Conference Call Transcript: July 5, 2016

I am Ludo Thomasson, director of wealth management here at Ensemble Capital.

Thank you for joining us for our third quarter client conference call. They are scheduled on the third business day after each quarter end. They do not replace individual client service calls or meetings but are intended to supplement individual portfolio discussions with discussions about current topics we feel all of our clients will benefit from. As always, we encourage you to reach out to any member of our Ensemble team with questions about your personal financial situation at any time.

Today, we will focus our entire call about the current market and economic conditions following the news of Great Britain leaving the E.U. (Brexit) as well as a selection of our portfolio companies.

Here is Sean.

Good afternoon. Thanks so much for taking the time to join us today. Going forward, we've decided to focuses these calls on the economy, the market and our portfolio holdings and shift comments on wealth planning or client logistics to other venues. As always, these comments are general in nature and are not a replacement for the individual investment advice we provide during in person meetings and one-on-one phone calls.

Now let's get to the market, our portfolios and what's going on in the global economy:

After a volatile first quarter, which saw a sharp decline before a full reversal left the S&P 500 up slightly, the second quarter through June 23 was relatively uneventful. The market traded in a tight range as market participants observed continued resilience in the US economy and recession fears faded. By June 23, the market was up a little over 3% for the quarter.

Then, in the middle of the night on June 23, the British people voted to leave the European Union in a move that greatly surprised political experts and market participants. The next two days saw the UK stock market drop sharply with EU member markets falling even further. Bond yields plummeted with the US 10-year treasury yield falling from 1 ¾ to just 1 1/2, equaling it's all time low. This afternoon it traded down to just 1.37%.

In the wake of Brexit, the US stock market collapsed, falling as much as 6%. But, in an amazing demonstration of how unpredictable the stock market is in the short term, the market quickly turned around and recovered effectively all of the post-Brexit losses. For the quarter, the S&P 500 ended up returning 2.5% with the year to date return standing at 3.8%

Our equity accounts on average trailed the S&P 500 by a little over 1% in the quarter. Year to date our equity accounts are about flat, trailing the S&P 500's gain. Looking at the drivers of broader market performance, we note that the most defensive sectors have offered the best returns. For instance, the utilities sector (an area where we have no holdings), has returned over 23% year to date. Consumer staples, where we have limited exposure, have returned almost 10%.

Underpinning these aggressive moves higher is the sharply falling yield on bonds. In a world where investors are compensated less than one and a half percent to own government bonds, stocks that offer dividend yields of 3%, such as many utilities and consumer staples stocks, appear to be very attractive.

However, at Ensemble we believe that investors are falling into a relative value trap. While offering better current income than bonds, defensive stocks currently trade at record high valuations. No matter how safe of a businesses a company might be, if investors pay too much for the stocks of these safe businesses, they run the risk of severe future underperformance.

For instance, a hypothetical utility stock that offers a 3% dividend yield and is able to grow earnings by 3% a year will generate total return for investors of just 6%. This is far below the 8%-9% rate of return historically generated by utility stocks. For this hypothetical stock to offer 8%-9% returns, it would need a dividend yield of 5%-6%, a dividend yield very much in line with the historical norm for utilities. In order to sport this type of yield, our hypothetical stock would need to fall by 40 to 50%.

This seems dramatic of course, but you can run the same math on bonds. In order for the 10-year Treasury bond to start yielding 4%, a level that would have been considered on the low end of normal not too long ago, the price of those bonds would need to fall by about 25% from current levels.

When safe assets become very richly priced, investors will either be doomed to long periods of historically low returns or a sharp drop in prices followed by more normal levels of returns. Neither of these outcomes is acceptable to us and so we have avoided buying richly valued defensive stocks or longer term bonds, both of which we believe offer limited long term return potential and material risk of significant short term price declines.

Yet, so far this year, it is the very assets that we believe are dangerous that have produced the best returns. While we have underperformed so far this year, during periods such as April through mid-June, which saw interest rates moving sideways or higher, our equity portfolios generally outperformed.

In short, we believe that 2016 to date has seen historically safe assets go from being quite expensive to even more expensive. Far from causing us to want to chase these assets, the market behavior makes us even more concerned that investors in these assets are headed for a painful outcome. Therefore we will continue to invest our clients' money in assets that we believe are not dependent on a continuation of historically high valuation levels and instead are offered in the market at prices materially below their intrinsic value.

So now let's spend a little time talking about Brexit and what it might mean for the economy and financial markets. First let's start with a little context. The UK economy makes up less than 4% of global GDP and none of our portfolio companies have more than 10% of their revenue generated within the UK. So while dropping out of the European Union might be a severe headwind to near term economic growth within the UK, it shouldn't by itself present a major headwind to global growth.

However, the European Union is the largest economy in the world, larger than either the US or China. Questions about the long term sustainability of the EU have swirled over the project since its inception. The 2008 financial crisis laid bare the complications involved in having a shared currency without having a shared fiscal government.

In the US, we of course have a shared currency across states with fiscal power vested to a degree in each state government. We also however, have very significant fiscal power vested in the federal government. This balance has worked within the US and despite the fact that many states are net payers into the federal treasury while others receive net benefits, the governing union has been broadly stable.

Within the EU however, member nations have separate languages and cultures and fiscal power is tilted towards each member nation. Disagreement and resentment between member nations in terms of who should be responsible for various fiscal obligations runs high.

Economists who thought from the beginning that the EU would not succeed pointed to the idea that much greater fiscal union would be required to preserve the monetary union of the shared Euro currency. With the UK leaving, the risk that the EU as a sustainable long term economic framework collapses at some point has increased sharply. If the economic headwinds, level of uncertainty and disruption to trade agreements that the UK faces were to spread to the EU more broadly, it is difficult to imagine how the global economy could power through such a large discontinuity in the world's largest economic zone.

However, there is another alternative scenario that could play out. Issues with the EU are not new, but the conflicts that have been brewing have not been resolved. It could be that the shock departure of the UK causes the EU to come together and make the tough decisions needed to set the economic union on stronger footing. In fact, it may well be that the worse things play out for the UK, the more serious the EU becomes in making sure that no other member leaves and that the issues that have given rise to members wanting to leave are addressed directly.

So, in the short term the main impact on markets will be the potential for uncertainty and fear to depress stock prices. In the medium to long-term the potential impact is primarily about disarray in or even collapse of the European Union.

As we navigate the turmoil, we'll be looking for opportunities to exit more fully valued investments and put the proceeds to work in stocks that might become excessively undervalued due to near-term fear and uncertainty. But, we'll make those investments without any false optimism that the EU's issues can be wished away. We believe that both the UK and the EU have a very tough and uncertain future ahead of them.

But of course, at Ensemble Capital we focus our attention primarily on individual companies and attempt to assess their unique prospects. While headlines about Brexit can drive the market in the short term, in the long term it will be the corporate performance of the individual companies we own that will drive our performance.

Today, I'm going to talk about two companies in our portfolio, both of which we think have little exposure to the risks related to Brexit.

Landstar Systems is a trucking logistics company that we've owned on and off for the last five years and which we've been adding to in recent months. When you are driving down the freeway, you invariably pass many big rig trucks. These trucks are the primary way that goods are moved around the United States. The one form of competition is trains, which are economically more efficient when you want to move goods more than 800 miles. But trains of course only fill the long haul portion of movement with individual trucks needed to unload goods from trains and get them to their primary destination.

One fact about trucking that surprises most people is that only 10% of trucks are owned by trucking companies with the other 90% owned by individual drivers who own one or maybe a couple of rigs. So on the shipping capacity side, there is huge fragmentation and a large need for a way to centralize the process of allocating shipments to individual trucks. The shipper side is just as fragmented with even large shippers often managing their shipping at the individual warehouse or factory level.

Landstar Systems doesn't themselves own any trucks. Instead, they provide a marketplace of sorts where truckers, shippers and agents come together to source loads and offer capacity. Landstar gets about 15% of the revenue for each loan shipped via their system with the rest going to agents and truckers. Of the revenue they keep about half is pure profit with the rest going to run their business. Over time, their profit margin has been increasing as they run more and more shipments through their somewhat fixed cost infrastructure. We estimate that they book as profit almost 70% of each incremental dollar of net revenue they collect, meaning that their profit margins can continue to grow for a long time.

Like any value added middleman, Landstar needs to generate value for each side of the transaction in order for their business to be sustainable. For shippers large and small, Landstar provides a single point of contact and responsibility to ensure that loads get delivered. Attempting to contact individual truckers directly would be cost prohibitive for shippers and so Landstar provides value by aggregating the highly fragmented trucking industry to provide on demand shipping capacity.

For truckers, Landstar offers access to a huge volume of loads and crucially, the potential to keep their trucks full as they are driving around the country.

Being a trucker is generally not a great job. However, it is reasonably high paying, especially since it does not require a college degree. However, the higher than average pay is earned through long hours, the need to be away from home constantly and the negative health impact from sitting almost all of the time.

The key to being successful as a trucker and earning good money is to keep your truck full as much as possible. If you haul a load from California to Florida and then drive an empty truck up to New York to pick up your next load, you won't earn nearly as much money as if you are able to pick up a new load in Florida and bring it to New York on the way to pick up your next load. Landstar offers ambitious truckers the opportunity to keep their rig fully optimized and earn good money.

Over the last year or two, Landstar has seen a slowdown in revenue growth as the price truckers are able to charge per load has declined. While Landstar truckers haul very little energy related equipment, the huge fall off of activity in energy industries has brought a lot of truckers who were hauling drilling and fracking equipment into the market. This influx of supply has crimped pricing and with it Landstar's revenue. But looking out longer term, the supply of truckers is constrained with fewer and fewer young people entering the industry.

While Landstar isn't the most glamourous business in our portfolio, we think that it is a high quality company with a very lucrative business model that currently can be had relatively cheaply due to market worries about more economically sensitive stocks.

Another company in our portfolio of note is TransDigm. TransDigm makes parts for airplanes. Globally, the number of passenger miles (or the number of passengers times the number of miles they each fly) has grown very steadily at a rate of about 4%-6% per year for decades. In 2001 when 9/11 caused people to avoid flying, the impact lasted only a year before passenger miles bounced back to new all-time highs.

When planes are flown, they are required by regulation to replace parts on a set schedule. This is where TransDigm makes their money. For the large majority of the parts they sell, they are the sole provider and have proprietary designs for the part. The constant requirement for airlines to replace parts and TransDigm's position as the only supplier for the parts they make gives them wonderful pricing power and the company generates EBITDA margins of close to 50%.

In addition, airline part manufacturing is a very fragmented industry with a huge number of small companies that design a small set of parts. Over the years, TransDigm has acted like a private equity investor, buying up smaller parts makers, helping them to raise prices and bringing them into the TransDigm fold.

Finally, the company is highly focused on maximizing returns to equity holders. While they do not pay out a regular dividend, in recent years they have paid out large special dividends equal to 10% to 20% of market capitalization.

On the surface, TransDigm looks like a global industrial company that runs the risk of being hurt by an economic slowdown. But in fact, TransDigm provides products that need constant replacement, even during recessions. In 2009, despite the financial collapse they still saw revenue growth as airlines deferred buying new planes and had to spend extra on parts to keep their old planes in service.

Both Landstar and TransDigm are examples of companies where we think their future is largely controlled by their execution in their specific businesses rather than the future of the European Union. There's no doubt that in the short term, if disruption in Europe causes market turmoil that Landstar and TransDigm's stocks will be impacted. But over the longer term, we think the intrinsic values of these companies will keep growing and will provide attractive rates of return for investors.

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The turnout for our call today is about twice as large as we've ever had. No doubt, the headlines about Brexit has caused concern and rational investors want to know what it all means. Often times as financial advisors, we find ourselves in the position of talking to clients during market corrections and encouraging them to stick with the plan they set during less tumultuous times.

However, it is important to note that far from being in a correction, the US stock market is within a couple percentage points of its all time high. Given the volatility of the past couple weeks, we see opportunity to rotate within our holdings as Brexit fueled concerns are throwing some good investment opportunities out with the bath water.

For investors whose asset allocation might be too aggressively tilted towards stocks, we think there is an unusual opportunity to rebalance with equity prices still close to record highs. But for investors whose asset allocation is appropriate, we think the main opportunity is to review their portfolio to reduce fully valued holdings and redirect the proceeds into stocks that offer better long term value.

During this call we made reference to our portfolio holdings and performance. If you'd like a copy of our historical equity composite performance or our 13F holdings disclosures, please send an email request to info@ensemblecapital.com.

I look forward to speaking with you next time and thanks for listening.