July 9, 2014

"Keep Calm and Carry On"

Seventy-five years ago this month, the British Ministry of Information printed a couple of million posters with the slogan "Keep Calm and Carry On" to strengthen the citizenry's morale ahead of anticipated attacks during World War II. The campaign was ultimately scrapped and all but a few dozen of the posters were recycled for pulp after the war. It was only in the last decade or so that the original posters resurfaced becoming a pop-culture catchphrase and predictably, in a highly stimulative monetary environment, sell at auction for more than $20,000 each.

After a more hesitant first quarter, investors heeded Chairman Yellen's missive to "Keep Calm and Carry On" as prices on most risk assets – stocks, government debt, high-yield credit, real estate, art, classic cars, and, yes, original posters from World War II – were marked up in the second quarter. The Fed's commitment to keep rates low for an extended period has been the key driver of this market's multiple expansion with earnings growth a distant second. Combining cheap capital with a dearth of organic revenue growth opportunities, as well as an onerous domestic tax code, has led to a frenzied $1.7 trillion wave of mergers and tax-driven inversion arrangements so far this year.

Although the "wealth effect" on consumer spending from the 200% rise in the market over the last five and one-half years has been curiously absent, there are emerging signs that the central bank's accommodative policies are igniting animal spirits in the real economy, not just the equity and bond markets. Data across a wider swath of the economy - housing, labor, manufacturing, automobile production - are showing steady, albeit mostly lackluster, improvements. On another promising note, management from several of the large banks and industrial firms we cover suggest the appetite for investments in capital projects and use of credit lines is improving.

Despite the encouraging economic data, it remains to be seen how the markets, business managers and consumers will react as the Fed completely eliminates their quantitative easing and likely starts to raise rates over the next 12-18 months. With our average margin of safety, or upside to fair value, compressed at 8%, extended valuations are providing minimal downside protection. We will remain prudent in allocating your capital in the current environment.

Strategic Growth Annualized Returns as of June 30, 2014

	Net	S&P 500	Alpha	R1000G	Alpha
2Q 2014	7.3%	5.2%	1.32	5.1%	2.93
Year-to-date	10.0%	7.1%	2.78	6.3%	4.21
1 Year	29.0%	24.6%	6.62	26.9%	8.94
3 Years	17.9%	16.6%	1.93	16.3%	2.68
5 Years	18.0%	18.8%	0.43	19.2%	0.61
10 Years	8.8%	7.8%	2.24	8.2%	2.32
"Peak-to-Peak"	9.4%	6.9%	3.42	8.1%	2.76

** Peak-to-Peak represents returns generated January 1, 2008 through June 30, 2014.*
Focus cumulative performance is available upon request.

Mar Vista's investment philosophy and process are built around the belief that capital *preservation* is equally important as *appreciation*. So while we are pleased to have enhanced the purchasing power of our investors' capital relative to passive benchmarks over nearly every time horizon, we are equally proud that we have achieved it with materially better down capture (72% and 77% versus the Russell 1000® Growth and S&P 500®, respectively) and lower beta (0.83 and 0.89, respectively) yet still attractive up capture (89% and 95%, respectively) over the ten and one-half years since our inception.

Update on Performance

For the 2nd quarter, Mar Vista's large-cap growth strategies outperformed both the Russell 1000® Growth Index and S&P 500® Index. Good relative returns in healthcare, consumer discretionary and financials contributed positively while our investments in energy and materials lagged the benchmark's sector performance. Our leaders were Allergan (+36%), Covidien (+22%), Schlumberger (+21%) and Apple (+21%), while EMC (-4%), P&G (-3%), Visa (-2%) and Baxter (-2%) lagged.

We would point to two key drivers for our performance so far in 2014: continued intrinsic value growth for our "serial compounders" and benefits from the wave of consolidation in healthcare.

As we discussed in our 2013 year end letter, given the compressed margins of safety, we expect the majority of our five-year returns to be driven by the expansion of intrinsic value and not the compression of the spread between price and value. We highlighted in that discussion four of our larger positions - *American Tower*, *Transdigm*, *Liberty Global* and *Markel* - which exemplified "compounding machines." So far this year, those four wide-moat businesses have collectively returned 11%, well ahead of the market, and approximately in-line with our estimate of their shareholder value growth.

We were also fortunate to be on the receiving end of the aforementioned frenzy of mergers and tax inversions as both *Allergan* and *Covidien* were approached by potential acquirers (Valeant and Medtronic, respectively) during the quarter. A burdensome U.S. tax code has led to a groundswell of acquisitions, particularly in healthcare, allowing companies to redomicile in more favorable tax regions and unshackle trapped overseas cash. These tax deals have begotten more deals as companies exploit their low-tax arbitrage to acquire higher-tax rate companies.

For example, Valeant, with much of their intellectual property based in Bermuda, pays a mere 3% tax rate compared to Allergan's current 27% rate. Just reducing Allergan's tax rate to 8% post-deal means a $500 million annual tax payment that used to go to the government would accrue to Valeant shareholders. In addition, Valeant believes they can cut multiple billions from R&D, marketing and administrative expenses by employing an operating strategy that is diametrically opposed to Allergan's: focus a smaller salesforce on durable global brands with limited need for innovation. Not surprisingly, the value created from the deal is compelling on a spreadsheet – Allergan's stand-alone operating margins expand from 35% to almost 70% and Valeant would generate 9-10% returns on the acquisition in the first year.

However, we remain skeptical about the strategy's longer-term organic growth and cultural implications. We also question the wisdom of applying this framework to Allergan – a company that has generated 15% annualized growth in free cash flow per share over the last seventeen years and generates returns on invested capital of over 35%. These are not the metrics of a profligate management team that has squandered shareholder capital.

Allergan has responded to the hostile offer with an aggressive plan of their own: expand operating margins from 35% to 50% over the next five years by leveraging their SG&A and R&D while maintaining the vast majority of their key research investments. This strategy should drive an accelerated 20-25% free cash flow growth. We believe there are additional moves to come in this chess match including Allergan's plan to use their underleveraged balance sheet for either a value-accretive acquisition, like Shire Pharmaceuticals, or the repurchase of up to 20% of their own stock. Under either scenario, we believe Allergan could be worth above $200 per share compared to Valeant's current offer of $172.

Portfolio Changes

With eerily quiet volatility and a market that is somewhere between fairly and over-valued, our friend, Mr. Manic-Depressive, hasn't provided many opportunities to deploy capital at highly attractive expected returns. Nevertheless, the Mar Vista investment team isn't sitting around twiddling our thumbs. Fat pitch opportunities can present themselves quickly and come from unexpected areas. Allergan, for example, sold off nearly 30% over a period of nine weeks last summer gifting us with an unexpected asymmetric opportunity.

We think another gift was handed to us this quarter when *Discovery Communications'* stock declined 20% from its highs. The company has built a wide and durable moat around non-fiction shows which generate greater economic profits due to the timelessness of documentaries (a *National Geographic* documentary from 2004 isn't dated unlike a *Friends* episode), lower production costs and content that is easily translatable for international markets. With the majority of revenue derived outside the U.S., Discovery should also benefit from its scale and exposure to faster growing international markets where pay

television penetration is almost one-half that of the US. We expect management to leverage the content across their global platform and compound free cash flow over 15% while returns on capital expand from 12% to 20% over our time horizon.

Adobe Systems was also a new buy during the quarter. We believe the market underappreciates its strong competitive position and higher lifetime value of each customer due to their transition from perpetual licenses to a subscription revenue model. This should drive more predictable revenue streams, a broader addressable market, stickier customers and more ubiquitous upgrade cycles. We believe the new model will further expand Adobe's durable moat as the standard operating system for the creative content ecosystem.

Note that both Discovery and Adobe, along with *Oracle* and *Mettler-Toledo*, deepen our stable of "cannibals," or companies that buy back large amounts of their own undervalued stock, reducing shares outstanding and increasing per share intrinsic value.

Standing on the Corner of Value and Growth

One of the more common questions we get during due diligence meetings is, "How can a growth manager justify owning businesses like Exxon and Berkshire Hathaway? Aren't they value stocks?" It is also among our favorite questions as it allows us to express our comfort as growth investors who also enjoy wearing the clothing of value investors – some might call it intellectual cross-dressing[*] but we consider it to be just intelligent investing.

Unlike the traditional definitions of growth which are based on revenue and earnings, our measure is based on the *growth of shareholder value*, or the reinvestment of capital that generates returns greater than its cost. Operating profits are an important component of that formula but how much capital is required to produce that growth is equally important. Growth will actually erode value if the profits aren't sufficient to compensate for the cost of additional capital required.

We tend to scratch our heads when it is suggested that Berkshire Hathaway is not a growth business; the collective earnings power of their wholly-owned and publically-traded stocks have compounded at a mid-teens rate over the last five and ten years compared to the S&P 500's earnings growth of 7% and 9%, respectively. This expansion in earnings isn't evident by looking at the typical income statement metrics but the information is there for those willing to dig into the financials. On top of this profit growth, Berkshire is able to employ capital that has almost no cost to it. Nearly $80 billion of float is on their books that has a *negative* cost of capital, since they get paid via underwriting profits to hold onto policy holder premiums. In the wrong hands, cheap capital could be dangerous as most business rollups have eventually proven. But in the hands of arguably the two greatest capital allocators of all time, the combination is nirvana for shareholder value creation.

Exxon also screens poorly using traditional growth metrics: production growth has been anemic and profits fluctuate with an unpredictable commodity price. But our framework identifies a business that has a corporate culture centered on generating excess returns on capital over nearly all time horizons. While it may take time to show up in revenue growth and earnings per share, we believe Exxon is on the cusp of a material acceleration in free cash flow and shareholder value growth. Over the last several years, Exxon has aggressively invested enormous capital in unproductive projects that are just now starting to yield high-margin barrels. As unit production improves and capital spending abates, returns on capital and free cash flow should accelerate which we believe is not reflected in the current stock price.

On average and over time, we think that owning these types of cross-dressers -- growth businesses masquerading as value stocks -- will lead to better than average outcomes.

Our Commitment to Our Investors

Though there are never guarantees in investing results, the Mar Vista team remains committed to the foundations of our success:

- Focus on the process, not the outcomes
- Emphasize capital protection as much as upside potential
- Think like rational business analysts first, not traders of individual stocks

---

[*] We are not clever enough to coin this term. Full credit goes to Warren Buffett in his 1992 Berkshire Hathaway shareholder letter.

- Identify good capital allocators that think and act like *Outsiders*
- Exploit the manic-depressive nature of Wall Street
- Take concentrated positions when the expected returns relative to the risks are favorable
- Align our economic incentives with our investors

As always, we appreciate the trust you have instilled in us as stewards of your capital. Our role as fiduciary is paramount to everything we do and open communication about how we are managing your capital is an important part of that responsibility.

Please let us know of any questions, comments or concerns you have. We look forward to the opportunity to discuss our investment philosophy and thoughts with you through these updates, conference calls and personal meetings. You can reach us by phone at 310.917.2800, via email at info@marvistainvestments.com or visit our website at www.marvistainvestments.com.

All the best,
The Mar Vista Investment Team

Mar Vista Investment Partners, LLC, a Delaware limited liability company, offers investment advisory services to individuals, pension and profit sharing plans, trusts, estates, corporations, as well as other institutional clients. Mar Vista also serves as a sub-adviser to Roxbury Capital Management, LLC ("Roxbury"), a Delaware limited liability company. Mar Vista has a contractual agreement with Roxbury through which Roxbury provides various administrative, operational, and business services, including trading, marketing, client service, compliance, and accounting. For purposes of compliance with GIPS®, Mar Vista has defined itself to not include bundled/WRAP fee accounts in the firm's assets. Mar Vista maintains a complete list and description of firm composites, which is available upon request.

On 7/12/07, Silas Myers and Brian Massey formed Mar Vista to manage various large-cap equity strategies. On 12/1/07, all of the assets under their management at Roxbury transitioned to Mar Vista through a sub-advisory arrangement. Information provided for the period from January 2004 through November 2007 represents the performance of portfolios managed by Mr. Myers and Mr. Massey while employed by Roxbury. Mar Vista claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Mar Vista has been independently verified for the periods 12/01/07 through 12/31/13. 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 Strategic Growth composite has been examined for the periods 12/31/03 through 12/31/13. The verification and performance examination reports are available upon request. Benchmark returns are not covered by the report of independent verifiers. For the entire period presented, Mr. Myers and Mr. Massey have been substantially responsible for the all the investment decisions of the large-cap equity strategies. Performance prior to 12/01/07 meets GIPS® portability requirements. ACA served as the verifier, conducted a verification and examined the composite's performance history that was ported over to Mar Vista prior to 12/01/07.

The Strategic Growth Composite was created 12/01/07, with an inception date of 12/31/03. All returns are based in U.S. dollars and are computed using a time-weighted total rate of return. The composite is defined to include all fully discretionary, fee paying portfolios with no minimum or maximum account value, managed in accordance with Mar Vista's Strategic Growth strategy, and that paid for execution on a transaction basis. Prior to 1/01/06, the composite was defined to include only taxable portfolios with no minimum or maximum value. One non-fee paying portfolio is included in the composite for the following periods: 0.2% of the composite's assets for year end 2008; 0.1% of the composite's assets for 2009; and 0.1% of the composite's assets for 2010; and 0.1% of the composite's assets for the period ending 9/30/11. Beginning 10/1/11 there are no longer any non-fee paying accounts in the composite. The results in the column marked Net of Fees for the periods 8/01/08 through the present, include a standard management fee applied to any non-fee paying portfolio for performance calculation purposes.

The primary benchmark is the Russell 1000® Growth Index, defined as an unmanaged, capitalization weighted index of those Russell 1,000 companies with higher price-to-book ratios and higher forecasted growth values. The secondary benchmark is the S&P 500® Index, defined as an unmanaged, capitalization weighted index of the common stocks of 500 major U.S. corporations. Index returns include dividends and/or interest income and, unlike composite returns, do not reflect fees or expenses. In addition, unlike the composite, which periodically maintains a significant cash position, the Russell 1000® Growth Index and the S&P 500® Index are fully invested. Investors cannot directly invest in an index. The dispersion in composite returns shown herein was measured using an asset-weighted standard deviation formula. Gross performance is net of all transaction costs, and net performance is net of any transaction costs, applicable performance-based fees and actual management fees, but before any custodial fees. All returns are calculated net of withholding taxes on dividends and interest. Actual results may differ from composite results depending upon the size of the portfolio, investment objectives and restrictions, the amount of transaction and related costs, the inception date of the portfolio and other factors. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Past performance is no guarantee of future results. Not FDIC insured, no bank guarantee, may lose value.

A complete list of portfolio holdings and specific securities transactions for the investment strategy during the preceding 12 months, the top contributors and underperformers calculation methodology and a list of every holding's contribution to the overall performance during the period is available upon request. The securities mentioned in this letter were held in the account of a Strategic Growth client that Mar Vista believes to be representative of the accounts that Mar Vista manages for this investment strategy during the period from March 31, 2014-June 30, 2014. Other Mar Vista clients managed with different investment objectives may hold different securities than those listed. The securities listed in this letter should not be considered a recommendation to purchase or sell any particular security. The reader should not assume that investments in the specific securities identified herein were or will be profitable. Risk data is being provided as supplemental to the Strategic Growth GIPS performance presentation, which is available upon request. Past performance is no guarantee of future results. Not FDIC insured, no bank guarantee, may lose value.