



Katherine Fischer:

Hello everyone, I am Katherine Fischer, a wealth manager here at Ensemble Capital. Thank you for joining us for our Summer 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, Fastenal and Starbucks.

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

Sean Stannard-Stockton:

Well it certainly has been an exciting first half of the year. It is amazing to think that just two quarter ago our call focused on why we thought the market was already discounting a mild recession and it made sense for investors to stay long US equities. I appreciate your interest in hearing from us in good times and bad.

The performance of our equity portfolio this quarter was strong, showing the continued absolute and relative performance trends that we saw last quarter. 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 up 6.19% vs the S&P 500 up 4.30%. On a year to date basis, this bring our equity portfolio composite to up 23.59% vs the S&P 500 up 18.54%.

The strength in our equity strategy during the quarter was driven by big moves from two of our largest positions with Broadridge up 24% and Ferrari up 22%. We also saw double digit gains from Starbucks, Mastercard, Trupanion and Verisk. On the weaker side, Charles Schwab & Co and First Republic both declined as interest rates fell and Google (also known as Alphabet) fell 8% as news broke that the company would be investigated by the department of justice on antitrust grounds.

Like most investors, we've spent a lot of time this year thinking about the ways in which a recession, and/or a heating up of the US-China trade war, might impact the economy and the companies in our portfolio. However, at the same time we've advocated the idea that when it comes to recessions, the best approach is to invest in strong companies that will thrive coming out the other side of recessions rather than trying to guess when a recession is on the horizon and attempt to get out of weaker companies just in time. On the trade war, as much as we think what happens is quite important, we also think that a US-China trade war will likely be a key feature of the investment landscape for the next decade or more. So rather than trying to guess what short term changes might occur, we're more focused on making sure we own companies that can navigate a shifting set of trade rules over the medium to long term.

But for all the focus on the trade war, when you look at the stocks that most influenced our performance, the trade war was not a material driver.

Broadridge, a service provider to banks and brokers, rallied 24% in the quarter as the company reported their third fiscal quarter and continued delivering the message that the quarterly misses of expectations that had



occurred earlier in the year were due to timing issues, while their full year results continue to be on track. The stock has performed about in line with the market over the last nine months. But after hitting an all time high last September, the stock sharply underperformed in the fourth quarter, dropping as much as 30% as investors got caught up in the optically weak quarterly reports. But as 2019 has worn on, it has become clear that the difficulties in quarterly results last year was entirely transient and was not at all an indication of a slowdown in the core business. This realization has led to the stock rallying 40% this year. While market overreactions to transitory issues are not always this dramatic and don't always reverse so quickly, the decline and rebound due to the short time horizon of most investors offered us a great opportunity to add more shares during the weakness and then trim back positions after the huge, quick gains. While we are long term investors, we are also willing to opportunistically add to or trim our positions when market pricing swings as dramatically as it did recently with Broadridge.

Ferrari tacked on another 22% in gains after posting a 35% return in the first quarter. With the stock now up 64% this year Ferrari has been a big driver of our performance. But like Broadridge, part of these gains are a recovery of what we thought was an undeserved selloff in the fourth quarter of last year. In our view, the four quarter sell off was due to market worries about a recession and auto tariffs. But both of these concerns are misplaced. Ferrari is actually the most recession resistant of all car companies. This is because of the 18-month wait list to buy a Ferrari and the fact that people who have enough money to buy a Ferrari almost always still have enough money during a recession. And while Ferrari could be subject to auto tariffs, their buyers are not very price sensitive. We saw this dynamic at play last year when the company announced their Monza supercar would be sold at a price of "somewhere between \$2 million and \$3 million" and then promptly sold out before they ever revealed the final price. This dynamic of companies with strong pricing power having a weapon to offset the impact of tariffs is an important part of how we think investors should seek to insulate their portfolio from the very real risk of a prolonged US-China trade war.

The strong returns from Starbucks, Mastercard, Trupanion and Verisk were all related to the companies continuing to generate solid results. For many of our portfolio holdings, it isn't so much that we think they will generate surprisingly strong results relative to short term expectations. Instead, it is far more common that we simply think that our portfolio holdings have such strong competitive advantages that they will resiliently bounce back from short term challenges and can continue to churn out solid results for far longer than the market gives them credit for. That's why we are often most pleased by under the radar performers in our portfolio that may not always be sexy and exciting, but which grind out results to be proud of for decades at a time. In just a bit, Todd will tell you about Fastenal, a company that fits this description very well.

On the weaker side, we saw both First Republic and Charles Schwab & Co decline due to interest rates falling. Both companies generate a significant part of their earnings from their "net interest margin" or the spread between the rates they pay their clients for depositing cash with them vs the higher rate they earn from lending that money back out. Over the last quarter, not only have interest rates declined, but the yield curve has flattened or even inverted, meaning that there is little or even a negative spread between very short term interest rates and longer term rates. At Ensemble, we are of the view that over the medium to long



term, the interest rate yield curve will be steeper, as it has typically been in the past, and that interest rates across the board will be higher. We recognize that we could be wrong about this. Interest rates are not easy to forecast. However, one reason to only buy stocks when they appear cheap is because that cheapness can help offset weaker than expected financial performance.

In the case of First Republic, the company has long managed their interest rate risk in such a way as to make their net interest margin very stable, even during period of large changes in interest rate levels. They give up the opportunity to generate outsize returns during periods of attractive interest rates regimes, but they also protect themselves against tough environments like we see today. Charles Schwab & Co sees more volatility in their net interest margin, but the company has also proven themselves adept at figuring out multiple, alternative ways to monetize their customer relationships over the years. With both First Republic and Schwab winning tons of new customers in recent years, we know they are delivering on their value proposition. We believe that in both cases, the companies will generate significantly higher earnings in the future than they do today. But even if we are too optimistic in our interest rate outlook, we think both stocks are cheap enough today to perform just fine.

The decline of Google's share price in the quarter was due to news that the department of justice is investigating whether to launch an investigation of the company on anti-trust grounds. It isn't just Google being targeted, the DOJ has said they are considering investigations of Google and Apple, while the Federal Trade Commission is considering investigations of Facebook and Amazon. It is important to note that no suits have been filed and no investigations have been launched. Instead the agencies are investigating whether to launch formal investigations.

On the surface, this certainly seems like bad news. However, we would note that the last similar antitrust investigation was of Microsoft and today they are the most valuable company in the world. That doesn't mean an anti-trust investigation is irrelevant, but it is important to note that even if the DOJ were to launch a formal investigation, and file charges and win in court, that still doesn't mean Google's stock price will perform poorly or that their business will suffer.

From our perspective as investors, our primary focus is on whether Google's profits are a function of illegal or anti-competitive behavior and if so, how any remedy to stop these behaviors would change future profits. So I'll say at the outset, that we believe unequivocally that the vast majority of Google's profits are a function of the company offering one of the single most important services ever invented. A service that brings information to the 7 billion internet connected devices around the world to people of every walk of life. As an American working in an office job, I simply cannot imagine navigating personal and works tasks without Google. And democratizing access to information across national boundaries has hugely positive social benefits. In fact, a hundred years ago the primary focus of philanthropists was to build libraries for just this reason. Viewed in this light, Google's opening up of the collective knowledge of humanity to anyone with an internet connected device at no cost to the user can easily be seen as one of the most important social benefits ever created by any nonprofit or for-profit organization.



That being said, might there be changes to some of Google's practices if they are subject to an in-depth investigation? Sure. But we do not think that these changes, should they happen, will strike at the core value that Google provides to the world and it is this value, not any particular business practice of their advertising offering, that is the root cause of the company's profit stream.

I will also say that at Ensemble Capital, we do agree that it is well past time for antitrust regulators globally to create a more modern approach to monopoly analysis. There is nothing inconsistent between being a supporter of free markets and a supporter of robust antitrust enforcement. Antitrust enforcement done right is designed to preserve free market competition and prevent companies from curtailing free market forces.

Two antitrust remedies that we think might be legitimate outcomes of these investigations is a more robust understanding of when the government can and should block acquisitions. Today, that analysis is primarily a function of the market share, based on revenue, of the two companies in question. But when companies sell intangible assets with little to no incremental cost of production, it often makes sense for them to defer building revenue and instead focus on user acquisition. Viewed in this light, both Facebook's acquisition of Instagram and Google's acquisition of Waze (at the time, the only meaningful competitor to Google Maps) may well should have been blocked. It is plausible that these investigations will lead to the retroactive blocking of the acquisitions of Waze and Instagram. In the case of Google and Waze, we do not think this outcome would have a material impact on the value of Google. But in the case of Facebook, a company we do not own in our portfolio, we think a retroactive blocking of the Instagram merger would trigger an existential crisis at the company.

Now before I wrap up, I'd like to acknowledge that many of the questions we have been receiving from our clients have been about the risks of a recession and the US-China trade war. For those interested in learning more about our views on this subject, I would point you to the blog post we wrote in May titled [Trade Wars & Recessions: Investing Under Conditions of Uncertainty](#).

Now I'd like to turn the call over to Todd, who will be discussing Fastenal, one of the newer holdings in our portfolio.

Todd Wenning:

Thanks Sean.

Fastenal is a company that most people have never heard of, yet it touches nearly everything we see around us.

Fastenal specializes in the curation, management, and logistics of moving billions of low value parts like nuts, bolts, screws, rivets (collectively known as fasteners) and other products from their point of origin around the world to their destination at or near the factory floor in a timely and cost-effective manner.

Fastenal's customers are manufacturers of end products we use every day, like cars, airplanes, furniture, appliances, electronics and so on.



While each of the parts Fastenal moves is low value, their role is essential in the manufacturing of high value products and the health of the manufacturers' operations. Delays in their supplies or having the wrong type of fastener in inventory can mean millions of dollars in costs for the manufacturers in the form of slowdowns, shutdowns, or poor product quality, safety, and recalls.

Fastenal's business is focused on making sure its customers have the right parts at the right time in the right place. If you're missing one type of screw on a \$10K or \$100MM machine, you're not shipping the product out today. At the same time having too many parts laying around can be costly and wasteful. Fastenal's role is to provide the mission-critical but low value products efficiently and reliably to their customers' factories.

Fastenal's services therefore cater to customers who value its ability to deliver both reliably and cost effectively because it aggregates the demand of its customers to extract higher volume discounts from suppliers. As a result, customers see compounded savings across their procurement chain.

In many cases, Fastenal is so deeply tied into customers' operations that it manages the real-time stock of inventory for their plants and takes on the burden of inventory costs on their behalf, helping them not only run their plants smoothly but also in managing their working capital more efficiently.

Over time, Fastenal has also expanded on the types of materials it provides on the factory floor beyond fasteners to include things like safety goggles, tools, metal suppliers, janitorial supplies, and other consumables that have similar distribution benefits and leverage Fastenal's expertise and infrastructure. And in fact, these other materials now account for most of its revenue with traditional fasteners accounting for less than 40%.

In return customers have rewarded Fastenal with a healthy premium above the cost of supplied parts, which is what's driven the 20% return on invested capital that's underpinned the stock's return over time. Since it went public in 1987, Fastenal's stock has returned a compounded 23% per year.

While most people have never heard of the company, Wall Street certainly has. In 2012, BusinessWeek ran a story highlighting the fact that in the prior 25 years since the crash of 1987, Fastenal had appreciated by 38,600% making it the best performing stock during that time period. But it wasn't just great fundamental performance that had driven the returns, there was also the fact that in 2012 the stock was trading near its all time high valuation, with a PE ratio of 37.

We took note of the company at that time but passed due to the valuation. Since then, the company has continued to execute very well, doubling earnings. However, from the time of the BusinessWeek article to our first purchases of the stock last summer, the stock only returned 40% (or 5% per year) while the S&P 500 returned 140% (or 15% per year). With rising earnings and a lagging stock price, we ended up being able to buy the stock last year at one of its lowest ever valuations, setting up what we hope will be a return to strong outperformance.



Fastenal's growth is heavily tied to North American manufacturing growth, where its customers predominantly operate. It also grows by increasing its share of spend penetration by winning over more customer plants and selling adjacent consumables for the factory or its workers to keep the plants running smoothly. This also further entrenches Fastenal with its national accounts by getting even deeper into customers' operations with tens of thousands of vending machines it directly manages in factories and hundreds of dedicated on-site stores within them. All of these bring Fastenal closer to its customers and deepens and expands its relationships, making Fastenal hard to displace.

Over the past decade, Fastenal has grown revenue by about 9% per year, with several points of that growth coming from market share gains. With only \$5B in revenue in 2018, Fastenal still has a long growth runway available to continue increasing its share of a very fragmented market, estimated to be about \$140B in the US alone.

Back to you, Sean.

Sean Stannard-Stockton:

Thanks Todd.

While manufactures depend on Fastenal for inputs that power everything they do, the same might be said for the role that coffee plays in many people's lives. Speaking for myself at least, without my regular dose of daily caffeine, the rest of my day pretty much grinds to a halt. Luckily for me and the rest of humanity responsible for consuming 400 billion cups of coffee every year, while caffeine is addictive, studies have continuously found it has very limited negative health implications with more and more studies pointing to its role in making people happy, healthy and productive.

It is for this reason that when we added Starbucks to our portfolio last year, we joked that the company was like Philip Morris and McDonalds rolled together but with the negative health implications removed. In our view, Starbucks is the premier global supplier of a key aspect of the human diet. Like all addictive substances, consumers of caffeine wrap their habit in a set of rituals. It is these rituals that provide an opportunity for Starbucks to cater to their customers desires in a way that is highly profitable.

The ritual of coffee consumption is important to Starbucks core customers. In the US, 40% of sales are made to active rewards members, those people who have the Starbucks app on their phone and use it to pay. Of these customers, half of them visit a Starbucks 16 times a month on average. In some ways, the Starbucks digital payment system can be considered the most successful digital currency of all time.

Katherine Fischer, who introduced the call today, has told me that she orders a Starbucks drink from their app on most work days. The app saves her preferred drink – a venti Americano with a regular splash of steamed soy milk – so just two or three clicks on her phone will have her favorite drink waiting for her to pick up on her way to the office. When I asked Katherine to review this part of our call script, she pointed out that she doesn't only go on most weekdays, but often orders from Starbucks on the weekends as well



and in fact had ordered twice this past Sunday. And in addition to her coffee-based drink, Katherine noted that she will occasionally add a spinach feta wrap if she needs an easy meal. Picking up a mobile order at Starbucks literally takes about 15 seconds. This is important to a parent of young children like Katherine who told me “When I’m with my kids the Starbucks mobile app it is such a lifesaver. It means I don’t have to wait in line and tell the kids no to pastries when all I want is my morning coffee.”

So what happens if a new coffee shop opens near Katherine and offers a modestly cheaper or even better product? Habits are powerful drivers of human behavior. Starbucks mobile infrastructure is designed to remove friction from the experience of buying from them. So while a casual coffee drinker out for a walk and planning to wait in line anyway might give the new shop a try, a mobile first, habitual Starbucks customer, of the type that generates as much as 40% of their revenue, experiences much higher “switching costs” to try something new. Add in the rewards they offer to these customers and competitors need to offer significantly superior value propositions to steal customers away.

There is one type of coffee retailer that is trying to do just this. Known collectively as Third Wave Coffee, these retailers led by Blue Bottle and including many local and/or small chain stores, are attempting to offer a significantly higher end experience. Our bullish view on Starbucks is not based on a belief these efforts will fail, but instead only that they will take limited market share and that Starbucks own Roastery and Reserve concepts will win a segment of customers wanting this higher end experience.

Mike Navone, one of the advisors here at Ensemble, is currently on vacation in Italy and sent us back a report of his visit to Starbucks Milan Roastery location. Here’s what he wrote:

“If there was one takeaway from Starbucks Milan I’d say two words: an experience. It was beautiful inside and the place was packed. Upon entry, you’re greeted and directed to where you should go (food, coffee, or the bar). We had espresso martinis. The server recommended some other drinks but at over 20 euros each we stuck with our martinis. Drinks surprisingly came with a full cheese board with olives, a nice touch! The couple next to us ordered one of the expensive drinks and the server said we should watch the preparation for ‘the experience.’ It was neat. Very carefully made with a beaker to steep, then shaken with ice. They wheeled out a special cart just to make this drink. Everyone was watching and taking pictures.

Then a huge copper cylinder in the center of the cafe had all the panels open up, like a flower blooming, and it revealed the coffee beans being sent to be washed, roasted, and packaged. There were no less than 30 people filming with their phones. The cafe was great, not a place to grab and go but instead stay for the experience and the show. It’s pricey but felt worth it for the unique experience.”

Now many retail products have gone through a premiumization process in recent years. Whether it is high end chocolate, craft beer or organic, locally sourced produce, consumers have shown an appetite for replacing traditional mainstream products with higher end versions. Our contention is that this process has already happened with coffee and it was triggered by Starbucks successful efforts to premiumize coffee in



the 1980s and 90s. While craft beer today still only makes up 25% of the beer market, Starbucks flipped closer to 80% of the coffee market to premium. What we see now with Third Wave Coffee is an ultra premiumization trend. For a small slice of the coffee market, some customers are willing and able to spend even more on their coffee and they seek a truly authentic experience. On our own research team, Arif is a fan of Blue Bottle and other Third Wave coffee shops. While he rarely visits a Starbucks on his own, he will admit that when traveling with his wife and children, they will often choose Starbucks because it offers a range of products to fit their varied needs. And so in the end we do not believe that the Third Wave trend is so broadly applicable that it threatens Starbucks in a meaningful way.

We've [written in the past](#) about the difference between search cost brands and identity brands. The former are those brands that offer a guarantee of a good product at a consistent quality level. The latter offers the purchaser a signal to them or their peers that reinforces the buyers' self-identity. Our contention is that in branded consumer products, search cost brands are dying as consumers have come to depend on Amazon star ratings and social media recommendations to influence purchase decisions. But Starbucks offers a service, not a product. When you are in a new town, or in an airport or even just in a different part of your home city, Starbucks offers a specific, known and consistent value proposition based on delivering you the dose of caffeine you seek and wrapping the purchase with a range of healthy foods or tasty treats as the occasion might call for. Speaking for myself, being served a bad cup of coffee is really annoying. And like most coffee drinkers, I have strong preferences that map not so much to objectively high or low quality, but instead are driven by what I'm used to. I saw this preference on display recently when I was at JFK airport and found myself walking past five separate places offering coffee in order to buy from Starbucks, the brand I trust to provide me the coffee I crave.

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](mailto:info@ensemblecapital.com).

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

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