Katherine Fischer:

Hello everyone, I am Katherine Fischer, a wealth manager here at Ensemble Capital. Thank you for joining us for our Winter 2019 conference call. Today, the focus will be on the recent performance of our portfolio, the current market and economic situation, and a discussion of two of our holdings, Charles Schwab & Company and Sensata Technologies.

Speaking today will be Sean Stannard-Stockton, chief investment officer of Ensemble Capital, and Arif Karim, senior investment analyst.

Sean Stannard-Stockton:

Hi everyone. I really appreciate you taking the time out of your busy lives to join our call today. It was a very volatile quarter so let's get right to it.

The performance of our equity portfolio this quarter was quite weak both due to the overall equity market decline and our strategy underperforming. While the final calculation of our equity composite will not be available until later this month, our current estimate is that our equity portfolio composite was down 15.57% vs the S&P 500 down 13.52%. Due to our strong performance in the first nine months of the year, our full year performance was essentially in line with the overall market with our strategy down 4.87% vs the S&P 500 down 4.39%.

The decline in our equity strategy during the quarter was driven by 25%+ declines in Trupanion, Netflix and Ferrari. On the more positive side Starbucks was up 14% while Oracle, Sensata Technologies, Verisk Analytics, First Republic Bank and Paychex declined by about 10%.

With all of our holdings except for Starbucks declining during the quarter, despite these company's serving a wide variety of customers and geographies, it is clear that a broad-based shift in market expectations has been the primary driver of performance, which I'll speak to in a moment.

The gain in Starbucks was a continuation of outperformance for this stock as the company showed progress towards reaccelerating the business and laid out at their Investor Day what we believe is a very credible long-term business plan. After a period of time earlier in the year when the stock was quite cheap, and we acquired our position, the 40%+ rally from the lows of the summer to the end of year highs brought the stock much closer to our assessment of fair value. Combined with the steep sell off in many other stocks creating what we believe are superior investment opportunities, we reduced our position in Starbucks to reinvest elsewhere. We believe the company offers a unique combination of dependable results and solid growth. While many other defensive stocks have been valued at levels we view as too expensive in recent years, the brief growth scare this past summer opened up an opportunity in Starbucks, although that opportunity was relatively short lived with the stock sharply outperforming the broader market and the consumer discretionary sector over a very short time period.

The outperformance of Oracle's stock that we noted last quarter continued into the end of the year. On our last call we noted that despite weak revenue growth, cash flow is growing nicely as they transition their client base to software as a service-based offerings. The company's prodigious cash flow has allowed them to buy back $20 billion worth of their stock in the last two quarters or approximately 11% of the entire company. While many investors see Oracle as a mature tech company that is being left behind by the Amazons and Googles of the world, we see a cash flow machine that we expect to continue producing buckets of cash for a very long time. We would note that it was only a few years ago that most investors had relegated Microsoft to the dustbin of uninteresting, mature tech companies, only to have the stock double over the last three years and become the most valuable stock in the world surpassing Amazon and Apple. We would also note that we're not the only investors who are positive on Oracle with Warren Buffett's Berkshire Hathaway establishing a position in the company during the third quarter.

The selling in both Trupanion and Netflix that we highlighted last quarter continued, with Netflix declining despite reporting very strong third quarter results and Trupanion's results exceeding analyst expectations. We believe Netflix's stock declined primarily due to the general "risk off" market environment. While many investors believe that the stock is too expensive, even after the recent decline, in October we wrote on the Intrinsic Investing blog about how the company is intentionally keeping their subscription price well below what customers are willing to pay. If you assume, as we do, that the company could reasonably charge between $15-$20 a month for their service vs the $10 they charge today, earnings would explode higher. Assuming this higher level of pricing and the current subscriber count, the stock ended the year trading at just 12 times earnings even while it continues to grow its subscriber count at 25% a year. Now certainly we don't think Netflix could reasonably raise their pricing to this higher level over night, but we also think it would be foolish to think that the service, which won more Emmy's this year for its own original programing than any other media company, is only worth $10 a month.

Ferrari was another stock experiencing significant weakness in the quarter. After attending the company's analyst day in Italy back in September, our enthusiasm for the company is unabated. We believe the stock's relative weakness this quarter has been due to first, the fact that it is an Italian company with a primary stock listing in Italy while market concerns that Italy may eventually exit the European Union have increased, and that it is a European car company at a time when the US is threatening to levy additional tariffs on cars imported from Europe. However, despite being headquartered in Italy, Ferrari's customers are global and while an Italian economic crisis could cause some short-term challenges for the company, we do not think it is a long-term risk to the success of their business. On tariffs, we are certain that the ultra-high net worth customers of Ferrari are not going to suddenly feel like they can't afford a new one if tariffs are raised. While an increased tariff on a Volkswagen might cause a US customer to buy a Ford instead, there are essentially no substitutes for a Ferrari and we do not think new tariffs are a material risk.

While that covers some of the company specific activity and news flow in our portfolio this quarter, the real story was the significant repricing of the overall market over the last three months that appears to us to now assume a US recession in 2019 is almost a sure thing. This is a sharp reversal from the increasingly optimistic economic outlook the market embraced over the course of the first three quarters of the year. At this point, the S&P 500 is trading at just 15 times current earnings, the cheapest level since 2013. We believe any economic optimism about continued growth let alone a continued acceleration of growth has now completely been removed from investors' expectations. Given persistent investor concerns that the stock market is overvalued, it is worth noting that 15 times earnings is as cheap as the US stock market has ever been during the past 30 years other than very brief periods at the depths of the financial crisis and the very beginning of the massive bull run of the 1990s.

It is important to note that almost all of the worries about a recession in the US are due to forecasts about the future, not a slowdown that is currently showing up in economic reports. The fact is that third quarter GDP growth was in excess of 5%, the fastest growth we've seen during the recovery from the Financial Crisis. Employment numbers, which are reported monthly, remained strong in every month of the fourth quarter, with the unemployment rate remaining near a 50-year low. Unemployment claims, which are reported weekly, saw a brief surge higher in November, but quickly fell back to the lowest levels seen in 50 years. Since the workforce is much larger today than it was 50 years ago, the percentage of workers filing for unemployment benefits remains at the lowest level on record.

The positive economic indicators are not just government statistics. Here is a collection of comments from the management teams of our portfolio holdings.

At the end of October, Mastercard's CEO said "On the macro, honestly, in our numbers, nothing is showing up that should give me reason to be cautious. If you look at our data that we've shown you till October 21st, you'll find that consumer spending remains kind of robust or even a little better in some cases."

At the end of November, Fastenal, which sells a wide range of basic supplies to manufacturing and industrial companies, reported that sales in the month were more than 12% above last year's level, a continuation of the same trend they have seen all year.

And then near the end of the year, Paychex, which is the leading payroll processor for small businesses, said "If you look at the vectors in our business, they're pointing up; not down. They're not pointing neutral; they're pointing up. And so when we look at the wealth of data that we have on everything from clients who go out of business to sales to new clients, it looks positive to us. So now we're in a situation where things can change rapidly but nothing that we're seeing says there are clouds on the horizon."

The fact is there are very few reliable indictors of pending recessions. The stock market has a long history of over estimating how frequently recessions will occur, with Nobel prize winning economist Paul Samuelson once joking that "the stock market has forecast nine of the last five recessions." Of course, the market's easy retort is that economists' recession forecasting record is even worse.

Two recession indicators that have historically been relatively useful signals are inversions of the yield curve and rising unemployment rates. In the past, when the unemployment rate has risen markedly for a period of six months or so, a recession has generally followed. However, the unemployment rate as mentioned earlier is sitting near 50 year lows.

A yield curve inversion occurs when short term interest rates rise to levels above longer-term rates. Historically, yield curve inversions have preceded a recession, although this hasn't always been true outside of the US. While the reason a rising unemployment rate signals problems for the economy is straightforward, an inversion of the yield curve is a negative because it implies that the bond market is predicting that the Federal Reserve will start cutting short term interest rates in the near future, which is something they would do in the face of a weakening economy. While there is some debate about which two points on the yield curve matter most, the best studies point to the difference between the Fed Funds rate and 10-year treasury bond yields and/or three month and 18 month treasury yields. Both of these curves are still positive, ie not inverted. So while they've moved closer to triggering a recession warning, they simply aren't there yet and the current difference between the short and long end of those curves is the same level we've seen during robust economies in the past.

One recession signal that is flashing warning signs is the fact that home sales have started to decline in the US. While home prices are still rising, the number of homes trading hands has fallen by a couple percentage vs 2017. Given the freshness of the housing led financial crisis in investors minds, this warning signal is catching people's attention. However, while a minor decline in home sales is a negative for the economy, it is nowhere close to a fool proof recession warning, with homes sale declines in both 2014 and 1995 being followed by robust economic growth and very, very strong stock market returns.

Declines of the magnitude seen in the fourth quarter do have a history of happening without a recession subsequently occurring. In fact, something similar happened as recently as early 2015. These declines have led to outstanding buying opportunities. However, sometimes recessions do occur and while we are optimistic that the US will not experience a recession in 2019, we're well aware of our own limited ability to accurately forecast economic trends and we do agree that there is somewhat heightened risk that one does occur.

There have been six recessions over the past 50 years. On average the stock market has declined by a little more than 30% during those recession. However, they've come in two flavors. The three mild recessions have seen the market decline by an average of 17%, while the two severe recessions and the recession that occurred in the wake of the Dot Com bubble bursting, saw the market decline an average of almost 50%.

So just as a generally framing of the risk-reward that investors are facing today in US stocks, it seems there are three general possibilities.

1. If no recession occurs: The stock market generates very strong returns over the course of the next couple of years.
2. If a mild recession occurs: With the stock market already selling off by the magnitude that would typically be associated with this outcome, there may be limited downside even if things play out this way.
3. If a severe recession occurs: In this event, there may be considerably more downside for US equity investors.

With a sample size of just six recessions, we offer this framework as only a loose guide to what history can tell us about the future. As Mark Twain famously said, "History doesn't repeat itself, but it often rhymes." While skittish investors may understandably worry about the severe recession scenario, it is important to understand that because recessions are not predictable, there is an ever-present risk of these sort of 50% declines. Any equity investor who desires to earn the 10% or so stock market returns that have been generated over the last 50 years, needs to be fully cognizant that these returns were realized along with some very sharp declines along the way. It is for this reason that money invested in the stock market must be invested for the long term, as there is a low, but real risk, in any given year that market prices will decline significantly. While it makes sense that investors tend to focus on this risk after the market has already experienced a material decline like the one seen in the fourth quarter, in fact this risk is always on the table.

Of course, it would be reasonable to worry that a recession is not the real risk, but instead the risk to the market has to do with the trade war with China, Federal Reserve policy or US political risks. However, since World War II, there have only been two market declines of over 20% that occurred outside of a recessionary period. One was the technical crash of 1987 and the other was the Cuban Missile Crisis. So while it certainly isn't impossible for the market to break down to new lows of over 20% off the late September high, most all crises that result in significant bear markets are related to recessions. And of course, both the 1987 crash and the Cuban Missile Crisis saw rapid stock market appreciation subsequent to these scares that did not result in a recession.

Now I'd like to turn the call over to Arif, who will be talking about why we are long Charles Schwab & Company and in particular why we think changes to their business model in recent years have made their business less sensitive to economic and stock market declines than it was in the more distant past.

Arif Karim:

Thanks Sean.

We've owned Schwab for many years. It's the company that most of us know from their "Talk to Chuck" advertisements for online brokerage services. Schwab's core value proposition is about helping its customers intelligently and efficiently invest their own money (or their clients' money in the case of independent RIAs, like ourselves at Ensemble Capital, who utilize its platform).

Since its founding around the time of trade commissions deregulation as a little discount broker in the 1970's, Schwab has greatly increased its scope, scale, competitive advantages, and service capabilities for customers much beyond online trading.

As a persistent disruptor, Schwab has continued to focus on providing increasingly higher value services while leveraging ongoing waves of technology to lower the cost of delivery of those services and sharing those savings in the form of lower prices to customers. These two elements are a core part of Schwab's culture.

These are embodied in Schwab's simple and powerful mantras, working to serve the customer "Through the Client's Eyes" and offering a "No Tradeoffs" choice, emphasizing the company's culture of putting its clients' goals, experience, and welfare first while meeting all of its clients' needs with both great service and low prices. Unsaid is the focus on operational efficiency that is an important part of Schwab's competitive advantage because it allows the company to offer low prices and higher value to customers, which wins them over and retains them, while also delivering attractive returns to shareholders.

As a result, Schwab has grown to become one of the largest asset managers in the US with $3.4T in asset under management (or AUM).

As the company has scaled, its ability to leverage technology has led it to become more efficient and offer lower prices while delivering more services at higher quality, leading to more customer wins – what's typically referred to as a "virtuous cycle". Schwab's culture has led it to earn among the highest customer satisfaction ratings in the industry.

As we mentioned, Schwab has moved up the value chain in the financial services industry as it's played a leading role in disrupting lower value parts of the chain. This has enabled it to grow its market opportunity, service capabilities, and profitability. It has done this by increasing its scope and scale over time, growing its addressable market both vertically and horizontally.

For example, in 1997, about half of Schwab's $2.3B revenue was driven by trading commissions while asset management services were less than 20% resulting in an operating margin of 19.5%.

A decade later in 2007 revenue had more than doubled to $5B, while those ratios had reversed, with asset management accounting for half of revenue and operating margins stood at 37%.

For 2018, Schwab is on track to have doubled revenue again to $10B and operating margin approaching 45% driven by the growth of Schwab Bank, which now accounts for more than half of revenue while the original trading commissions business now accounts for less than 8% of revenue.

To illustrate its evolution over time, between 1997 and 2007, right when customers were coming online through Internet adoption, the now online discount broker Schwab won many of these over with its simplicity and trust oriented messaging highlighting Chuck Schwab emphasizing low commission rates, but not the cheapest, because it offered a certain service quality too.

It moved vertically up the value chain from the lower value, transactional trading commissions business into the asset management fee business by building out its Mutual Fund OneSource platform. OneSource allowed customers to buy and sell mutual funds commission-free and conveniently while charging the funds who wanted access to the millions of customers on its platform with a healthy share of their management fees. In addition, Schwab launched its own competitive funds, which third party OneSource funds competed alongside, demonstrating the power of Schwab's growing scale.

It was a win-win-win formula – Customers won because they received greater choice, convenience, and lower costs; Schwab won regardless of customers choosing its own funds or third-party funds so long as customers' assets stayed on its platform; and the third parties won because they got access to a large customer base at reasonable enough terms.

In addition, Schwab expanded horizontally across the value chain by leveraging all of its capabilities and scale built for individual retail customers to create a turnkey backend platform for independent financial advisors, empowering them to more easily leave traditional wirehouse brokerage firms and become independent business owners themselves. This allowed Schwab to add even more momentum to growing its asset scale and operating efficiency that made it a more formidable competitor in winning over retail assets and RIAs over time.

Schwab has continued adding more services since, growing its capabilities at scale, and leading disruption in the latest round featuring fund fee commoditization through mass ETF adoption but also a growing need for basic financial advisory services for the young and "mass-affluent". Instead of fighting the recent wave of VC funded "roboadvisors", Schwab has embraced the technology and very quickly become the leader in delivering financial advice to the broader, less wealthy base of customers who may have not had access in the past because of higher minimums or didn't need the "high-touch" ongoing personal service.

By adopting such financial innovations and cannibalizing its own historical revenue in favor of higher value services to best serve customers, Schwab has accelerated its customer win rate with new net new asset growth of 14% or $400B over its base of 2.8T at the end of 2016.

Furthermore, Schwab has pressed its scale and efficiency advantage by proactively driving fees lower on the AUM businesses like ETFs, Mutual Funds, and Advisory Services, and the trading commissions business, all of which have lowered explicit costs for clients, delivering to them tremendous value, and driving market share gains against the competition.

Concurrently, Schwab has delivered tremendous value for shareholders too by leveraging its "secret weapon" of a business, Schwab Bank. As mentioned, Schwab Bank has become a huge driver of value over the past decade growing to over half of total revenue and continues to hold great promise for future value creation.

In essence, Schwab, the brokerage and advisory company, is able to offer clients great service and great prices on its explicit cost AUM and brokerage services that clients are price sensitive about and winning them over as customers. It then makes its money on the implicit opportunity cost clients bear in the form of uninvested tactical cash balances that are automatically swept into the Bank to drive incremental profit margins and shareholder returns. While the AUM business charges a fee based on the amount of assets managed, the Bank makes a spread of about 200bps between the interest rate it pays on deposits and what it earns investing that client cash in generally safe government and corporate securities. As a result, though assets in the Bank amount to 10-15% of total assets under management, they earn 20x as much as the AUM business on a per customer dollar basis with low incremental cost. The result of this fantastically complementary business are happy customers and happy shareholders.

Recently however, the stock has come under pressure because of declining expectations for future Fed rate increases due to worries about an economic slowdown that Sean talked about. These worries in the market have driven interest rate curves to flatten, potentially threatening spreads at all banks. Rising fed funds and increasing spreads are positive inputs into Schwab Bank's net interest revenue but so are higher cash balances which have historically come from higher equity market volatility accompanying the lower growth expectations, as we've recently experienced. Evidence of this is that cash balances have begun to rise at Schwab after about 18 months of decline amidst a strong equity market. A significant reduction in interest rates in the future would probably be accompanied by a significant increase in cash balances as historic data has shown, thereby cushioning the Bank's interest income.

The shift in the business' revenue composition and profitability towards the more stable Bank, means that the company has a whole is a lot less cyclical than it used to be in previous cycles when the AUM business's revenue would be impacted by large market drawdowns. As a result, we believe the market is misjudging the intrinsic stability in the value of Schwab's overall business regardless of economic conditions over the next few years, which makes Schwab a compelling investment for us today.

Back to you Sean.

Sean Stannard-Stockton:

Next up I want to talk about our investment in Sensata Technologies. Barron's, the Wall Street Journal's weekly magazine, published an article profiling Ensemble's investment in Sensata back in late October. You can find a link to the article on our website and I thought I'd offer additional color on the call today.

Sensata Technologies provides sensors to essentially all of the world's automakers to make cars safer, more fuel-efficient, and less damaging to the environment. While global auto sales will likely grow at just a low single-digit rate over the long term, the amount of sensor content per car is growing at a mid-to-high single digit rate and we expect this to continue for a long time.

These sensors are key components of mission critical automotive systems like electronic stability control, tire pressure monitoring for safety, cylinder deactivation to improve fuel efficiency once a car hits cruising speed on the freeway, and selective catalytic reduction systems which reduce emissions and which Volkswagen announced they would be using after they were caught cheating on emission tests.

These sensors are found in gas, diesel, hybrid and electric vehicles in the US, Europe and Asia. Sensata engineers literally work on site with the major automakers to design new cars, ensuring that Sensata sensors are designed in from the very beginning. The only automaker that does not do much work with Sensata is Toyota, which controls its own captive sensor making company called Denso. However, in recent years, Toyota has started to turn to Sensata to make parts that Denso finds too difficult to produce at acceptable quality levels.

While any forecast about the future is subject to uncertainty, the ongoing increase of sensor content per vehicle is a very safe bet in our view. It is simple to observe that high end cars have a lot more sensor content than the average car and that there is a long history of the systems and features found in high end cars making their way into every day cars over time. This trend is particularly notable in China, where a quarter of the world's cars are sold. Over the past few years, sensor content per car in China has more than doubled, yet it would need to double twice more before it reached the level of sensor content in the average American car.

At Ensemble, we believe that the shift towards electric cars will occur more rapidly than most people expect. While it used to be that buyers of EVs primarily did so as a form of social responsibility, we believe that over the next decade the cost of buying, fueling and maintaining electric cars will fall below the same costs of a gas powered car, leading to self interested buyers simply looking for cheaper transportation to choose electric vehicles. Sensata's management feels similarly. Having focused on expanding their sensors for EVs for a couple years now, their recent acquisition of a company called GIGAVAC that sells sensors used in Teslas has now pushed Sensata content per electric vehicle to levels above those seen in gas powered cars. This means that should a shift towards EVs play out, it would be a tailwind to Sensata's results.

So then why is the stock so cheap? It is currently trading at just 12 times its expected earnings for 2018 despite the company reporting accelerating growth in the third quarter and raising their guidance for the year. Given this is a stock that has historically traded at PE ratios in the high teens, we know that the market is effectively assuming that we are on the verge of seeing a large decline in auto sales, which implicitly assumes a recession is coming. This view is at odds with what Sensata's management thinks, who said at the end of October that they see no indications that a large decline in global auto sales will occur any time soon.

But it is absolutely true that auto sales in China have indeed been declining since July. In the US and Europe, which collectively make up about two thirds of the global auto market, growth and declines in auto sales is relatively modest outside of recessions and post recession recoveries. But auto sales in China are very volatile. In fact, during the past five years, China's auto sales in any given month have declined from the previous year in 25% of all months, even while auto sales grew by 35% over the full five years.

In the US and Europe, auto sales are near the same normalized level they've been for the last couple decades, excluding periods of recession. We don't expect auto sales in these developed market to grow even over the long term. But while Chinese auto sales are volatile, car ownership per capita in China is way below that of developed markets and we think it is a near impossibility that car sales won't grow in China over the medium to long term.

Sensata's stock selling off due to worries about China and broader US stock market is nothing new. We wrote about Sensata on the Intrinsic Investing blog almost three years ago. At the time we reflected on the steep selloff that had occurred in early 2015. We wrote "The decline was fueled by early indications of turmoil in the Chinese economy and declines in the broader stock market." This is of course exactly what is happening now. From its lows in early 2015, the stock came close to doubling through this past summer. Now a similar set of worries has cropped up setting up what we believe is another very attractive investment opportunity.

In closing, I'd like to share a quote from Leon Cooperman, an investor who has produced outstanding returns over many, many years. "Everyone I know that has accumulated wealth, whether it's Warren Buffett, Ken Langone, Mario Gabelli, made their fortunes out of buying weakness and selling strength… You buy weakness and you sell strength. That's the way to make money in the market."

This sounds so simple and so obviously true. And it is. Cooperman is exactly right. But what Cooperman doesn't highlight is how emotionally difficult this otherwise simple process is. It is indeed the process that almost all great investors actually follow, but the fact is that at moments of weakness there are always very legitimate reasons to want to sell just as during moments of strength it always seems like the good times will go on forever.

Thank you all for joining our call today. During this call, we referred to the portfolio holdings of Ensemble Capital Management. If you would like to request a copy of Ensemble Capital's historical equity composite performance or our 13F holdings disclosure, please send an email request to info@ensemblecapital.com.

Thanks for listening. I look forward to speaking with you on our next call.

As of the date of the conference call, clients invested in Ensemble Capital Management's core equity strategy own shares of Alphabet (GOOGL), Charles Schwab & Company Inc (SCHW), Fastenal Company (FAST), Ferrari (RACE), First Republic Bank (FRC), Mastercard (MA), Netflix (NFLX), Oracle (ORCL), Paychex (PAYX), Trupanion (TRUP), Starbucks (SBUX), Sensata Technologies (ST) and Verisk (VRSK). These companies represent only a percentage of the full strategy. As a result of client-specific circumstances, individual clients may hold positions that are not part of Ensemble Capital's core equity strategy. Ensemble is a fully discretionary advisor 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.

Each quarter we file a 13F report of holdings, which discloses all of our reportable client holdings. Please refer to our current 13F filing or contact us at info@ensemblecapital.com for a current or past copy of such filing.

INVESTMENT RISKS

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. 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.