severe recessions that corporate earnings decline by a magnitude and for a duration of time that justifies back to back yearly declines in the stock market. Which is why this sort of back to back down years for the S&P 500 has only occurred twice since World War II.

In our view the key risk, as it relates to the health of the global economy, the performance of the US stock market, and the relative performance of our equity strategy, is that inflation reverses its recent fade and comes back strongly in 2023, forcing the Fed to raise rates much higher than the market currently expects and pushing the economy into a severe recession.

We do not expect this to occur. But we do think it is a possibility. Back in March of 2022, when we first wrote about the stagflation panic gripping the market, we made clear that the stagflation risk was real, it was just being significantly over discounted by the market. For instance, we wrote about how the Russian invasion of Ukraine, that had occurred two weeks earlier, was sending up the price of oil. But how the stagflationary catastrophe of the 1970s saw oil prices increase by 10x over a decade, not the 50% increase that existed at that time. Today of course, oil prices in the US are 14% below where they were when Russia invaded.

Might the war spiral out of control and send oil prices skyrocketing? This is indeed a possibility that investors must consider. Yet the fact that oil prices are down, not up dramatically since Russia's invasion as was widely expected, highlights how far we are from the risk that the decade ahead looks like a replay of the 1970s.

Our portfolio is made up of very high quality companies, with strong prospects ahead of them, and highly capable management teams. We think our portfolio trades at very attractive valuations in the stock market, with some of our holdings now trading as cheaply as they have since the early years of the recovery from the Financial Crisis a decade ago.

We recognize the economic risks ahead and yet we are confident that over the course of time, our investment strategy will deliver strong returns, just as it has done over the last 19 years.

Notable detractors from our performance came from our investments in Google, First Republic, and Chipotle

Google (-7.76%): In October, Google's earnings announcement revealed that not only had revenue grown more slowly than expected, but the company had maintained hiring at a rapid clip. While other, far less profitable, companies are currently being forced to slash expenses, Google's profit margins remain near record highs despite coming in lower than expected. With investors demanding that companies focus on maximizing near term earnings, it appears that Google is willing to invest through this downturn, scooping

up talented engineers being let go by inferior companies. We believe that Google will best serve shareholders by continuing to hire based on their medium and long term needs, not by maximizing current profit margins. But that being said, the company has already been working to lower costs and may well engage in targeted layoffs at some point. Yet we also think that Google has a lot of flexibility to reduce expenses or even engage in outright layoffs, if needed. Between their massive cash flow production and $140 billion of cash on their balance sheet, we have no concern about Google's ability to navigate to the other side of the current economic disruption. In fact, we wish the company would aggressively increase the rate at which they are buying back stock as it is clear to us that their level of cash reserve is far above any reasonable need.

First Republic (-6.42%): Despite being one of the few banks in the country still growing their deposit base, and growing their loan book at double digit rates, First Republic will likely see earnings decline in 2023 due to the high rate of interest they are needing to pay on their deposits relative to what they are earning on mortgages they wrote previously at low interest rates. However, this dynamic is entirely in the control of First Republic. They recognize that it is during periods like today that their company wins market share. As mortgage lenders back out of the industry, First Republic is able to win new, very profitable customers who will stay with them for life, based on the company's ultra-low attrition rate. The company is sacrificing near term earnings in the pursuit of maximizing long term earnings, exactly how we think the best management teams operate during weak periods in the economy.

Chipotle (-7.67%): Despite beating earnings expectations handily for the third quarter, the company offered guidance suggesting a modest slowdown in demand. The company is well position demographically as while it may lose lower income customers who can't afford the increased prices the company is charging, they are also winning over higher income customers who may "trade down" from casual restaurants to Chipotle's "high end, fast food" offering.

On the more positive side, we saw notable performance contribution from Nike, Mastercard, and Netflix.

Nike (+41.20%): After making an appearance last quarter on our biggest detractors list, Nike reversed its losses and then some from the third quarter. The company is facing the dual challenges of managing a global supply chain in the midst of a pandemic and navigating the rapidly changing COVID situation in China. Having already signaled to investors that they had too much apparel inventory they would need to discount to get rid of, the company reported gangbuster sales of footwear just as China has started to emerge from their Zero COVID policy that was depressing economic activity.

Mastercard (+22.49%): Mastercard, which effectively earns a percentage based fee on spending and thus has a nearly perfect hedge against inflation, has been among the rare growth stocks that beat the market in 2022. Finishing the year down just 4.8%, the company has plowed through significant currency headwinds from the strong US dollar while delivering double-digit growth in revenue and earnings.

Netflix (+25.25%): While the stock bottomed back in May, it was only in October that the company reported a return to growth in subscriber counts and guided to a continued growth recovery. The company had been

adding new subscribers at a low teens annualized rate prior to 2022, which is why the rapid shift to small losses in subscriber counts in the first half of 2022 put such a scare into investors. But their third quarter results and fourth quarter guidance point to subscriber growth rebounding to an annualized 6%-7%. While we think this slower growth will accelerate further, the fact the company's subscriber growth has rebounded even as the global consumer remains under economic pressure is testament to how extreme and bearish investor sentiment was earlier this year when the stock was priced as if they would never be able to grow again.

Company Focus: Masimo (MASI) and Paychex (PAYX)

Masimo: 2022 was a wild year for Masimo – and that's saying something given the concurrent volatility in the market at large. In February, Masimo announced it was acquiring a consumer audio holding company called Sound United, which owns higher-end audio brands like Polk, Denon, and Bowers & Wilkins. The deal price was for $1.025 billion, but the stock dropped 37%, representing nearly $5 billion in market value, on the day after the announcement. The amplitude of the drop relative to the deal value suggested investor revulsion that went far beyond the acquisition itself.

At first glance, we were also puzzled by the company's decision to acquire Sound United. In particular, we were disappointed by the way the deal – by far the largest in Masimo history and a departure from its stated M&A strategy – was communicated to shareholders. For example, Masimo did not hold a separate conference call with investors to specifically discuss the deal and instead combined it with its routine fourth quarter earnings conference call, which greatly limited the time that analysts had to ask questions and diminished what was otherwise a strong quarter for the core healthcare business. Compounding the problem, Masimo's founder/CEO Joe Kiani told investors he was an "audiophile," which raised concerns about this being a pet project, and management declined to answer certain questions due to stated worries about potentially tipping off competitors.

We spoke directly with management after the conference call, where we communicated our concerns and shared our feedback about poor investor communications.

Having owned Masimo for three years prior to the deal being announced, we had conviction in our fair value estimate for the legacy healthcare business and thought the post-acquisition share price significantly discounted that valuable franchise. While the plunging stock price was hard to take and it would have been emotionally easier for us to exit the stock, the discounted price was already the new reality, and it was our job to freshly evaluate the opportunity as it was now presented. The discounted share price provided us time to learn more about Masimo's strategy and give them time to develop products with Sound United, some of which we were able to see at Masimo's much-awaited investor day in December at company headquarters.

In August, an activist investor, Politan Capital, acquired a nearly 9% stake in Masimo, and though we have no comment on the merits of Politan's strategy, we do believe their interest in Masimo aligns with our own take that the current market price dramatically undervalues Masimo's core health franchise.

Looking back at a blog post we wrote in November 2019, we wrote that "Masimo is a technology company pursuing better solutions in the healthcare industry, rather than a healthcare company using technology as

an avenue for higher-priced solutions." We continue to believe this is the correct way to view Masimo rather than as a "healthcare" company. It's an engineering-first culture that happened to solve difficult problems in the healthcare industry and developed expertise in the field, including regulatory and R&D know-how.

Masimo's motivation for the Sound United deal is clearer when viewed through this lens, as there are a number of markets where highly accurate non-invasive sensors can be used to improve lives. One of the ways in which Masimo might achieve this is through remote patient monitoring using its W1 Watch. In March 2020, when hospitals were overrun and struggling to triage COVID patients, Masimo came up with a solution to remotely monitor patients with medical-grade sensors that within weeks received emergency FDA approval. By February 2021, Masimo SafetyNet technology was deployed to 200 hospitals to keep track of patients at home who were not critical enough to be admitted, while keeping hospital beds reserved for the most ill patients. In October 2020, Masimo shared that an additional 2,000 hospitals were evaluating the product. The stressful rush on hospitals was relatively short-lived, thankfully, but provided a high profile use-case for monitoring patients outside of the hospital setting.

Masimo's W1 Watch is focused on medical-grade health monitoring and there are no apps or frills as found in competing "wellness" focused smartwatches. During the investor day, Masimo shared data showing its W1 Watch caught every adverse medical event tested during a patient's sleep cycle while the Apple Watch only caught between 6% and 7%. If you wear a watch designed to alert you and your medical team to life-threatening episodes, your watch cannot miss true alarms, nor can it produce many false alarms. The former could be catastrophic, and the latter would make the device unusable as false alarms would cause undue stress and greatly reduce doctor-patient confidence in the product.

The opportunity for continuous and remote patient monitoring is massive. From the hospital point of view, many hospitals are losing money with each Medicare/Medicaid patient and need to find ways to reduce per patient costs. Being able to confidently send patients home and monitor their progress in that setting could help hospital systems save money and help patients recover more quickly. Additionally, hospitals are penalized by Medicare/Medicaid when patients are readmitted within 30 days of discharge with the same ailment. There's clear monetary motivation for hospitals, in appropriate circumstances, to monitor patients at home rather than in the hospital setting.

From the patient point of view, recovering at home is generally preferable to recovering in the hospital and also reduces the risk of catching viruses and infections. Patients are also often nervous about being sent home, worried about adverse scenarios occurring away from medical care. Medical-grade monitoring can help reassure recently discharged patients and those with chronic conditions like COPD and congestive heart failure and reduce the impulse to rush to the emergency room.

Masimo has submitted 510k approval for the W1 Watch with the FDA. The W1 is available today and can currently be used to share live medical data with your doctor through printed reports or with loved ones concerned about your health.

We were pleased to see that Masimo is further leveraging its Sound United acquisition by enabling W1 Watch users to plug into Denon's HEOS connectivity technology, which connects user data to Masimo's HIPPA-compliant cloud. In other words, if you have a Denon speaker with HEOS in your home, it's another way

beyond your smartphone to get your health data to the cloud. Like a "Trojan horse" of sorts, Masimo announced at the investor day that they are turning on this functionality to 4 million households with Denon speakers in 2023 with more to come in 2024.

As more people "age in place" or spend their retirement years at home, the more they will rely on at-home health services. A benefit of the Sound United deal is that there's a network of professional independent contractors who install home audio equipment made by Sound United's brands. It does not seem a stretch to imagine that these contractors can also install remote medical monitoring in people's homes.

While it remains to be seen if Masimo can properly commercialize the opportunities and profitably take share in the much larger total addressable markets it acquired with Sound United, we continue to have confidence that management remains authentically committed to improving patient outcomes and reducing costs through the use of superior non-invasive sensors and products.

Paychex: We've been long time shareholders of Paychex, a company that serves small and midsize businesses (SMB) with payroll, HR, and PEO services and technology. These are the types of services that are critical to the functioning of all businesses but not necessarily the core focus of their mission or value creation. And to do them properly in house with the right level of staff, without errors and in compliance with regulations, requires a level of scale we believe is in the hundreds to thousands of employees. It's this market comprised of businesses with a handful to a couple of hundred employees where Paychex focuses its efforts to serve businesses with these mission critical needs.

Paychex was founded in 1971, went public in 1983 and has generated a 20% compounded annual total return since. It started with a payroll service offering and over time has expanded to HR services, employee benefits administration, employee management software, and then fully outsourced employee management services that now includes the 2nd largest Professional Employer Organization (PEO).

In its last fiscal year, it reported more than 730,000 clients and paid 1 in 12 private sector employees in the US generating over $4 billion in revenue, 40% operating margins, an adjusted return on invested capital of over 100%, and threw off nearly $1.4 billion in cash. This is a very lucrative business; one that is supported by a ton of value it creates for its clients doing the meticulous and important behind the scenes work that allows businesses to function every day. It's the kind of business we've previously termed a "cash machine".

Given how mission critical it is to pay employees consistently and correctly, withhold and submit taxes, gather, maintain, and update employee records, stay in compliance with regulations and provide great service to employees, it's not hard to understand why clients would be very sticky after selecting a service provider – there are huge switching costs involved in the form of time and information burdens and the possibility of mistakes that impact employee paychecks and benefits in switching providers. Collectively the time across an entire employee pool spent to set these systems up and the risk of errors make it they type of service that you'd rather "set it and forget it" for generally risk adverse managers who are more keen to be working on delivering value for their own clients and generating revenue.

Switching from Paychex to another vendor only happens if there is a significant reason to do so - such as poor service quality, unacceptable numbers of errors, or much better capabilities. These are all factors that

are within the company's control with the exception of being able to "be all things to all people", ie at some point some clients will grow large enough that their needs will get complex enough to move on to a more customizable platform or take the HR/Payroll services inhouse.

Paychex' client retention looks optically low at 84%, but this has its underlying roots in a significant number of clients who go out of business in the small business market – about 20% of small businesses shut their doors in their first year, while only half remain in business after 5 years. We all know being a small entrepreneur is a risky venture, yet enough start new businesses to keep feeding the Paychex funnel of new clients to replace those lost. On the other hand, those businesses that continue to thrive fuel growth for Paychex's business which prices many of its services on a per employee per month basis. So as retained customers grow the number of their employees and benefits, Paychex' revenue also grows.

Paychex has seen revenue grow in the range of 5-7% in the decade prior to the COVID era. Results during the "COVID" period were surprisingly resilient aided by US stimulus packages for businesses, and then accelerated with the pent-up demand in the reopening afterwards. During this period, just like many other businesses who adapted to remote or hybrid work and offered new products as customers' needs quickly changed, Paychex also managed to both accelerate changes within its sales and service organizations that made it more efficient and quickly brought to market new services to help customers efficiently utilize government stimulus programs such as the Paycheck Protection Plan (PPP), Loan Forgiveness, and Employee Retention Tax Credit (ERTC) programs.

Paychex' ability to quickly build and deploy critical services that leveraged the customer employee data it already had during a tumultuous time helped a significant number of its clients survive thru the period and increase their loyalty, raising its retention rate from 82% in its May-ending Fiscal Year 2019 to 85% in FY21. In total, Paychex helped over 500,000 businesses apply for and receive $65 billion in PPP loans (9% of the total program payouts and an even larger proportion of loans disbursed to small and medium sized businesses), apply for loan forgiveness afterwards, and helped more than 40,000 clients qualify for and obtain $8 billion in employee retention credits.

In addition, the labor challenges of the past year or so have driven greater adoption of its HR services and software technologies in order to improve employee services in the form of mobile self-service options and employee benefits management for its clients. When it comes to benefits, small and medium businesses are structurally disadvantaged when competing in the marketplace to offer the best compensation packages vs large businesses. For example, many insurance offerings get cheaper per employee with scale and Paychex's PEO service allows it to bring down the collective cost by pooling all its participating small businesses into one huge employee pool. Bringing automation technologies to its small business clients has also enabled them to work more efficiently during an inflationary period where productivity gains have been the key to preserving and growing their revenue and margins under tight labor constraints. The self-service capabilities and automation has helped also Paychex increase the productivity of its own customer service reps and salesforce, resulting in record core service margins.

The pandemic period has brought to light the importance of adaptability and resilience in business' ability to thrive over time. The common adage, "the only constant is change", was very much emphasized during that

period. However, more broadly we've seen technology really start to penetrate all types of businesses especially over the past decade with the proliferation of the internet everywhere and smartphones in everyone's pockets. Prior to the pandemic there was some worry that Paychex was too slow to adapt to the consumerization of business services and the self-service buying and control that an increasing proportion of a "digital native" business owners and employees have come to expect. However, despite the company's origins in the 1970s mainframe era and its coming of age in the 1980s and 1990s PC period, Paychex has shown an ability to adapt at a pace that keeps up (if not necessarily lead) with customers' needs and being able to leverage its expertise as a trusted partner to provide needed services at both steady and rapidly changing periods of their business lives.

Finally, while the services Paychex provides are not the most exciting topics to talk about, they are essential business to business mission critical services, and they can be very lucrative longer term investments as Paychex's stock performance demonstrates. We own similar businesses such as Fastenal and Broadridge that also display those types of characteristics. And in markets such as the one we experienced in 2022, in which doubts about the future growth of more discretionary services come into doubt, these kinds of "must have" services made for relative safe havens.

2022 Q4 Contributors and Detractors to Absolute Return Data

Description	Symbol	Average Weight	Contribution	Description	Symbol	Average Weight	Contribution
Mastercard Inc. Class-A	MA	8.40%	1.73%	Masimo Corp.	MASI	4.61%	0.23%
Netflix, Inc.	NFLX	6.43%	1.44%	ServiceNow. Inc.	NOW	3.94%	0.18%
Nike, Inc. Class-B	NKE	3.84%	1.38%	Perimeter Solutions SA	PRM	0.90%	0.13%
Home Depot, Inc.	HD	7.13%	1.02%	Paychex, Inc.	PAYX	2.94%	0.10%
Booking Holdings, Inc.	BKNG	4.66%	0.98%	Fastenal Co.	FAST	3.17%	0.09%
Ferrari NV	RACE	6.34%	0.98%	Nintendo Co LTD	NTDOY	4.13%	0.09%
NVR, Inc.	NVR	4.89%	0.79%	Broadridge Financial Solutions, Inc.	BR	4.61%	-0.29%
Charles Schwab Corp.	SCHW	3.48%	0.57%	Chipotle Mexican Gril, Inc.	CMG	4.76%	-0.36%
First American Financial Corp.	FAF	3.06%	0.39%	First Republic Bank	FRC	7.34%	-0.45%
Landstar Systems, Inc.	LSTR	3.12%	0.39%	Alphabet, Inc. Class-A	GOOGL	7.22%	-0.71%
Illumina, Inc.	ILMN	4.80%	0.27%				

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities listed above. The performance information shown above has been calculated using a representative client account managed by the firm in our core equity strategy and represents the securities held for the quarter ended 12/31/2022. Information on the methodology used to calculate the performance information is available upon request. The performance shown in this chart will not equal Ensemble's composite performance due to, among other things, the deduction of fees and expenses from the composite performance and the timing of transactions in Ensemble's clients' accounts.

ADDITIONAL IMPORTANT DISCLOSURES

Ensemble Capital is an SEC registered investment adviser; however, this does not imply any level of skill or training and no inference of such should be made. The opinions expressed herein are as of the date of publication and are provided for informational purposes only. Content will not be updated after publication and should not be considered current after the publication date. We provide historical content for transparency purposes only. All opinions are subject to change without notice and due to changes in the market or economic conditions may not necessarily come to pass. Nothing contained herein should be construed as a comprehensive statement of the matters discussed, considered investment, financial, legal, or tax advice, or a recommendation to buy or sell any securities, and no investment decision should be made based solely on any information provided herein. Ensemble Capital does not become a fiduciary to any reader or other person or entity by the person's use of or access to the material. The reader assumes the responsibility of evaluating the merits and risks associated with the use of any information or other content and for any decisions based on such content.

Ensemble's Equity strategy is intended to maximize the long-term value of the underlying accounts. The strategy generally invests in U.S. common stocks, but from time to time the underlying accounts may hold cash and/or fixed-income investments in an attempt to maximize capital gains. The strategy holds mostly large and medium-capitalization stocks, although accounts may also hold small-capitalization stocks.

Performance results for the Ensemble Equity composite since the composite's inception on December 31, 2003, are unaudited and are subject to change. The Ensemble Equity composite includes realized and unrealized gains and losses, the reinvestment of dividends and other earnings, and is net of management fees, brokerage transaction costs and other expenses. Taxes have not been deducted. Net of fee performance was calculated using actual management fees.

Management fees for an Ensemble Equity account range from 1.00% to 0.50% on an annual basis and are typically deducted quarterly. Fees are negotiable, and not all accounts included in the composite are charged the same rate. Results are based on fee paying, fully discretionary, unconstrained accounts managed with an Ensemble Equity objective and include those Ensemble Equity accounts no longer with the firm. Accounts must exceed $500,000 to be included in the composite. Accounts with assets below $500,000 and accounts with objectives other than Ensemble Equity are excluded.

Unless otherwise stated, returns for periods exceeding 1 year are annualized.

The comparative benchmark is the Standard and Poor's Total Return Index of 500 Stocks ("S&P 500"), an index of 500 large capitalization equities, generally considered a comprehensive indicator of market performance. The S&P 500 Total Return Index includes realized and unrealized gains and losses, the reinvestment of dividends and other earnings and is not subject to fees and expenses. It is not possible to invest directly in an index. The holdings in the Ensemble Equity strategy may differ significantly from the securities that comprise the benchmark.

All investments in securities carry risks, including the risk of losing one's entire investment. Investing in stocks, bonds, exchange traded funds, mutual funds, and money market funds involve risk of loss. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable or suitable for a particular investor's financial situation or risk tolerance. Some securities rely on leverage which accentuates gains & losses. Foreign investing involves greater volatility and political, economic and currency risks and differences in accounting methods. Future investments will be made under different economic and market conditions than those that prevailed during past periods. Past performance of an individual security is no guarantee of future results. Past performance of Ensemble Capital client investment accounts is no guarantee of future results. In addition, there is no guarantee that the investment objectives of Ensemble Capital's equity strategy will be met. Asset allocation and portfolio diversification cannot ensure or guarantee better performance and cannot eliminate the risk of investment losses.

As a result of client-specific circumstances, individual clients may hold positions that are not part of Ensemble Capital's equity strategy. Ensemble is a fully discretionary adviser and may exit a portfolio position at any time without notice, in its own discretion. Ensemble Capital employees and related persons may hold positions or other interests in the securities mentioned herein. Employees and related persons trade for their own accounts on the basis of their personal investment goals and financial circumstances.

Some of the information provided herein has been obtained from third party sources that we believe to be reliable, but it is not guaranteed. This content may contain forward-looking statements using terminology such as "may", "will", "expect", "intend", "anticipate", "estimate", "believe", "continue", "potential" or other similar terms. Although we make such statements based on assumptions that we believe to be reasonable, there can be no assurance that actual results will not differ materially from those expressed in the forward-looking statements. Such statements involve risks, uncertainties and assumptions and should not be construed as any kind of guarantee. Readers are cautioned not to put undue reliance on forward-looking statements.