Same As It Ever Was

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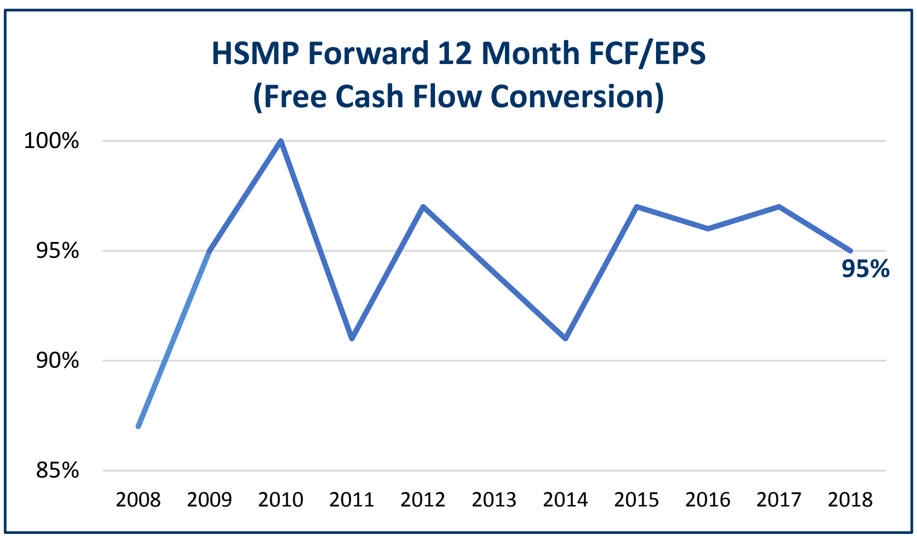
After a strong year last year, 2018 has not yet been kind to our Concentrated Quality Growth portfolio. Despite the pullback we are experiencing, the focus remains squarely on finding quality businesses, growing the earnings stream each year, and deploying a strict valuation discipline.

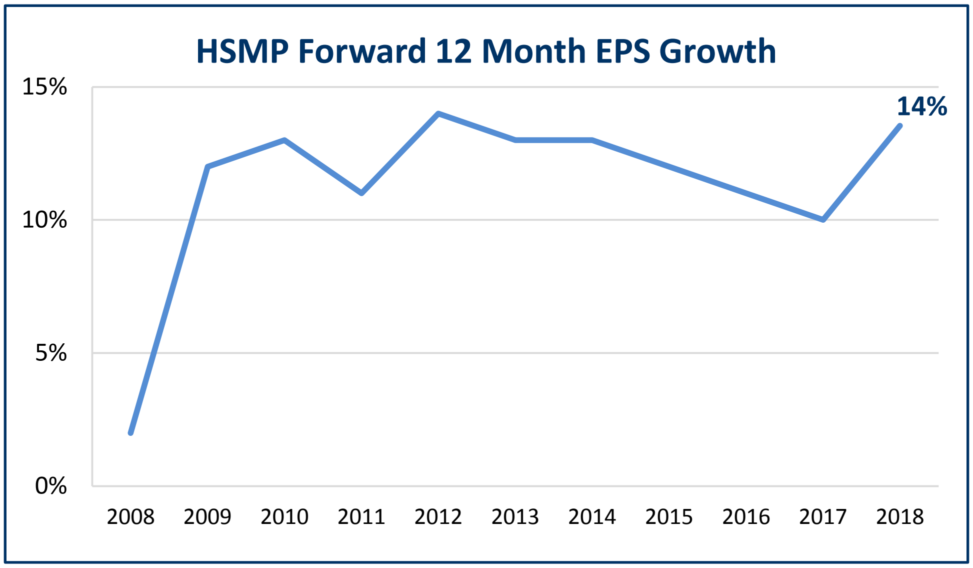
We see the building blocks of quality, growth, and value well in place. One important aspect of quality businesses that we look for is strong free cash flow (FCF) and one metric we use is the free cash flow conversion rate (FCF/EPS) for our companies. That is, what is left from a free cash flow perspective after capital spending and working capital requirements. As you can see in the chart below, free cash flow has pretty much run at 90% to 100% on the dollar of net income and stands at a healthy 95% today. This leaves ample sums after reinvestment, to return capital back to shareholders, or make strategic, close-in acquisitions to enhance growth.



Note: Metrics are weighted averages from HSMP Composite and based on HSMP estimates as of year end periods; 2018 data is as of 5/31/2018.

We look to drive appreciation with annual earnings growth and work hard to grow earnings regardless of the market environment. As you can see in the following graph, we generally have estimated annual earnings growth at 10% or better, with the exception being at year-end 2008 looking into 2009 and in the throes of the financial crisis and recession. Although we are deep into the economic cycle, we were still predicting about 10% annual earnings-per-share (EPS) growth in 2018 which got bumped to 16% after the announcement of tax reform. That last data point of almost 14% on a forward 12 month basis currently captures part of this year's tax-enhanced above average year with part of a more normalized year of 10% next year.

See page 4 for important disclosures.



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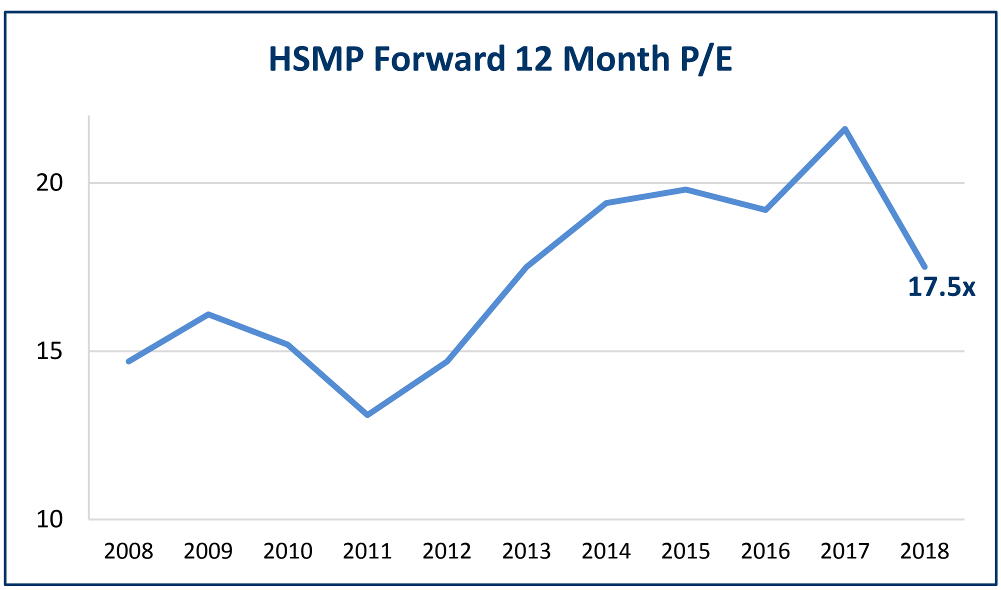
The next chart shows our estimated forward 12 month P/E ratio. This series picks up the 2008 decline as a starting point. As an aside, the portfolio was selling for more than 20X at the end of 2007. Multiples bottomed in late 2011 and had been on a steady rise since then. We have used our valuation discipline continuously over these years, taking profits on companies where appreciation potential based on valuation work seems lower and redeploying capital into names in which we saw better long-term appreciation upside. In many ways, last year (2017) was a good example of the process at work as we limited the rise in our price/earnings multiple by using our valuation discipline and deploying our multi-dimensional quality growth approach (which includes moving across the growth spectrum based on fundamentals and valuation). As you can see, multiples declined this year as we have pulled back, earnings have grown (enhanced by tax reform), and time has elapsed. This makes us positive about the future—not negative—as a key building block of future appreciation—valuation—is more not less attractive. I should add that our current estimates capture options expense.



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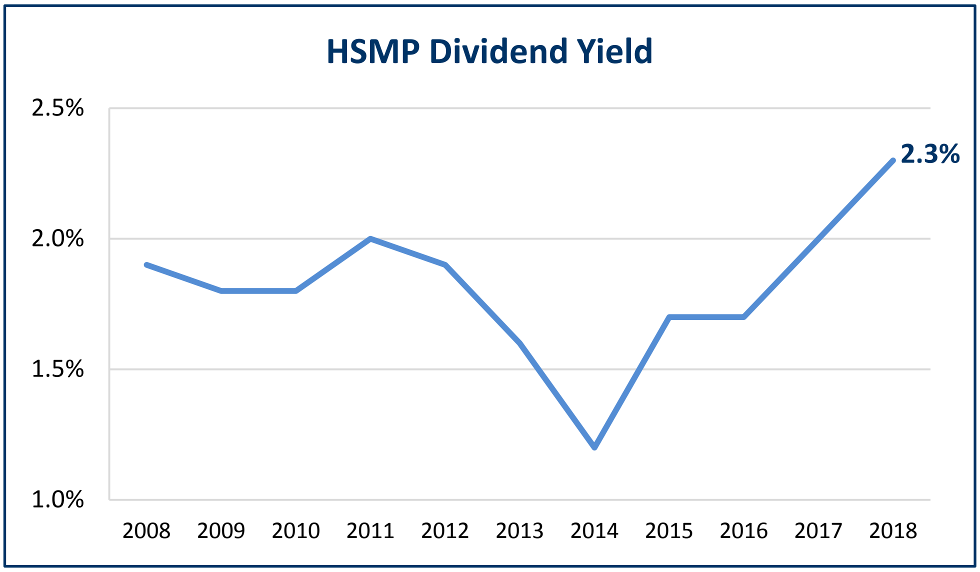
In the final graph, you can see the dividend yield which has run from about 1.25%-2.5% (and dividends have grown every year). We look for total returns to be a function of earnings growth, the direction of price earnings ratios, and dividends. In our view, dividends are also a sign of healthy financials and we have always liked managements that give money back to shareholders in the form of dividends and share repurchases. The dividend yield has gravitated higher as we have found some attractively valued names that happen to pay solid dividends, and is also a function of the portfolios retreat in the face of growing earnings, cash flows, and dividends.



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While we go through challenging periods such as now when our methodology is out of favor, we have confidence that our emphasis on quality businesses, a growing earnings stream, and the maintenance of a valuation discipline will drive returns over the long pull. Our investment approach remains the same as it ever was and we look forward to updating you in the times ahead.

See page 4 for important disclosures.

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