HS MANAGEMENT PARTNERS, LLC

Third Quarter 2016 Investment Perspective

investment styles ebb and flow . . . fundamentals never go out of favor

640 Fifth Avenue, 18th Floor
New York, NY 10019
212.888.0060
www.hsmanage.com

October 11, 2016

CIO Commentary

Investment Perspective

Our sole focus remains on our Concentrated Quality Growth methodology. It starts with identifying companies with attractive business models, which we then look to assemble in a portfolio where we are making our clients the owners of an earnings and cash flow stream that grows each and every year, and faster than average in most years. And while we care deeply about the quality of the businesses and look to the earnings growth to drive appreciation over time, we agree with Warren Buffett that growth and value are joined at the hip. We are not momentum investors and have a disciplined valuation approach which strives to make our clients the owners of this growing earnings stream at what we believe is an attractive valuation.

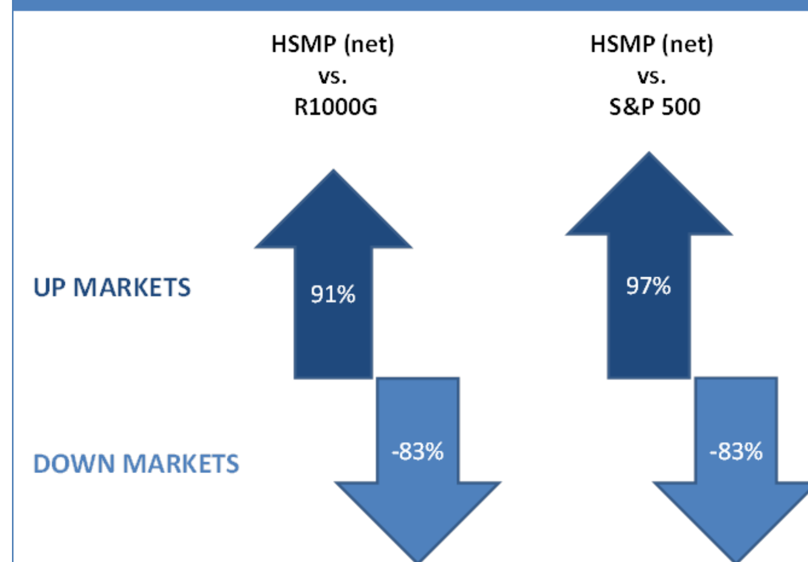
This strategy is underpinned by taking a multi-dimensional approach to quality growth. That is, we don't pigeon-hole ourselves on any one type of quality growth equity. We like dominant, durable, defensive companies which may not grow at a rapid pace but have attractive business models and a long duration of the ride. We also find appeal in more robust top-line growth companies with faster earnings gains so long as the fundamentals are good and the valuation is attractive. And while many of the companies we invest in are the 800 pound gorillas with large market capitalizations, we will go down the cap scale below $10 billion (but not usually less than $2 billion) if we identify a company that may be earlier in its life cycle and/or has the business model characteristics we prize. This multi-dimensional approach also stretches to our willingness to own non-US domiciled companies that have the franchise and financial characteristics of domestic entities that appeal to us.

We also believe philosophically that our clients' capital is scarce capital and come to work every day trying to determine the best use of this capital. Our approach is to buy and hold great businesses so long as the fundamentals are good, the valuation is attractive, and that there are not better alternatives elsewhere. We drive hard for new names and in the process look to challenge the conviction levels of all our holdings. We force ourselves to do something human nature often does not like to do—which is to make hard decisions—and actively manage the portfolio based on our valuation work and as new alternatives collide with our hard cap of 25 names.

Finally, we are benchmark agnostic. 27% of our current portfolio consists of holdings that are in fact not even contained in the R1000G. 30% of our holdings are not in the S&P 500. Our holdings in total account for 26% of the R1000G's weightings and 16% of the S&P 500's weightings.

Ultimately, this methodology is geared to deliver positive absolute returns over time. We are taking stakes in businesses, benefitting from the growth of these businesses and being sensitive to the prices we pay for them. This approach has resulted in our capturing much —but not all— of the upside in good markets, and generally has resulted in less downside in more challenging periods. Over the long run, the math of combining both good and bad times has added up to superior relative returns.

HS MANAGEMENT PARTNERS, LLC



**Performance results are presented net-of-fees and include the reinvestment of dividends and other earnings. Past performance is not indicative of future results.*

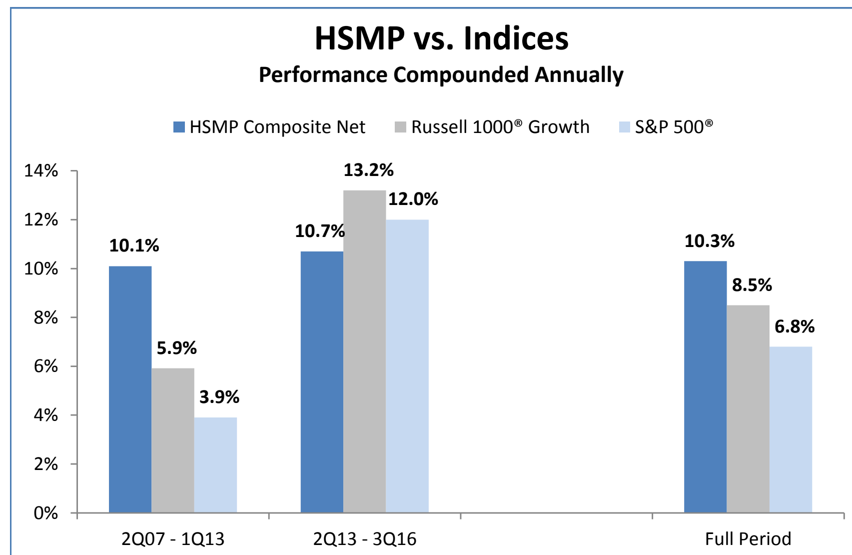
Stepping back, we have gone through a period where we have continued to deliver absolute portfolio gains but have lagged the major indexes. We are approaching the ten year mark of our historical track record and looking back at our performance through our firm's history is instructive. From the second quarter of 2007 (when our performance track record began) through the first quarter of 2013, we went through a market that consisted of both good and bad times. The market peaked late in 2007 and then crashed in 2008. Markets bottomed in early 2009 and then the bull market began. There was a severe valuation retreat in the third quarter of 2011 in which all major indexes dropped more than 10%. All told, and through our first six years, there were 15 up quarters for the R1000G and 14 up quarters for the S&P 500. Conversely there were 9 down quarters for the R1000G and 10 down quarters for the S&P 500. We outperformed in about 80% of these down quarters.

For this period (Q2 2007 through Q1 2013), we delivered absolute returns after fees annualizing at roughly 10%. In essence, we benefitted from the growth in earnings of our portfolio companies plus dividends but lost some multiple. And while markets experienced both ups and downs, they did generate annualized returns of 4% (for the S&P 500) to 6% (for the R1000G).

It has been a different story over the last 3 ½ years and since the second quarter of 2013. We are now in years 4 to 7 (7 ½ actually) of the bull market. Over the past few years, it has become a narrower market and a move to passive investing has reinforced the prevailing trend and contributed to lower levels of volatility. It has actually been a market where there has been just one down quarter in the prior 14 quarters for both the R1000G and the S&P 500 (we outperformed that quarter).

All told in this time (Q2 2013 through Q3 2016), we delivered absolute returns approaching 11% (net of fees). Much like before, we benefitted from the growth in portfolio earnings (though at diminishing rates) plus dividends but added some multiple too. Markets have virtually experienced only up times with rising multiples an increasingly important factor, and have generated annual returns of roughly 13% and 12%, respectively, for the R1000G and the S&P 500.

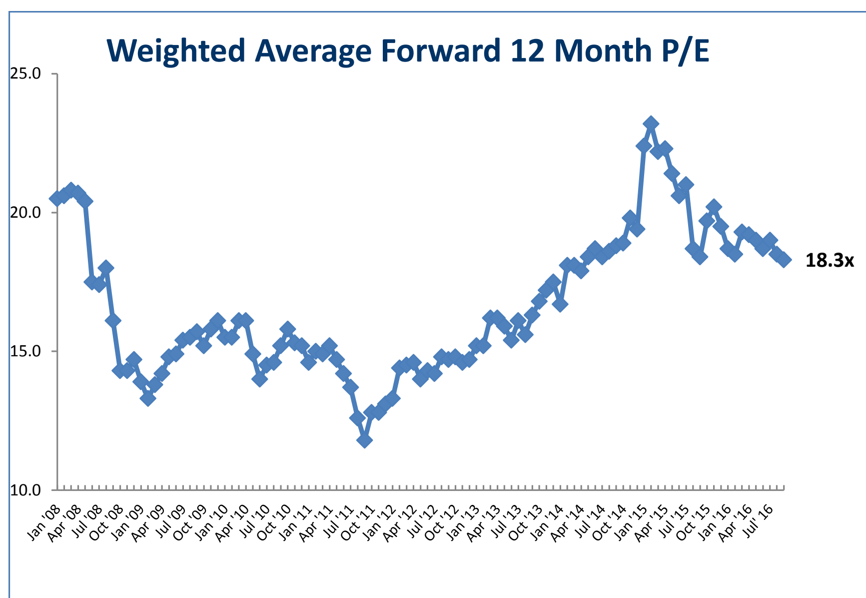
See page 6 for important disclosures.



Performance results are presented net-of-fees through 9/30/16 and include the reinvestment of dividends and other earnings. Past performance is not indicative of future results.

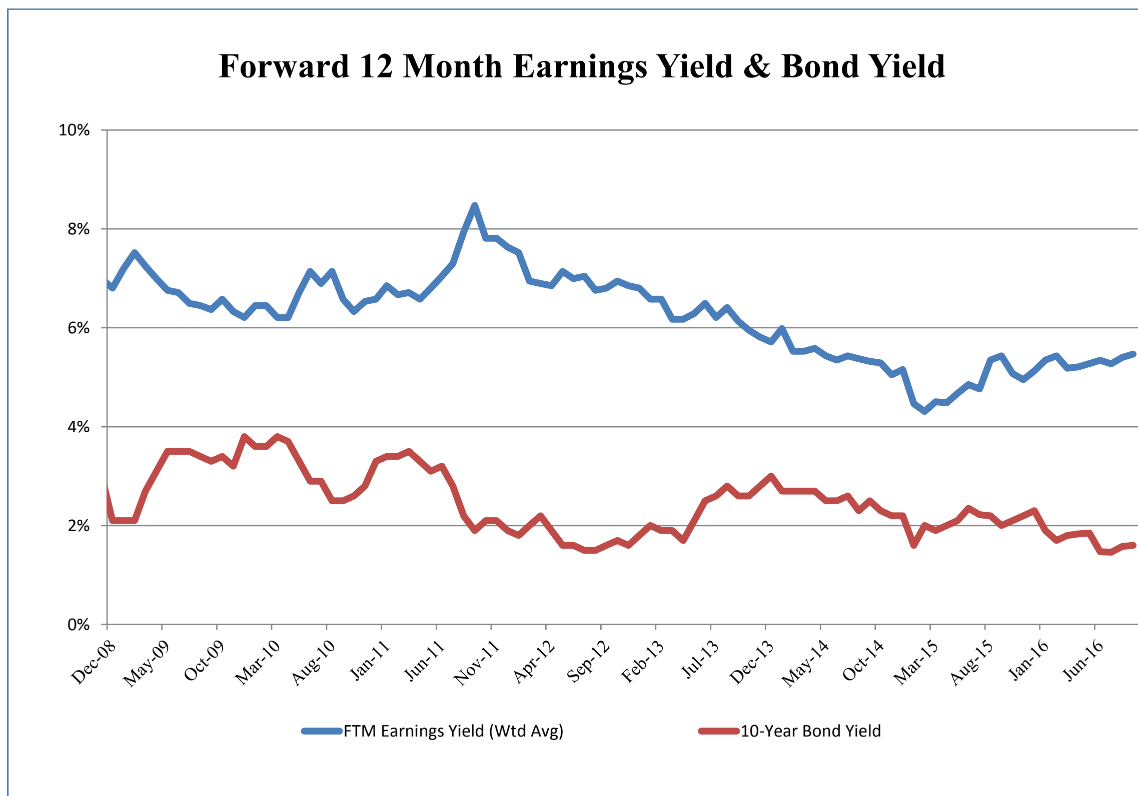
When you add it all up, and now look at almost a decade's worth of returns (9 ½ years to be exact), there is a picture of both up and down markets. There was turmoil and tranquility in this time, and in this period, our absolute returns of more than 10% annually (net of fees) largely reflect the growth in our portfolios earnings. Market returns approaching 9% and 7%, respectively, for the R1000G and the S&P 500 stand slightly above longer range historical averages. Whether it is for our concentrated quality growth portfolio or a broader average, it comes down to 3 things: earnings, dividends, and price/earnings ratios. Results over time reflect precisely that.

So that brings us to today and the outlook going forward. When it comes to earnings, we are later in the economic cycle and this is a low growth, low inflation world. This is the message we hear in the market place from our companies and from economists such as Fed Chair Janet Yellen or the IMF (International Monetary Fund). In this world, we believe that advancing our portfolio earnings at a 10% annual pace will be a good rate of growth. Most of this growth must be driven by real top-line demand with some assistance from the benefits of free cash flow.



Based on HS Management Partners, LLC estimates as of 9/30/16.

When it comes to valuation, we think multiples for the high quality companies in your portfolio are reasonable. The estimated price/earnings ratio of the portfolio is now around 18x, down from the peak of about 23x in February of 2015, as earnings outpaced portfolio gains during this period. Moreover, the earnings yield (the inverse of the price/earnings ratio) of the portfolio has moved up at a time when long-term bond yields have declined and stand at multiples of the 10 year treasury yield level, which we view as compelling.



**Based on HS Management Partners, LLC estimates as of 9/30/16.*

So as we think ahead, your portfolio's absolute prospects will be determined by earnings growth (estimated at 10%), dividend yields (almost 2%), and the direction of multiples. If there is a widespread recession, our earnings stream will not grow 10% through this time, though we think the nature of the businesses we invest in (not capital intensive, not commodity-oriented, some defensive characteristics) will enable us to at least keep the earnings stream growing modestly (and far better than corporate profits at large, which usually decline sharply in those times).

Relative returns will reflect many factors including corporate earnings growth and valuations. We do not prognosticate about what the market will do though suspect we will experience more volatility than recent sanguine times. When markets go up steadily, participants assume the trend is their friend, and in those times, business, earnings, and valuation risk is not as front and center in investors' minds. Conversely, when markets are bad, there is a tendency to assume they will never get better. Our working assumption is that we will go through times of both greed and fear. Usually, it is in more challenging times that quality matters, resilient growth matters, and valuation matters.

H S MANAGEMENT PARTNERS, LLC

Conclusion

We remain confident in our methodology and process. This approach has driven absolute gains over the long term and has proved sturdy through tougher times. We like the businesses we own and continue to find attractive new opportunities in which to invest. Finally, the building blocks of quality companies, above average earnings and cash flow growth, and attractive valuations remain in place to generate future appreciation. Thanks as always for your confidence in us, and we look forward to updating you in the times ahead.

Sincerely,

Harry W. Segalas

See page 6 for important disclosures.

IMPORTANT DISCLOSURES

When we use "HSMP" or "HS Management Partners" or Firm" or "we" or "us" or "our" in this document, we are referring to HS Management Partners, LLC. When we use "Composite" in this document, we are referring to our HS Management Partners Concentrated Quality Growth Composite.

This piece represents the opinion of HSMP as of September 2016 based on our understanding of market conditions and reported information about the aforementioned companies. The opinions stated here are subject to change without notice and are provided solely for purposes of illustration or discussion. The information in this document should not be construed as a recommendation to buy or sell any particular security. This document should not be used as the only basis for making investment decisions.

HSMP claims compliance with the Global Investment Performance Standards (GIPS®). For the purpose of complying with GIPS®, HS Management Partners defines itself as HS Management Partners, LLC, an independent SEC registered investment adviser. (Please note that although HSMP is registered with the SEC as an investment adviser, SEC registration does not imply any certain level of skill or training.) The Composite includes all fully discretionary fee paying accounts which employ our style of investing in 20 to 25 quality growth businesses. These accounts must have a market value of greater than $500,000 at the time of initial inclusion, including those accounts no longer with the Firm. The U.S. Dollar is the currency used to express performance. For more information or for a copy of our fully compliant GIPS® presentation and/or list of composite descriptions, please contact us at 212.888.0060.

For benchmark purposes, the Composite is compared to the S&P 500® and Russell 1000® Growth indices, however, the Composite may contain securities not represented in either or both indices. The S&P 500® Index is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The performance comparisons in this document are provided for market context only, and there are meaningful differences between the Composite and the S&P 500® and Russell 1000® Growth indices (such as in terms of composition, concentration and volatility) that should be considered when comparing performance. Moreover, client account performance may vary from that of the Composite or from that of other client accounts for reasons such as account size, timing of transactions and market conditions at the time of investment.

The performance data contained in this piece should not be taken as an indication of how the performance of the Composite or of a client account will be in the future. Past performance is not indicative of and does not guarantee future results.

Investment in securities involves significant risks that clients should be prepared to bear, including the risk of loss of the original amount invested. We encourage you to refer to our Firm Brochure (which is available on our website (www.hsmanage.com) or upon request at 212.888.0060 for some material risks applicable to our investment strategy and additional information regarding our Firm.

The securities identified and described in this piece do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. While we believe that our investment strategy will produce desired returns, there can be no assurance that HSMP will achieve its investment objective or will be successful in implementing its investment strategy.

Please note that during certain transitional periods of selling or buying a security or due to some corporate actions such as spinoffs, or due to some other factors, the Portfolio may hold more or less than 20 to 25 securities.

Upside [downside] ratios were computed by dividing the cumulative annualized return of the HSMP Composite (net-of-fee) in months of positive [negative] index returns by the cumulative annualized return of said index for those same months.

Trademark Disclosures: GIPS® is a registered trademark of the CFA Institute. CFA Institute has not been involved in the preparation or review of this piece. Russell Investment Group is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group. S&P 500® Index is a registered trademark of Standard and Poor's Financial Services LLC, a division of the McGraw-Hill Companies, Inc. Standard & Poor's is the owner of the trademarks, service marks, and copyrights related to its indexes.

© Copyright 2016 HS Management Partners, LLC. All rights reserved. This material may not be reproduced without permission.

H S MANAGEMENT PARTNERS, LLC