Conference Call Transcript: July 15, 2015

Good afternoon. Thank you for joining our first client conference call. It is really great to have such a strong turnout today. We recently upgraded our client statements to offer more clarity about your investments with us, and this call is part of that overall mission to make what we do for you as transparent and understandable as possible. We believe that investors are best served when they understand what they own and why. When market volatility strikes—which it has not for a while, but it always does in the end—those investors that have conviction in their investment process and their specific investments are able to stay disciplined. Importantly, this call is not meant to replace any of the regular one-on-one interactions we have with any of you, so you can still expect that we will connect with you on a regular basis to discuss your specific financial plan and portfolios.

So, I am just going to start with an overview of the general market and the economy. The S&P 500—the best measure and mind of the general market—was up 1.2 percent in the first half of the year. Short term bonds were slightly higher in value and longer term bonds were somewhat lower as interest rates moved higher over the first course of the first half of the year. Yet, underneath that relatively flat outcome, there was some market volatility, especially in the month of January. After a good year last year in the stock market, and the change in currencies that occurred within the second half of last year and the beginning of this year, ended up being stronger than many analysts expected it in its impact on company earnings. So with the dollar strengthening against the euro and the yen, companies that had exposure to those areas—in terms of demand from their customers—saw those results come in lower than expected. Google, the company that we own for many of our clients, had this sort of situation. We—and any analysts—track a company's earnings trend and revenue trends on a currency-neutral basis. Looked at that extent, Google saw very steady results from the second half of last year into the first half of this year; but after accounting for the currency impact, their revenue growth declined in the high single digits.

So this occurred across much of the stock market from everything like consumer product companies like Procter & Gamble to tech companies, and the fact is that, today 40 percent of S&P 500 revenue is derived from outside the United States. This number was only ten percent 25 years ago, and so this shift means that global currency trends impact companies' earnings to a much greater extent overall. We generally think that currency fluctuates and are almost completely unpredictable; this is generally believed to be the case across many economists. So because of that, we track closely what current currency means for our company's earnings, but we invest in companies who we think their currency-neutral results will be very strong.

One bright spot in the stock market was more medium-sized companies where, right now, Ensemble's portfolios are more heavily weighted, and this is because many medium-sized companies have more domestic revenue. Many companies that are large caps get that way through serving global audiences where smaller and mid-cap companies often, but not always, have more domestic revenue.

In the first half of the year, interest rates also moved to multi-year lows, which is somewhat amazing. For years now, many people, Ensemble included, have been calling for interest rates to move higher over a time. In March of this year, they ended up trading all the way down to 1.65—that is the 10 year treasury yield—just about as low as they were at any time in the past 50 years, but that reversed quickly and after starting the year at a 2.15 interest rate; they finished the first half at 2.35. Today they have been quite volatile over the last week, as news about Greece has hit the airwaves.

The Federal Reserve outlook on all this has a big impact. What the Federal Reserve is telling us right now—telling markets—is that they view September as a likely time when they will begin raising rates, but the Fed themselves are not sure. It would be even more likely to come after September other than before. The Fed, too, has been consistently wrong in expecting that they would have the ability to raise rates and it may be deferred some more. However, we do continue to think that interest rates will move higher, and the rate that prevailed today seemed untenable for a number of reasons. The big question for investors is, "Are rising rates bad for stocks?" They are for bonds, unequivocally; when interest rates move higher, the value of bonds decline, especially for longer term bonds. However, rising rates historically have correlated with the good market for stocks. This is not broad, partly because there are two reasons why interest rates move higher: either one, because inflation expectations have moved higher, and so interest rates need to move higher to accommodate higher inflation; or two, because growth expectations have moved higher and investors are more willing to invest in stocks. By and large in the historical basis, interest rates have moved higher during periods of increasing growth expectations and that is why the Fed themselves think they can raise rates. So while it is very difficult to know exactly how stocks will act this time, we do not see rising rates as being an unequivocal negative for stocks. Historically, it is interesting to note that stocks have often traded poorly, modestly in the initial stages of interest rate rallies before moving higher.

It is interesting to think about where interest will rates end up. Historically, the 10 year treasury has averaged about five percent—more than double where it is today. The Federal Reserve publishes their own estimates and they appeared at—I believe—at the 10 year will normalize over the longer term in a four to four-and-a-half percent range. This is materially higher than it is right now. Under that environment, you would have mortgages at six-and-a-half or seven percent, not the four percent that you can get today. What all this means for bond investors today is that if you are in 20- or 30-year bonds—bonds that we do not own for any of our clients—the value of these bonds would fall materially if interest rates were to move as high as I suggest that they might. Short term bonds—as they mature in a year or two or three—would have very little downward movement because those bonds would come to maturity, investors would get the cash back and be able to reinvest at the then prevailing higher rates.

The big headlines the last week or so has been Greece, of course. The Greek economy is similar in size and scope to Los Angeles, so it can be hard to some extent to understand why it might have such an impact on global financial markets. We think that it has next to no impact in terms of the direct impact of what happens in Greece on terms of Greece's demand for anybody else's products. However, the reason there is so much volatility is that Greece potentially leaving the eurozone puts the premise of the eurozone at risk. Investors might start worrying whether Portugal or Spain might leave the eurozone at one point or another. Oftentimes, crises precipitate a coming together, a solidifying, if they do not succeed in breaking things apart. So it may be that this occurrence leads to a stronger eurozone over time. That is certainly what Merkel and other leaders of the eurozone are pushing for.

One of the other big things that happened more in the first half of the year is that the energy price is falling. Oil has dropped over 50 percent from its high and this has led to the energy investments which we have a few in our portfolio declining significantly. It is really the only area in our client portfolios where we have seen equity investments decline in value in the first half of the year. We have seen six 50 percent declines in oil over the past 30 years. In every case, it is one of two reasons: either demand falls below the level of supply or supply increases significantly. What we have right now is a classic supply imbalance. North America in particular produced more and more and more oil over the last five years. In fact, if you exclude North America from oil production, global oil production has been in steady decline for the past five years, but the shale discoveries and other areas of North America have offset all of that global decline and created even more oil supply than many of you thought possible just two or three years ago. The thing about oil is it is like all markets—it is supply and demand—and if prices stay below the marginal cost of production, which is where they are today, then supply will fall. We are seeing that in North America already, with North American producers cutting the number of rigs that they operate by over 50 percent. So one of two things will happen; either demand will increase to reach the level of supply or supply will decline to meet the level of demand. Predicting what the oil price is incredibly hard, but it is important to keep in mind that right now most experts believe that it costs about seventy-five dollars a barrel to pull an additional barrel of oil out of the ground. So oil prices staying below that level for very long seems improbable because for that to happen, oil companies would have to intentionally lose money on each barrel that they pulled out. We will see what happens, but we do think that over time oil prices will normalize at levels higher than they are today.

Within employment and spending, what we are seeing is job creation is ok; it is not great. Each month, we create new jobs, but many people have wondered whether the unemployment rate is fraudulent almost, whether it overstates how healthy the economy is. But one confirming data point is that unemployment claims—which are filed every week which are not subject to any sort of seasonal adjustments—are confirming this relatively bright employment outlook. Unemployment claims are at multi-decade lows so even if companies are not hiring voraciously—except, of course, in the Bay Area—we are seeing the companies are just simply not laying many people off at all right now. This is leading to wages starting to move higher. This is good for company sales—when people earn more money, they tend to spend more money—but it also may be bad for profit margins. One of the questions we get a lot after such a long goal market is that whether the market is excessively valued. The market PE (price-to-earnings) ratio is actually quite close to its historical norm. People who say that the market is very expensive are using long-term historical levels of profit margins and implicitly arguing that profit margins must come down from current levels, which may happen. But it is interesting to note that international revenue—as I had noted earlier, which has gone from ten percent to 40 percent of S&P 500 revenue—it generally taxed at much lower rates than US revenue, and therefore it makes sense that profit margins would be at strong levels. In addition to lower interest costs that we have seen over the past number of years has been a lift to margins, as has the shift to higher margin technology businesses. So honestly, Ensemble does not know if the market's expensive, but it certainly does not seem wildly out of whack to us. And because we cannot know what the market will do next or whether it is expensive or cheap, we focus on individual companies where we have very strong opinions about valuation and about companies' prospects.

So I am going to talk now about a couple individual stocks that are widely held in our client portfolios, but it is important to note that Ensemble runs custom portfolios on behalf of our client base. Some holdings may be in stocks that, when we bought them years ago, they were very cheap and today they are in client portfolios, but we consider them a hold, they are not worth selling, we think they are good companies but they do not represent great bargain opportunities for new buyers, so new clients may not own those stocks.

The Advisory Board Company is one of our largest holdings. It is a consulting and software company that serves hospitals. The company began as a research co-op working with the Mayo Clinic, Cleveland Clinic, and many others of the most advanced, most progressive health clinics. In bringing them together to figure out, "How can we do healthcare better? How can we bring down cost and improve patient outcomes?" Hospitals love this research and they are generally non-profits and willingly were working together under Adversary Board's guidance, but over time, Advisory Board found that hospitals could not take the best practices they were learning and implement them because they did not have the right software, so Advisory Board began providing the software as well. Along the way, they recognized that the education market, universities, were subject to similar trends as hospitals; they had out of control cost inflation and need to improve outcomes for students and non-profit status. So over the years, the company has begun serving this market alongside hospitals. We had owned Advisory Board on and off for a number of years in small positions, but we bought a sizeable stake for many clients in the spring of 2014 when the stock fell from what was then record highs. Throughout the second half of the year, the stock went into a tailspin, frankly, falling from 54 to 38 in the November-December time period, dragging our portfolio performance significantly. During that time, we did not believe that the company's fundamentals were falling apart. The company had started the year, saying that they might grow revenue at 15 percent and by late 2014 it appeared it might come in more like 13 percent, and while this was slightly worse than expected, was not a huge deal. This is a high-growth company that is doing very well, but on Wall Street this represents an earnings miss—one of the worst sins that a company can execute. As the stock dove down to 38, we bought more, making it basically our largest position. Today it has rebounded in trades at 58, again, having acquired another education software and consulting business and strengthened their healthcare business, so we continue to see the company is doing one of the most important things in America today—bringing down the cost of healthcare and improving patient outcomes—and we think that it is a stock to own for the long run.

Second company we own is First American Financial. First American provides title insurance and anytime somebody buys or sells a house, you get the title checked by generally First American Financial or their one other major competitor. Each of these companies has a title plan, what they have built over decades of knowledge and understanding and records around titles, and when you go through the buying process, as you go in the Bay Area to purchase a one-, three-, or five-million dollar home, buyers do not tend to push back on the cost of their title insurance. In fact, your realtor or mortgage lender will direct you into an office to sign the escrow paperwork, which is at First American Financial's offices, although many buyers do not even know their name. During that process, it is required—it does not cost you very much as a relative piece of everything else—and First American gets paid for every title they process, so what is interesting is that housing prices have come back rather dramatically from the bust, not just in the Bay Area where they have seemed to come screaming back, but overall, home prices are back close to where they were in 2007, but home sales volumes have not. The number of homes being sold—both new and existing homes—are still at levels seen in the 1990s. So we think that prices may certainly flatten out at these levels, but sales numbers almost have to move higher. A longer sale cycle means that people are staying in homes for longer and longer periods while in fact Americans are becoming more and more mobile. Any time you own something housing related and you have clients in the Bay Area, people wonder if the current boom in prices is a bubble, and who knows, maybe prices in the Bay Area are overinflated, but it is important to note that since 2007, mortgage rates have been cut in half, so your cost of ownership is much lower while rents have doubled or more. So whether pricing is somewhat exception in the Bay Area is certainly debatable, but it is nothing like the excesses we saw in 2007 so we expect home sales to start increasing. We thought that home prices would start increasing last year, but they stayed flat, and First American did ok as a stock, but year-to-date, they are now growing at ten percent—a level that we think can be maintained for a number of years. The fact is we have a hard time predicting exactly when things will happen in the short term, which is why we invest for three to five year time frames or even longer. Housing is not just related to First American, of course, it is part of the overall economy. It is one of the most important parts of the economy, and so it is important to keep that in mind when you think about the overall economy in the United States that housing has been relatively in the doldrums and has just begun to roar back quite strongly. So have auto sales, of course. During much of the recession and the years following the recession, people believed that younger people—

millennials—would live in urban apartments and take Uber everywhere and the missing first time homebuyer has been a big part of the volume problem, but as they improved and younger people have been getting jobs, we are seeing that they are beginning to buy cars and homes once again.

I just want to talk a bit about Google. Everybody knows what Google is, everybody uses Google and that, of course, is one of the reasons why it is such an attractive investment. They have actually dominant market share in internet search; way more market share than Coke has market share within soda. Almost all of Google's revenue, despite all of the articles you see about self-driving cars and internet balloons, comes from the links that you click on, the ads that appear on search engines. This company has been a big winner for our clients over time but until this week, the stock was flat for 2015 and over the last 12 months in fact it was down almost ten percent while the market was up ten percent. The market often is worried that the founders of Google do not actually care about the bottom line or about shareholders. Wall Street tends to fall in and out of love with Google on a regular basis and they hate, in a way, that Google focuses on the very long term and will not give analysts guidance on what they expect to earn next quarter as many other companies do. Back in March, Google hired a new CFO, a woman named Ruth Porat from Morgan Stanley. What is interesting is that while Ruth is a very accomplished CFO, she comes from a financial, not technology background—she did over sea technology companies in her work with Morgan Stanley. She may bring more of an expense in capital allocation, meaning stock buybacks and dividends around her policy at Google. We think this is a good thing and we will see how it plays out. Her first call is tomorrow and the stock is now up almost ten percent and just in the past week as the Wall Street Journal and other analysts begin speculating the new CFO may urge Google to start paying a dividend or buyback stocks. Whether this happens on a first call—we will see.

Well, I have touched on one other special topic which we will try to do in each of these calls and just talk a bit about how we manage portfolios. Today I am going to talk about position sizing. We think it is an incredibly important and underappreciated aspect of managing a portfolio. It is not just what you buy and when you sell it, but how much you own of it. We think that position sizing is about weighing the return potential against your degree of certainty that something is going to happen. It is interesting that somebody offers you a bet to flip a coin and said they would pay you ten-to-one if you correctly called the coin. It is a great bet—there is no doubt about it—but you should not bet everything on that, because there is a 50 percent chance that you are going to lose. So the certainty that you are right is only 50-50, even though the payoff is very large. With greater certainty, you can take bigger position sizes, so when you look at the portfolios we manage on your behalf, if you look at the position size, it should tell you a couple things. One, that we think that return potential in the future is quite significant, that we think that our degree of certainty about how their fundamentals is going to play out is higher than it is for companies with small positions, and the last one being how new the position is to us. When we take and put new stocks into a portfolio, we have typically studied them for weeks and months before making our initial buys, but those initial buys are almost always on the smaller side. Over the next six-to-twelve months, we build deeper and deeper conviction as we get to know the companies, and hopefully build them up to a larger position if our certainty develops in a positive way. Overall, we tend to target about 20 equity securities in a portfolio. The diversification benefits of adding fourth, fifth, tenth or twelfth security to the next is quite large in the volatility of the portfolio goes down significantly, but as you approach 20 and go to 25 and go past, the incremental diversification benefits are almost minute, but adding your 50th, 75th, or 100th best idea to a portfolio, obviously, diminishes the return potential. So we think that the number of securities that we keep our clients in helps us balance a level of diversification that captures almost all the diversification you see in a full index portfolio, while keeping our clients' money in our best ideas.

So looking forward just a bit as we come to an end, the last few years have been very, very good for the stock market. It has been almost four years since we have seen a ten percent pullback. We did go seven years without a ten percent pullback in the 1990s so the fact that it has been a while is by no means a sure thing that we are going to see a decline. Of course, we could see a ten percent decline after the market first rallied 15 percent, and so you would have missed out if you tried to time that ten percent decline. The fact is ten percent corrections happen within the context of a bull market all the time. They happen on average about once a year, and 20 percent corrections happen about every three years on average. So corrections in this range are just part of the facts of life in being an equity investor. If they were timeable occurrences that you could jump in and out of, we certainly would not endeavor to do so, but history shows that certainly not Ensemble and just about no one we know of has the ability to accurately time the next ten percent move in the market. But the question is, "Who benefits from volatility and pullbacks?" Certainly not people who need that money in the short term, which is why we run balanced portfolios for clients who have short term monetary needs, but if you have a three, five years or longer time horizon, then volatility can be a big benefit because it gives you an opportunity to upgrade your portfolio.

So with that, I just want to say thank you very much for your ongoing trust and giving us the opportunity to work with you. Ensemble is growing and largely from client referrals, and we really appreciate the long term relationships we have forged with our clients. As I mentioned, this call does not replace client service calls and meetings so you are welcome to ask any questions you might have privately, but now I will hand the call back to the operator if you have any questions you might have. Thank you.