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Building a Durable Moat in Active Management

As we learned in Finance 101, shareholder value is created when returns on an investment exceed the cost of capital employed. But sustaining those excess returns is only possible when durable competitive advantages can keep competition at bay. Otherwise, new entrants decrease pricing power, increase capital intensity, and erode margins until the opportunities for value creation fade away. Therein lies the challenge for all businesses: how to build an economic moat that allows for the compounding of intrinsic value well into the future.

By the same token, Mar Vista only creates value for our investors if we generate risk-adjusted returns that exceed the opportunity cost of investing in a passive index. As history has proven, outperforming passive benchmarks is no easy task. The fact that we have generated value, or *alpha*, for our investors over most time horizons does not prove that we can perform this feat in the future. For that reason, we've consciously built ***durable advantages*** into our investment framework, culture, business structure and economic incentives that we believe will minimize the internal and external pressures that cause most active managers to underperform over time.

Investment Framework

- Our **value-based investment framework focused on wide-moat growth franchises** is, in our opinion, the optimal path to generate value over the long term;
- We **emphasize capital preservation as much as we do capital appreciation**;
- We take **concentrated positions when the expected returns relative to the risks are favorable** and make decisions **independent of benchmark weightings** or consensus thinking;
- We focus on our **consistent, predictable and repeatable process**, not the outcomes;
- We **think like rational business analysts first**, not traders of individual stocks;
- Our patience, discipline and understanding of behavioral biases allow us to **exploit the manic-depressive nature** of the market while at the same time, minimize the impact cognitive biases have on our own decision-making;

Culture

- We are **protective of our rewarding and enjoyable culture** that fosters learning, openness, camaraderie, accountability and client-aligned economic incentives;
- We are **students of investing** and the investment philosophy that we employ. Our investment skills, circle of competence and latticework of mental models will continually expand and improve over the coming decades;
- We instill a **team-based approach yet favor diverse opinions and independent thinking** so that we don't fall prey to "group think";

Business Structure

- We have structured our business affairs to **maximize time spent thinking about capital allocation** and minimize time spent on day-to-day business operations;
- We are fortunate to have **attracted like-minded investors** who share our fundamental values, risk tolerances, return objectives and time horizons. Aligned investors allow us to invest with fewer external pressures that often influence inferior or irrational decision-making;
- Our **Circle of Competence is well-defined** and our strategies stay firmly within that universe.

Economic Incentives

- Our **economic incentives drive client-aligned behavior** and connect the investment team's decision-making to the long-term objectives of our clients;
- Our investment team owns and controls Mar Vista which ensures **focus on long-term performance and not asset gathering**. We will close our strategies to new assets should it hinder our investors' performance;
- Substantially all of our **partners' personal equity investments are in Mar Vista products** or in businesses that are owned by one of our strategies;

- Lastly, our team is in the **sweet-spot for an investment manager's career**; we can exploit advantages from two decades of accumulated experience and knowledge yet we are young enough to have **several decades of compounding our investors' capital ahead of us**.

In sum, most active managers underperform, in our estimate, due to institutional imperatives that generate irrational decisions, the fallacy that "average performance is safe" and the loneliness of contrarian thinking at the risk of being wrong. We have removed as many of those externalities and biases as possible and instead fully aligned ourselves with our investors. Ultimately, Mar Vista will provide value and our clients will win if we intelligently invest at the intersection of growth and value.

Speculation versus Investing

> *"An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."* — Ben Graham

As is typical for long bull market runs, especially in late stages, there are mounting signs of excessive optimism and speculation built into certain areas, especially biotech. While we would never claim to have an informational edge on the scientific merits of earlier-stage pipelines, we are skeptical that companies with small amounts of current revenue will eventually justify their lofty valuations. Just as one example among many, Abbvie's $21 billion acquisition of Pharmacyclics requires Imbruvica, a drug approved for blood cancers, to generate annual revenues exceeding $10 billion just to produce an *acceptable* rate of return. The drug, whose profits are partially shared with Johnson & Johnson, is expected to provide revenues of just $1 billion in 2015. Perhaps we are on the cusp of a biotechnology revolution that will deem our conservative assumptions irrelevant but many valuations are suggesting the revolution is *fait accompli*. There will undoubtedly be big winners, for both investors and patients, but if reality falls short of the lofty expectations, biotech stocks promise neither safety of principle nor an adequate return.

As always, the investment team appreciates the trust you have instilled in us as stewards of your capital. We take our role as fiduciary seriously and open communication about how we are managing your capital is an important part of that responsibility. Please don't hesitate to let us know of any questions, comments or concerns you may have. We look forward to the opportunity to discuss our investment philosophy and thoughts through these quarterly updates, conference calls, and personal meetings with you. If you care for copies of prior quarterly commentaries, please let us know. You can reach us by phone at (310) 917 2800, via email at info@marvistainvestments.com or visit our website at www.marvistainvestments.com.

All the best,

The Mar Vista Investment Team