July 2019

“I’ve Got It, I’ve Got It -- What Is It?” Revisited

Thirty years ago, Peter Lynch penned his highly popular *One Up on Wall Street*, which sent many aspiring students of investing, including us, on a lifetime pursuit of “tenbaggers.” His plainspoken style and seemingly simple process of just paying attention to the products or services you encounter on a daily basis made investing accessible to the non-professional.

With the benefit of hindsight, some of Mr. Lynch’s concepts may seem quaint. The investment game today is far more competitive for both large and small investors than in the late 1980’s. Generating an edge by casually observing consumer trends is a challenge against hedge funds monitoring satellite images of retailer parking lots. Regardless, many of Mr. Lynch’s core tenets are timeless and deeply imbedded in Mar Vista’s culture: *ignore the herd*, *market timing is for fools, know your circle of competence* and *think rationally*.

One chapter of the book, referenced in the title of this letter, recently came to mind. To understand better what he owned and why, Mr. Lynch classified stocks into six categories: slow growers, stalwarts, fast growers, cyclicals, asset plays, and turnarounds. Each group represented differing levels of expected returns and risk and his exposure to each helped him profile the portfolio.

Similarly, our team recently worked on an exercise to categorize our businesses based on a variety of common characteristics. Since Mar Vista’s primary research focuses on the key drivers of per share intrinsic value (excess returns on capital, durability of competitive advantages, reinvestment opportunities and range of potential outcomes), the questions we asked were:

- Does management reinvest all excess capital or are capital needs limited and any surplus is returned to shareholders?
- Are competitive dynamics and growth rates mature and relatively stable or is the moat still emerging?
- Are economic returns highly cyclical or do they hold up well during recessions?

These questions bracket the extreme ends of the spectrum and many factors will overlap and evolve over time but we found six categories largely cover the distinctive characteristics of our wide-moat portfolio.

Category	**Unique Feature**
Z Companies	Grows invested capital greater than 10% annually with high incremental returns
Cannibals	Strong secular growth with limited capital needs, consistent repurchaser of undervalued shares
Cyclical Compounders	Cyclical earnings but progressively higher economic profits at peaks and troughs
Emerging Moats	Underappreciated embryonic moat but large addressable market and share gains
Stalwarts	Mature and defensive with stable capital needs, capital returned via dividends or repurchases
Matchmakers	Powerful capital-light, winner-take-all network effect by connecting consumers and suppliers

Z Companies

Z Companies[1] represent a bonanza of compounding shareholder wealth. When a business enjoys robust invested capital growth and high incremental returns on capital, a "serial compounding machine" is born. These are the poster-children of Mar Vista's investment style and the category from where most potential "tenbaggers" could arise.

Why are there persistent multi-bagger opportunities in Z Companies? One, the power of compounding goes only to those with patience and a long time horizon, attributes that are often in short supply. Second, the non-linear nature of compounding is just not intuitive. Common financial metrics like margins, free cash flow and returns on capital will not uncover the beauty of most of these business models. In fact, the metrics might look mundane as management smartly invests to maximize the durability and magnitude of excess returns.

Z Companies comprise more than a quarter of our portfolio. *American Tower*, *First Republic*, and *Roper Technologies*, for example, have each expanded their invested capital at mid-teens annualized rates over the last decade. *TransDigm Group* has grown its capital base at an even faster 24% rate since 2008 mostly into moat-expanding and value-creating tuck-in acquisitions that far exceed the cost of capital. We see further compounding opportunities in the decade ahead for each of our Z Companies.

Cannibals

Cannibals are cash-spewing machines with few reinvestment or acquisition opportunities so they consistently buy back their own undervalued stock. Our favorite Cannibals enjoy secular growth tailwinds such as a sizable and growing addressable market, share gains, pricing power and high incremental margins but with one added benefit -- growth requires very little incremental capital. All things being equal, a dollar of operating profit from an asset-light business adds more value than a dollar of profit from a more capital-intensive business.

Cannibal management teams throw accelerant on per share intrinsic value growth as profits expand over an ever-declining number of shares. Mathematically, the Cannibal model has a finite life as shares outstanding shrink to one but patient shareholders enjoy an increasingly larger slice of a growing pie.

Our portfolio of slowly-going-private Cannibals includes *O'Reilly Automotive* (44% of shares repurchased since 2010), *Mettler Toledo* (42% since 2005), *Moody's* (37% since 2005) and *Intuit* (27% since 2007), among others.

Cyclical Compounders

Cyclical Compounders' near-term results may gyrate unpredictably as macroeconomic drivers influence demand but, over a full cycle, these companies generate progressively higher economic profits at the nadirs and peaks. Our favorite Cyclical Compounders exploit weaker competition during the downturns and, through faster share gains or smart acquisitions, further extend their competitive advantages.

Knowing where industries are in their cycle is important to generating alpha and protecting capital when investing in Cyclical Compounders. The businesses appear *least expensive* later in the cycle when profits are robust and *most expensive* when demand and profits are at a nadir. Perversely, the stocks present the least risk at the bottom and the most risk at the top.

Microchip, *Sensata* and *Honeywell* are a few examples of Cyclical Compounders we own that have substantially improved their moat and economic earnings power during the current cycle.

---

[1] "Z Company" pays homage to another vintage investment book, *The Quest for Value* (1991), which deeply influenced our investment framework over the last two decades. The authors, Joel Stern and Bennett Stewart, built upon Al Rappaport's *Creating Shareholder Value* (1986) and formalized the concept of Economic Value Added (EVA) to measure shareholder value. They categorized Z Companies as those that grow invested capital at high rates with a return of at least 2.5% more than its cost of capital.

Emerging Moats

Emerging Moats are typically smaller businesses that show promise as a dominant franchise but are still carving out their competitive advantages. Financial metrics may not reveal the budding moat as management invests aggressively to expand its scope and duration. Typically facing sizable addressable markets and material share gains, Emerging Moats can be multi-baggers as they reap the rewards of profitable growth.

Teleflex is an example of an Emerging Moat medical device company in our portfolio. Accelerating revenue growth, substantial improvements in operating margins, intelligent investments in innovation and value-creating tuck-in acquisitions all conspire to drive mid-teens economic returns.

Stalwarts

Stalwarts are not the fastest growing businesses in the portfolio but they can be an important source of alpha particularly during downturns. Mature but stable growth, established moats, high returns on capital and fortress balance sheets define these well-established companies. With prodigious amounts of cash flow and fewer opportunities for major reinvestment, they usually return excess cash flow in the form of consistently growing dividends or modest share repurchases. Tenbaggers are highly unlikely in this category but we would expect our capital to appreciate by one-half to two-thirds over a five-year period. Purchasing with an attractive margin of safety only adds to those expected returns and helps with downside protection.

Johnson & Johnson, *Unilever*, *Oracle* and *Pepsi* are examples of our Stalwarts.

Matchmakers

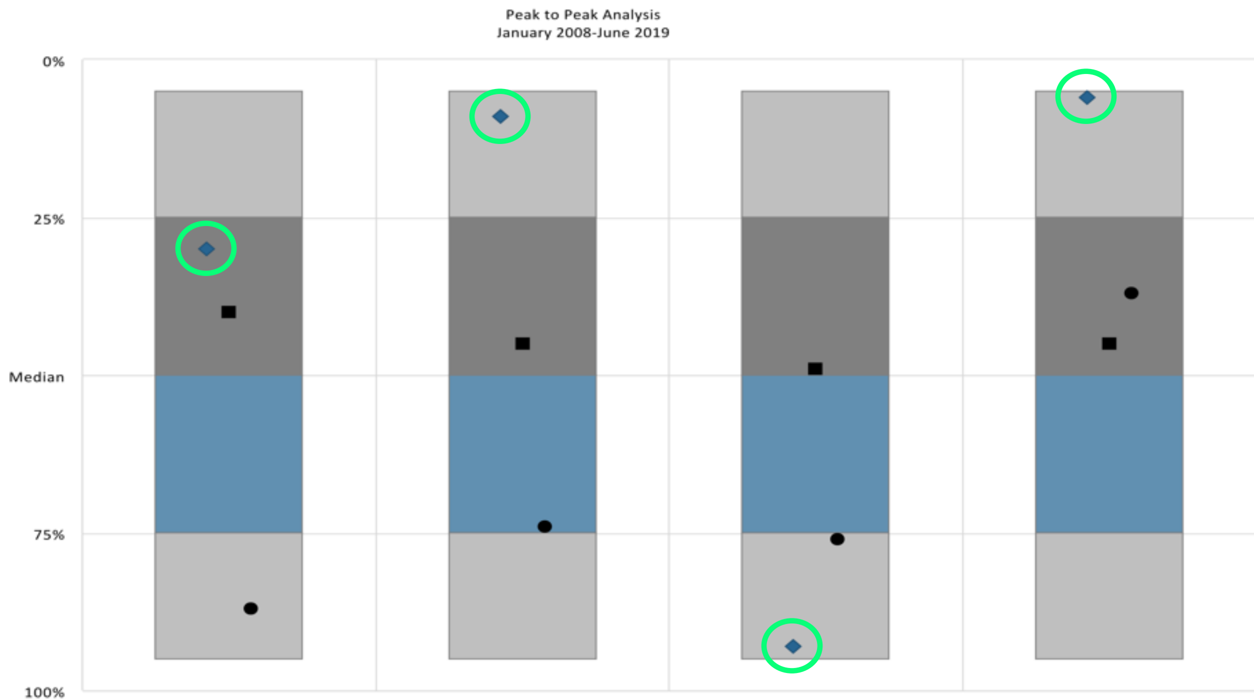
Matchmakers, Ecosystems, Platforms...no matter what you call them…are rapidly transforming nearly every industry. These businesses benefit from a powerful and difficult to disrupt network effect by digitally connecting consumers and suppliers to facilitate commerce. Compared to the more traditional linear value chain, Matchmakers scale more efficiently since growth is not constrained by the need for capital. For example, *Bookings.com*, one of our platform holdings, does not need to invest in physical hotel room inventory to grow revenues. They let the traditional hotel chains build and manage the assets while *Bookings.com* benefits from connecting those needing a hotel room with available inventory.

Matchmakers may possess similar features as our other categories but we thought these multi-sided platform models are so distinctive and powerful that they deserved their own segment. *Amazon*'s aggressive investments to dominate adjacent markets makes it also a Z Company. *Booking.com* has repurchased 15% of its shares over the last four years while *Apple* has reduced its shares by almost one-third in the last six years making them Cannibals as well.

With characteristics like “asset-light,” “winner-takes-all,” and “difficult to disrupt,” it is no wonder the big players have dominated stock market performance over the last decade. In total, Matchmakers make up about 20% of our portfolio. Based purely on fundamentals, we would like to have more capital allocated to these businesses but their valuations are reflecting highly optimistic outcomes without much room for hiccups or economic slowdowns.

Differentiated Pattern of Long-term Outcomes

Judging whether our, or any manager's, returns are due to skill or luck is a challenging task. Over shorter periods, returns are largely a random walk. Over the longer term, the road to positive alpha generation is bumpy and typically marked by extended periods of underperformance. However, a manager's skill should be more evident over a full market cycle, which we would define as "peak-to-peak." The chart below is an unambiguous report card of Mar Vista's peer ranking for each of the key components of our outcomes since the prior market peak: Total Returns, Alpha (returns relative to the level of risk incurred), Beta (volatility relative to the market) and Down Market Capture (measure of protecting capital):



Universe: eVestment US Large Cap Growth Equity

	Returns	Rk	Annualized Alpha	Rk	Beta	Rk	Downside Market Capture	Rk
5th percentile	12.42		2.16		1.16		78.31	
25th percentile	10.83		0.83		1.05		92.84	
Median	10.07		-0.14		1.00		101.05	
75th percentile	9.10		-1.11		0.94		106.80	
95th percentile	7.59		-2.70		0.84		115.99	
# of Observations	190		190		190		190	
Strategic Growth	10.63	30	1.72	9	0.85	93	80.57	6
Russell 1000 Growth	10.35	40	0.00	45	1.00	49	100.00	45
S&P 500	8.52	87	-1.08	74	0.93	76	98.38	37

The risk-return profile over the now forty-six quarter "peak-to-peak" cycle is consistent with the goals of Mar Vista's process: generate value for our investors (Alpha = +1.72, 9th percentile) through superior compounding of capital (Absolute Annualized Returns = +10.6% gross of fees, 30th percentile) while incurring less risk (Beta = 0.85, 93rd percentile) and better capital protection (Down Market Capture = 80.6%, 6th percentile).

Our performance compared to the S&P 500® Index has expanded over the past five years but our outperformance compared to the Russell 1000® Growth Index has narrowed in the largely unidirectional market. The far left bar above shows our total return (not adjusted for risk) rankings have fallen from top decile to the 30th percentile. **Investment history, and our own**

experience, has shown that the value of prudence and conservatism fades into the background during these more exuberant periods and is only revealed with the fullness of time.

Outlook

Over time, the expected returns of our portfolio should reflect two components: (1) the compounding nature of our businesses and (2) the discount we are paying relative to fair value. There will be times when the sentiment pendulum swings towards optimism; portfolio returns exceed the underlying intrinsic value growth, and margins of safety contract. Conversely, fear, skepticism and lower stock prices provide opportunities for both higher expected returns and less risk. Judged by our relatively narrow average margin of safety, or discount to intrinsic value, we think the pendulum sits decidedly on the optimistic side of the scale. **The 3% portfolio average discount sits at the extreme low end of the last fifteen years and the number of stocks that are trading below our estimate of fair value is the smallest our team has experienced.**

Mar Vista claims no special skill in predicting the market's direction but, in the fullness of time, we believe a patient, high-conviction portfolio comprised of competitively advantaged businesses with stock prices that represent an appropriate margin of safety will generate excess risk-adjusted returns. In an investment environment with sustained optimism and stock prices that are outpacing intrinsic value growth, we will remain diligent, conservative and patient as we deploy capital within our wide-moat universe.

Mar Vista's Commitment to Our Investors

Though there are never guarantees in investing results, the Mar Vista team remains committed to the foundations of our success:

- Focus on the process, not the outcomes
- Emphasize capital protection as much as upside potential
- Think like rational business analysts first, not traders of individual stocks
- Identify good capital allocators that think and act like *Outsiders*
- Exploit the manic-depressive nature of Wall Street
- Take concentrated positions when the expected returns relative to the risks are favorable
- Expand our circle of competence and latticework of mental models
- Align our economic incentives with our investors

As always, we appreciate the trust you have instilled in us as stewards of your capital. Our role as fiduciary is paramount to everything we do and open communication about how we are managing your capital is an important part of that responsibility.

Please let us know of any questions, comments or concerns you have. We look forward to the opportunity to discuss our investment philosophy and thoughts with you through these updates, conference calls and personal meetings. 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

Strategic Growth Annualized Returns as of June 30, 2019

	Net	S&P 500®	Alpha	R1000®G	Alpha
1 Year	13.4%	10.4%	2.91	11.6%	3.17
3 Years	14.8%	14.2%	0.95	18.1%	-0.39
5 Years	11.5%	10.7%	1.31	13.4%	0.30
10 Years	14.7%	14.7%	0.92	16.3%	0.39
15 Years	9.7%	8.8%	1.98	9.9%	1.60
Since Inception	9.6%	8.7%	2.05	9.8%	1.74
"Peak-to-Peak"	10.3%	8.5%	2.73	10.4%	1.72

** Peak-to-Peak represents returns generated January 1, 2008 through June 30, 2019.*

Focus Annualized Returns as of June 30, 2019

	Net	S&P 500®	Alpha	R1000®G	Alpha
1 Year	12.6%	10.4%	1.54	11.6%	1.81
3 Years	14.7%	14.2%	0.02	18.1%	-1.43
5 Years	12.0%	10.7%	1.04	13.4%	-0.07
10 Years	15.1%	14.7%	1.14	16.3%	0.51
15 Years	9.9%	8.8%	1.66	9.9%	1.07
Since Inception	10.9%	9.8%	2.26	10.9%	1.70
"Peak-to-Peak"	10.5%	8.5%	2.84	10.4%	1.61

** Peak-to-Peak represents returns generated January 1, 2008 through June 30, 2019.*

Global Annualized Returns as of June 30, 2019

	Net	MSCI World Net®	Alpha
1 Year	15.7%	6.3%	9.58
3 Years	12.9%	11.8%	2.54
5 Years	8.4%	6.6%	2.95
Since Inception	11.3%	10.7%	2.44

Investors in Mar Vista's Strategic Growth, Focus or Global strategies acknowledge and agree that (I) any information provided by the Firm is not a recommendation to invest in the strategies and that the Firm is not undertaking to provide any investment advice to the investor (impartial or otherwise), or to give advice to the investor in a fiduciary capacity in connection with an investment in the strategies and, accordingly, no part of any compensation received by the Firm is for the provision of investment advice to the investor and (II) Mar Vista has a financial interest in the investor's investment in the strategies on account of the fees and other compensation the Firm expects to receive from the client.

Mar Vista Investment Partners, LLC, a Delaware limited liability company, offers investment advisory services to individuals, pension and profit sharing plans, trusts, estates, corporations, as well as other institutional clients. For purposes of compliance with GIPS®, Mar Vista has defined itself to include bundled/wrap fee accounts in the firm's assets. Prior to January 1, 2018, Mar Vista defined itself to not include bundled/wrap fee accounts in the firm's assets. Mar Vista maintains a complete list and description of firm composites, which is available upon request.

Mar Vista claims compliance with the Global Investment Performance Standards (GIPS®).

The Strategic Growth Composite was created 12/01/07, with an inception date of 12/31/03. All returns are based in U.S. dollars and are computed using a time-weighted total rate of return. The composite is defined to include all fully discretionary portfolios with no minimum or maximum account value, managed in accordance with Mar Vista's Strategic Growth strategy, and that paid for execution on a transaction basis. Prior to 1/01/06, the composite was defined to include only taxable portfolios with no minimum or maximum value. The results in the column marked Net of Fees for the periods 8/01/08 through the present, include a standard management fee applied to any non-fee paying portfolio for performance calculation purposes.

The Focus composite was created 12/01/07, with an inception date of 12/31/02. All returns are based in U.S. dollars and are computed using a time-weighted total rate of return. The composite is defined to include all fully discretionary, taxable and tax-exempt portfolios with no minimum or maximum account value, managed in accordance with Mar Vista's Focus strategy, which is a concentrated portfolio invested in 15 to 20 equities, and that paid for execution on a transaction basis. Prior to 4/1/04 the composite was defined to include tax-exempt portfolios with a minimum portfolio value of $500,000. From 12/31/02 forward, the composite includes portfolios without restrictions and also portfolios with minor restrictions that affect up to a maximum of 5% of the portfolio's value based on the cost of the restricted securities at the time of purchase by other similarly managed portfolios.

The primary benchmark is the Russell 1000® Growth Index, defined as an unmanaged, capitalization weighted index of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Index returns include dividends and/or interest income and, unlike composite returns, do not reflect fees or expenses. In addition, unlike the composite, which periodically maintains a significant cash position, the Russell 1000® Growth Index is fully invested. Investors cannot directly invest in an index. The secondary benchmark is the S&P 500® Index, defined as an unmanaged, capitalization weighted index of the common stocks of 500 major U.S. corporations. Index returns include dividends and/or interest income and, unlike composite returns, do not reflect fees or expenses. In addition, unlike the composite, which periodically maintains a significant cash position, the S&P 500® Index is fully invested. Investors cannot directly invest in an index.

The Global Equity composite was created in 2012, with an inception date of 12/31/11. All returns are based in U.S. dollars and are computed using a time-weighted total rate of return. The composite is defined to include all fully discretionary, taxable and tax-exempt portfolios with no minimum or maximum account value, managed for at least one month in accordance with Mar Vista's Global Equity strategy, which is a portfolio invested in 15-30 equities, and that paid for execution on a transaction basis. The benchmark is the MSCI World Index. The results in the column marked net of fees for the periods 1/01/12 through the present, include a standard management fee applied to any non-fee paying portfolio for performance calculation purposes.

The benchmark is the MSCI World Index, defined as a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 23 developed market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. In addition, unlike the composite, which periodically maintains a cash position, the MSCI World Index is fully invested. Investors cannot directly invest in an index.

The dispersion in composite returns shown herein was measured using an asset-weighted standard deviation formula. Performance results presented reflect the reinvestment of dividends and other earnings. Gross performance is net of all transaction costs, and net performance is net of any transaction costs, applicable performance-based fees and actual management fees, but before any custodial fees. All returns are calculated net of withholding taxes on dividends and interest. Actual results may differ from composite results depending upon the size of the portfolio, investment objectives and restrictions, the amount of transaction and related costs, the inception date of the portfolio and other factors. In the Global composite, three non-fee paying accounts are net down by the maximum fee. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. The firm's Strategic Growth and Focus fee schedule is as follows: First $25 million – 0.75%; Next $25 million - 0.60%; Next $50 million – 0.50%; Over $100 million - Negotiable. The Firm's Global Equity fee schedule is as follows: First $25 million – 0.75%; Next $25 million - 0.60%; Next $50 million – 0.50%; Over $100 million - Negotiable. Special circumstances may cause fees to vary from this schedule and Mar Vista reserves the right to negotiate fees with clients. Fees are payable quarterly in arrears or advance based on 1/4th of the annual rate.

A complete list of portfolio holdings and specific securities transactions for the investment strategy during the preceding 12 months, the top contributors and underperformers calculation methodology and a list of every holding's contribution to the overall performance during the period is available upon request and a presentation that complies with GIPS® for each strategy mentioned are available upon request by contacting Mar Vista directly at (310) 917-2800 or by emailing at info@marvistainvestments.com. The securities mentioned in this letter were held in the account of a Strategic Growth client that Mar Vista believes to be representative of the accounts that Mar Vista manages for this investment strategy during the period from March 31, 2019-June 30, 2019. Other Mar Vista clients managed with different investment objectives may hold different securities than those listed. The securities listed in this letter should not be considered a recommendation to purchase or sell any particular security. The reader should not assume that investments in the specific securities identified herein were or will be profitable. Risk data is being provided as supplemental to the Strategic Growth, Focus and Global Equity GIPS® performance presentations, which are available upon request. Past performance is no guarantee of future results. Not FDIC insured, no bank guarantee, may lose value.