October 10, 2014

Twerking at the Fed

As quantitative easing comes to an end this month, we imagine the halls of the Federal Reserve could be filled with high fives, fist bumps and, if it weren't such a regal institution, maybe even a little celebratory twerking. For over five years, the domestic economy has leaned heavily on a Fed-engineered, abnormally low cost of capital that, at first, kept banks afloat and stabilized housing, but eventually abetted consumer spending, corporate investment and hiring, and culminated in a merger frenzy that is approaching $3 trillion so far this year. Recent evidence abounds that the patient is ready to stand on his own:

- New jobs are averaging 225,000 per month and unemployment is under 6% for the first time in six years.
- Household debt service payments as a percentage of disposable income, at under 10%, are at their lowest levels since the Fed started recording the data in 1980.
- The government budget deficit is down to 2.8% of GDP, below the average of the last forty years.
- Corporate margins continue to expand to all-time highs, nearly 10%, as labor and debt costs remain repressed.
- Most U.S. banks are well capitalized with capital ratios well above regulatory requirements.

Any discussion about the economy requires the obligatory "on the other hand…" Outside the U.S., developed economies continue to struggle from the financial crisis. Europe's more austere fiscal and monetary policies are failing to pull them out of their disinflationary malaise. Japan too is wallowing at less than 1% GDP growth and zero inflation, despite heavy rounds of stimulus. Meanwhile, developing economies outpace the rest of the world but are decelerating, particularly Brazil and China. Of course, the elephant in the room remains the impact the Fed's exit from the bond markets will have on interest rates and the domestic economy. The risk of a Japan-like decade with depressed rates and growth is equally balanced against the risk of an overheating economy with runaway inflation and rapidly rising rates.

With the S&P 500® Index up over 43% since its last down quarter (4Q12), over 80% since its last 10% correction (3Q11) and nearly 200% since the cyclical bottom (2Q09), the equity markets are betting on a decidedly favorable environment for stocks. Market valuations based on rosy expectations do not usually lead to outsized forward returns for equity investors. Recall the near nirvana environment as we entered the new millennium: the U.S. won the Cold War, oil cost only $20 per barrel, fiscal budget surpluses were perceived to be permanent, and technology was forever bending the productivity curve. Yet, equity returns over the ensuing decade were among the worst in history. Conversely, the early 80's started with high inflation, stifling interest rates, an energy policy that depended on unfriendly foreign governments, and deflated global influence for the U.S. Such an environment led to the greatest twenty-year bull run in history.

The Mar Vista investment team spends little time trying to figure out where the current market sits on that historical spectrum. Rather, we judge whether the market is expensive or cheap by the average margin of safety, or upside to fair value, of our portfolio. Currently, our portfolio's discount to fair value is at 12% and remains at the low end of our historical ranges (15-30%) over the last decade. Accordingly, our three to five year return expectations have not changed: returns should more closely correlate with our companies' per share intrinsic value growth (10-12% average with a range of 7% to 20% assuming a stable economic environment) and only a modest return from the discounted price. In other words, the compounding nature of our businesses should provide the excess returns in this type of environment.

Searching for Arks

Our investment decisions are not based on predictions for the economy, interest rates or inflation and we do not make directional bets in our portfolio based on those macro expectations. Rather, the investment team sticks to the Noah Principle: *Predicting rain doesn't count. Building arks does*. Our objective is to build a portfolio of companies that can adapt and extend their competitive advantages regardless of the externalities. We focus on the individual merits of the business, its ability to expand returns on capital and the price we pay relative to the value we receive.

With that framework, our largest positions exude those attributes: *American Tower, Berkshire Hathaway, Oracle, Honeywell, Transdigm* and, the most recent addition to our largest holdings, *Liberty Global.* They all generate annuity-like cash flows, can compound intrinsic value 10-20% annually, and possess "anti-fragile" attributes – management can exploit and extend the duration of competitive advantages in more stressed environments when others are struggling.

During the quarter, we sold three businesses, *Covidien, Boeing* and *Nike*, as each stock price approached our estimate of fair value. We reallocated the capital to three businesses that we think represented better risk-reward profiles: *TJX Companies*, *Precision Castparts* and *Core Labs*.

TJX Companies (TJX)

TJX has built an economic moat around its off-price retailing model and global inventory sourcing platform. We believe the off-price channel is a secular market share gainer and relatively immune from e-commerce disruption. TJX's unique business model sells inventory at 30% below retail and drives 40% faster turns that the typical retailer. As a result, returns on invested capital and free cash flow conversion are well above the retail industry. Carol Meyrowitz and her team have a long track record as effective capital allocators and store operators in both good and bad retail environments. Their discipline will be critical in exploiting the global opportunity to expand to more than 5,000 stores from just over 3,000 today. TJX is cannibalistic with a consistent buyback representing 3-4% of the shares outstanding per year.

Precision Castparts (PCP)

Precision Castparts has an unmatched position in aerospace supply as many of its highly complex aircraft components can only be produced by a few, if any, competitors while exceedingly high switching costs create prohibitive barriers to entry. The primary driver of revenue and profit growth is PCP's significant aerospace exposure which is in the midst of the biggest upcycle since the 1950's. Management has demonstrated a unique talent for acquiring businesses, operating them more efficiently and driving attractive returns on investment. We think this will continue and lead to margin and ROIC improvements ahead of consensus expectations. The recent price decline in PCP shares was driven by lower than expected results in six of the last eight quarters. We believe PCP will, over time, see 5-7% organic revenue growth 13-15% free cash flow growth through the end of the decade.

Core Labs (CLB)

With incremental operating margins over 35% and returns on invested capital that exceed 60%, Core is well rewarded for its proprietary reservoir description and production technologies. The company possesses one of the most durable competitive advantages in oil field services and, as existing oilfields mature and production wanes, the value of Core's services only increases. Given the increasing difficulty of finding new oil reserves, maximizing the value of existing reservoirs is critical to producer economics. We've long been admirers of Core's position in the oilfield service value-chain but the stock rarely represented an appropriate valuation. The stock price recently dropped almost 40% due to project delays and concerns that weaker economic growth and a stronger dollar will impact oil prices. While shorter-term results will be determined by the price of the commodity, we believe that, over time, the business is well positioned to benefit from powerful secular trends and will generate high-teens intrinsic value growth.

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 stock
- 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

Strategic Growth Annualized Net Returns as of September 30, 2014

	Net	S&P 500	Alpha	R1000G	Alpha
3Q 2014	-0.2%	1.1%		1.5%	
Year-to-date	9.8%	8.3%		7.9%	
1 Year	21.3%	19.7%	0.50	19.2%	1.64
3 Years	23.3%	23.0%	-0.14	22.5%	2.57
5 Years	14.5%	15.7%	0.09	16.5%	0.07
7 Years	8.3%	6.0%	3.09	7.6%	2.08
Since Inception	8.5%	7.7%	2.01	8.0%	2.15
“Peak-to-Peak”	9.0%	6.8%	3.11	8.0%	2.44

** Peak-to-Peak represents returns generated January 1, 2008 through September 30, 2014.*

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 June 30, 2014-September 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.