Once in a Lifetime

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On Saturday night February 8th, I had the opportunity to attend David Byrne's sold out Broadway show, American Utopia. Described by New York Magazine as "Total, Buoyant Joy," the show features one of the former Talking Heads front man's best-known songs "Once in a Lifetime." To say the least, this now feels like a lifetime ago. The song presciently asks the question "and you may ask yourself; well how did I get here?"

The global COVID-19 pandemic is truly a once in a lifetime event. I have experienced much in my 38-year investment career: the 1987 Crash, the first Iraq War, the late 90's Asian Crisis, the 2000 Tech Bubble bursting, 9/11, and the 2008/2009 Financial Crisis and Great Recession. We have not experienced anything like this. As Arne Sorenson, Marriott's intrepid CEO put it, "COVID-19 is like nothing we have ever seen before. For a company that is 92 years old, that has borne witness to the great depression, World War II and many other economic and global crises, that is saying something. But here are the facts, COVID-19 is having a more severe and sudden financial impact than 9/11 and the 2009 Financial Crisis combined."

As you recall, our focus is on finding attractive business models with strong cash flows, growing the earnings stream each year, and following a strict valuation discipline. Historically, while not immune from recessions, our portfolio companies have tended to exhibit recession resistant characteristics, and at least generated modest earnings growth relative to more traditionally cyclical profit streams away from us. And, we believe, our adherence to valuation has also reduced risks post exuberant market periods.

The COVID-19 crisis has largely not been about the quality of the business model or valuation. It's about today's earnings and cash flows. Ed Yardeni of Yardeni Research notes that, "In the past, U.S. recessions were led by downturns in manufacturing. This time, the recession is being led by the services economy as a result of shutdowns in industries." In other words, the issue we face is gauging the impact for our companies—most of them serving consumers globally--in a world where people simply stopped showing up.

To be sure, COVID-19 has hit our portfolio companies hard in both a direct and immediate fashion. There will also be indirect and lagged effects that permeate throughout the global economy and confront all companies, especially as more consumer facing companies slash capital expenditures, pull back on all discretionary spending, and sharply reduce inventory and working capital levels.

See pages 4-5 for important disclosures.

As you know, our methodology focuses on EPS (earnings per share) growth and the P/E (price/earnings) ratio. For now, and during this period of tumult, it has been very hard to reasonably assess what the E (earnings) may be, or what the P/E is. But for what it is worth, prior to the crisis unfolding, we had forecast low double-digit EPS growth in 2020. Our best guess currently is that earnings will be down 10%-20% this year. It could well be worse. For perspective, Ed Hyman of ISI now forecasts S&P EPS of $100 this year…down from a $164 last year, or roughly a 40% drop.

Free cash flow has always been vital to us, and our companies have historically exhibited high free cash flow conversion, approaching 100%. That is, for every $1.00 of net income, we have seen free cash flow of usually $0.90 or more after capital spending and working capital needs. Typically, this excess cash has gone to pay dividends, repurchase shares, or make close-in acquisitions. The challenge today is that the E (earnings component) of the free cash flow yield is under duress. To that end, we have seen companies move to draw down credit lines, stop repurchasing shares and even suspend dividends. While the latter was not what we had envisioned even a few weeks back, it makes prudent sense considering how the situation has evolved.

Stock prices have been enormously volatile in response to COVID-19. We have seen day to day fluctuations in given stock prices and the entire portfolio that we have not seen before. We do not profess to be experts on algorithmic or computerized trading; we are fundamental analysts at heart. Our view has always been that we will look to capitalize on swings—both good and bad—if our assessment of a company's future value differs from where stock prices currently trade. It does seem though that the bid for many stocks was overwhelmed, especially those within our portfolio with relatively smaller market capitalizations. This has added to the current downside pressure on the portfolio.

Active management remains at the core of our investment approach. We have moved to be responsive to changes in stock prices, adjustments to our views of future values along with current worth, and the need to rebalance the portfolio due to the extreme volatility cited above. As you know, we have always been willing to go against the grain—not for the sake of being contrarian—but often because we have found the best opportunities arise during times when transitory factors overshadow secular possibilities. And we have done so during this period as it relates to buying new names, adding and subtracting from existing holdings, and exiting positions needed to fund purchases.

As I said before, valuation metrics are tricky since it is hard to know where earnings settle. That said, based on our current numbers (a moving target), we believe that the P/E is roughly 18X-19X forward 12-month estimates. This is down from where we have been and is based on a notable contraction in forward 12-month estimates. We had forecast the forward P/E at about 22X more optimistic estimates at the start of the year.

Of course, we have seen a steep retreat in long-term bond yields. As a result, the earnings yield/bond yield ratio (EY/BY) is now off the charts with the earnings yield roughly 8X the bond yield. For perspective, this earnings yield stood at 2.4X the bond yield as the year began. I would not get carried away with this metric especially since there is so much play in the numbers. It will come down to at what level do earnings stabilize. This is a health issue rather than a monetary or fiscal issue. That said, both monetary and fiscal stimulus efforts are at unprecedented levels and could amplify any recovery post the health crisis.

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I referenced earlier the David Byrne song, “Once in a Lifetime.” One of the key stanzas in the song is the repeating of the same line… “same as it ever was, same as it ever was, same as it ever was.” I once titled a report with that line; only this time, I don’t think that is right. I don’t think it will be the same as it ever was. The suddenness and depth of the crisis will lead to a range of different challenges. Nestle’s CEO Marc Schneider warned employees: “Please get ready for the storm to hit—because hit it will.” Some companies will go through near death experiences. And the reality is that unemployment will surge, and many independents and mom and pop operators will not survive.

The balance sheet now becomes the center of attention. Companies, broadly, were prodded to take on debt, and many away from us went overboard, especially with interest rates so low. It is likely that we will go through a time with much more conservative balance sheets. Capital spending is likely to be subdued. Technology and software projects—an increasing part of spending plans—will be prioritized and in some cases delayed. “Nice to have” will have to wait. Initiatives to move into new markets may well be curtailed. Buying back stock will probably move out of vogue—building cash balances will be this year’s charge.

Notwithstanding the enormous challenges facing our portfolio’s earnings stream currently, we feel that next year’s outlook will be less affected, and the long-term outlook even less so. The inherent cash flow characteristics of the businesses we own should once again kick in as revenue comes back. While pressures exist, we feel balance sheets overall are solid and a long-term advantage. We expect many will emerge stronger, especially relative to weaker competition, and many competitors may go out of business.

Andrew Cuomo, New York’s Governor, said it best: “This is a marathon, not a sprint.” He said that as it relates to handling the current health crisis. In our minds, it is also true as it relates to your portfolios. This is a moment in time. The declines we have experienced reflect this moment in time. We are running the marathon—not the sprint—and are looking out at what given companies may look like not next month or next quarter but 12-18 months from now…even 3-5 years from now.

Thanks for your confidence in us. We know these are trying times and wish you and your families the best health and safety as we navigate this crisis. We appreciate your trust in us as we run this marathon on your behalf.

Sincerely,

Harry W. Segalas

See pages 4-5 for important disclosures.

GIPS Disclosure

HS Management Partners, LLC

Concentrated Quality Growth Composite

Annual Disclosure Presentation

	Firm	Composite		Performance Results					3-Year Annualized Std Deviation		
				Composite							
Year End	Assets (millions)	Assets (USD) (millions)	Number of Accounts	Gross	Net	S&P 500®	Russell 1000® Growth	Composite Dispersion (Std Dev)	Composite Gross	S&P 500®	Russell 1000® Growth
2019	**3,566**	**3,478**	**280**	**38.12%**	**37.13%**	**31.49%**	**36.39%**	**1.13**	**11.29**	**11.93**	**13.07**
4Q-19	3,566	3,478	280	6.84%	6.63%	9.07%	10.62%	.07	11.29	11.93	13.07
3Q-19	3,377	3,260	263	5.24%	5.05%	1.70%	1.49%	.49	11.36	12.01	13.11
2Q-19	3,266	3,197	254	8.57%	8.38%	4.30%	4.64%	.12	11.38	12.02	13.21
1Q-19	3,234	3,173	257	13.15%	12.95%	13.65%	16.10%	.27	10.23	10.58	12.02
2018	3,145	2,967	259	-4.42%	-5.07%	-4.38%	-1.51%	.28	10.04	10.80	12.12
2017	4,028	3,840	236	33.87%	33.06%	21.83%	30.21%	.46	9.61	9.92	10.54
2016	3,446	3,269	199	6.92%	6.25%	11.96%	7.08%	.10	10.72	10.59	11.15
2015	3,143	3,014	176	3.94%	3.32%	1.38%	5.67%	.81	11.03	10.48	10.70
2014	3,295	3,193	148	13.06%	12.39%	13.69%	13.05%	.26	9.85	8.98	9.59
2013	2,392	2,298	136	31.76%	31.04%	32.39%	33.48%	.09	12.26	11.94	12.18
2012	1,622	1,616	94	28.86%	28.16%	16.00%	15.26%	.15	13.82	15.09	15.66
2011	884	880	72	5.55%	5.00%	2.11%	2.64%	.11	15.81	18.70	17.76
2010	531	528	46	17.13%	16.44%	15.06%	16.71%	.28	19.54	21.85	22.11
2009	292	290	32	35.91%	35.06%	26.46%	37.21%	.33			
2008**	172	152	27	(34.49%)	(34.80%)	(37.00%)	(38.44%)	N.A.			
2007*	-	6	5 or fewer	16.84%	16.08%	4.83%	10.51%	N.A.			

* Performance shown for 2007 is from April 1, 2007 through December 31, 2007.

** HS Management Partners, LLC charges its fees quarterly in arrears and therefore no significant fees were charged to client accounts in the first quarter of 2008. Had a modeled fee of 0.90% per annum been applied, the net of fee return for the first quarter of 2008 would be (10.82%).

N.A. - Information is not statistically meaningful due to an insufficient number of portfolios (5 or fewer) in the Composite for the entire year.

__The HS Management Partners Concentrated Quality Growth Composite__ includes all fully discretionary, actively managed, fee paying accounts which employ our style of investing in 20-25 quality growth businesses. These accounts must have a market value exceeding $500,000 at the time of initial inclusion in the Composite and have a market value exceeding $300,000 to maintain inclusion.

Accounts that have contributions/withdrawals of greater than 10% of their market value (at the time of the cash flow) shall be excluded from Composite membership. Accounts that are not actively managed according to the intended strategy are excluded at the end of the last full day in which they last met the inclusion criteria. Accounts are reinstated into the Composite on the first day after the account again meets our inclusion criteria. Prior to April 1, 2009, our inclusion and exclusion criteria were applied on a monthly basis, rather than daily. Additional information regarding the treatment of significant cash flows is available upon request. Also available upon request are policies for valuing portfolios, calculating performance, and preparing compliant presentations.

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 HS Management Partners Concentrated Quality Growth Composite was created January 1, 2008. Prior to January 1, 2008 the accounts in the Composite were non-fee paying individual accounts managed by Harry Segalas in accordance with HS Management Partners' investment policies, becoming HS Management Partners accounts in December 2007. Prior to July 1, 2011, the HS Management Partners Concentrated Quality Growth Composite was known as the HS Management Partners Concentrated Growth Composite.

The Composite Dispersion presented is an asset-weighted standard deviation calculated using gross performance results for accounts included within the Composite for the entire period.

HS Management Partners, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. HS Management Partners, LLC has been independently verified for the period January 1, 2008 through December 31, 2019. Verification assesses whether (1) the Firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the Firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. The Concentrated Quality Growth Composite has been examined for the period January 1, 2008 through December 31, 2019. The verification and performance examination reports are available upon request.

The performance track record from April 1, 2007 through December 31, 2007 has been examined by Ashland Partners & Company, LLP and is compliant with the portability requirements of the GIPS® standards. A copy of the verification report is available upon request.

HS Management Partners, LLC is an independent SEC registered investment advisor (SEC registration does not imply a certain level of skill or training). The Firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, including those accounts no longer with the Firm. Past performance is not indicative of future results.

The U.S. Dollar is the currency used to express performance. When international ordinary shares or ADRs are held in portfolios in the Composite, performance is shown net of foreign withholding taxes. Returns are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated using actual management fees. Prior to January 1, 2008, a representative fee of 0.90% annually was applied to the individual accounts in the Composite managed by Harry Segalas. Additional information regarding the policies for calculating and reporting returns is available upon request. Policies governing compliance with the GIPS® Standards were followed in establishing HS Management Partners' performance record and the accounts to be included therein. In that regard, certain individual accounts managed by Harry Segalas were excluded from the Composite because of material differences in the management style of those accounts and HS Management Partners' investment policies. The GIPS® standards were applied retroactively for the purposes of computing 2007 performance, and are being applied prospectively in a consistent manner.

Investment advisory fees are charged as a percentage of on an account's assets under management. The annual fee schedule for accounts that are at least $10 million under management is as follows: 0.90% on first $25 million, 0.70% on next $25 million and 0.50% on the balance. Accounts below $10 million pay the greater of 1% or $10,000. Actual investment advisory fees may deviate from the above fee schedule at the Firm's sole discretion. Please refer to our Form ADV for more information related to our fees.

See pages 4-5 for important disclosures.

IMPORTANT DISCLOSURES

When we use *HSMP*, *HS Management Partners*, or *Firm*, we mean HS Management Partners, LLC. When we use *Composite,* we mean our HS Management Partners Concentrated Quality Growth Composite. This piece represents our opinion as of 3/30/20 based on our understanding of market conditions and publicly available information. It has forward-looking statements that are by their nature uncertain and based on our assumptions (such as when we refer to possible/future/estimated earnings, cash flows, earnings-per-share (EPS), growth rates, price-earnings ratios (P/E), market conditions, or portfolio/client portfolio outlook); there is no assurance that forward-looking statements are accurate as actual results and future events can differ materially from our assumptions. It is written from the perspective of our Composite holdings, performance and estimated metrics, and it does not refer to any specific group/client account (when we use *our portfolio(s)/your portfolio(s)* we mean client portfolios in general from our Composite perspective – please see below regarding differences between the Composite and actual client portfolios/ accounts). The information here is solely for illustration/discussion, is subject to change without notice, should not be construed as a recommendation to buy or sell any particular security, and should not be used as a base for making investment decisions. Investing in securities involves significant risks, including the risk of loss of the original amount invested.

In response to the current coronavirus (COVID-19) global pandemic and in an effort to protect the safety and well-being of our team and the continuity of our critical business operations, our employees are working remotely and we suspended business travel and replaced in-person meetings with conference calls and video chats. We have tested our capacity to operate remotely and members of our team have worked from home in the past, and as of this moment, we believe we can perform critical services (making investment decisions, trading and settlement, and communicating with clients about the status of their accounts), assuming that current conditions do not worsen dramatically over the next few days, that our team and close family members do not fall ill infected with COVID-19, that there are no significant disruptions to our key service providers, and that our team continues to have internet connectivity and phone access from home. Although our business continuity / disaster recovery plan aims to mitigate the impact of natural disasters or catastrophic events by maintaining critical business functions, while keeping the safety of our employees first, no plan can guarantee the continuity of our operations in the presence of these events. In particular, given the rapidly evolving situation and the unknown impact of COVID-19, we cannot predict with certainty its effect to our business and client portfolios.

We typically build a concentrated portfolio with a hard cap on company names and with an aim to keeping clients' capital nearly fully invested. Our investment advice is limited to domestic and foreign equity securities of publicly traded companies. Client accounts generally hold 20-25 companies, although in certain circumstances they may hold more or less names. We do not maintain limits on industry or sector weightings, and while we do limit portfolio positions by company, clients' portfolios are likely to be significantly concentrated by sector, industry and/or geography, among other factors. While we believe that our investment strategy will produce desired returns, there can be no assurance that we will achieve our investment objectives. 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 performance shown should not be taken as an indication of how the Composite or a client account will perform in the future; past performance is not indicative of and does not guarantee future results. HSMP claims compliance with the Global Investment Performance Standards (GIPS®). HS Management Partners, LLC is an independent SEC registered investment adviser (SEC registration does not imply any certain level of skill or training). The Composite includes all fully discretionary, actively managed, fee paying accounts which employ our style of investing in 20-25 quality growth businesses, including those accounts no longer with the Firm. Accounts must have a market value of greater than $500,000 at the time of initial inclusion in the Composite and meet certain other criteria to maintain inclusion. The U.S. Dollar is the currency used to express performance. Composite performance is presented net of fees and includes the reinvestment of dividends and other earnings. The Composite is compared to the Russell 1000® Growth Index and the S&P 500® Index as benchmarks for market context only. The Russell 1000 Growth Index is an unmanaged index which measures the performance of those Russell 1000® Index companies (largest 1,000 U.S. companies based on market capitalization) with higher price-to-book ratios and higher forecasted growth values. The S&P 500 Index is an unmanaged market capitalization-weighted index designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Neither index bears fees and expenses and investors cannot invest directly in either of them. There are meaningful differences between the Composite and each index that should be considered when comparing performance, such as in terms of composition, concentration and volatility. For example: (1) the Composite can contain securities not represented in either or both indices and is much more concentrated than either index in terms of companies and sectors; (2) the average market capitalization of companies in the Composite will likely differ from that of either index; and (3) market or economic conditions may affect positively/negatively the Composite's performance but not the indices, which do not bear market risk. Although most discretionary client accounts are included in the Composite and dispersion is typically low over time, not all client accounts are in the Composite, and even for those in the Composite, there can be dispersion, particularly when viewed over narrow time periods. Client account holdings and performance can vary from the Composite or from other client accounts (even different accounts of the same client), and also from the representative portfolio, for several reasons, such as: client restrictions, account type and size, timing and market conditions at an account's inception and contributions/withdrawals, timing and terms of trades, actual client investment advisory fees (or the lack thereof), and client directed brokerage/commission recapture instructions. Furthermore, under our sole investment strategy (HSMP Concentrated Quality Growth Equity strategy) we provide investment advice on a discretionary basis (we make all the investment decisions and trade the accounts) and also on a non-discretionary basis in the form of model portfolios for use in multimanager products (we act as a non-discretionary sub-adviser and do not make the final investment decisions nor trade the accounts); therefore, certain information here (including holdings, performance, Composite, and investment strategy implementation) is not applicable to model portfolio clients as we have no control and do not monitor the implementation (complete, partial or not at all) of model portfolios, and the performance of model portfolio clients is not attributable to us.

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