April 2016

Active Managers Can't Jump (so Invest with the Seven-Footers)

In streetball parlance, active managers have thrown up enough bricks to host a masons' convention. Marking the worst relative quarter since 1998, less than one-in-five large cap managers, and only 6% of large cap growth managers, outperformed the S&P 500® Index in the first quarter of 2016. We don't put much weight on just three months of performance data but, despite what Mark Twain writes, statistics don't lie: fewer than one-quarter of managers outperform their benchmarks over the long-term. With such disappointing outcomes, the economic value of our profession will remain in question and cheap beta will look relatively attractive.

While it is a fact that the average investment manager doesn't outperform (just as the average person can't dunk), does there exist an identifiable subset of skilled investors (or basketball players) that can beat the averages? In basketball, the answer is easy. A group of seven-footers will obviously enjoy a higher propensity to dunk than the general population.

But where are the equivalent of seven-footers in active management? Martijn Cremers and Ankur Pareek answered that question in their study "Patient Capital Outperformance: The Investment Skill of Active Managers Who Trade Infrequently."[1] According to their research, the necessary conditions for outperformance require both high-conviction, as measured by holdings that differ substantially from the benchmark, and patience, as defined by portfolio turnover. The professors found that institutional managers holding both characteristics outperformed in general by more than 2% annually, before fees.

Managers possessing either trait, let alone both simultaneously, are rare. Over the last three decades, average active share, the percentage of holdings that differ from the benchmark, has shrunk to 60% from 75% in 1980. In other words, we have become a profession of largely "benchmark huggers." Turnover, an inverse measure of patience, has increased even more dramatically with the average holding period dropping from five years in the 1970's to under twelve months today. Such short time horizons lie more in the realm of *speculation* than *investing*.

But merely sitting for years on a portfolio of low-quality, overvalued stocks that aren't in the benchmark won't lead to good outcomes. We would dovetail Cremers and Pareek's study with other research suggesting preservation of capital-focused, value-based, and owner-oriented investment strategies as other key attributes of durable value-creating managers. One may recognize the shared values with Warren Buffett's mythical intellectual village, Graham-and-Doddsville. He had it nailed thirty years ago.

By design and disposition, Mar Vista's strategies align with these characteristics and, over a full investment cycle, the outcomes. We manage a decidedly high-conviction and patient strategy with 85%+ active share and an average turnover of ~35-40%, while our holding period for a business averages five years. In the face of continued challenges for active managers, Mar Vista has built, we believe, resilient analytical and behavioral advantages common amongst *active managers that can jump*…just don't expect us to dunk a basketball.

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[1] Cremers, Martijn and Ankur Pareek. "Patient Capital Outperformance: The Investment Skill of Active Managers Who Trade Infrequently." September 2014.

A Dream Team of Capital Allocators

"After ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business."

-- *Warren Buffett, 1987 Shareholder Letter*

As Buffett's quote implies, the higher a business' returns on capital and the longer one's investment horizon, the more management's capital deployment strategies will influence *per share intrinsic value growth*. Accordingly, Mar Vista's investment team spends an inordinate amount of time assessing and debating the capital allocation skills of, and opportunities for, our companies' management. Protecting, widening and extending the duration of competitive advantages via skillful capital allocation, and possessing the "capacity to suffer" to the benefit of long-term returns, are simply among the most important skills we look for in management. As we have discussed in prior letters on *Outsider*-type[2] management teams, our CEOs adroitly steer at the helm of advantaged business models.

For example, *Mettler-Toledo*'s deeply ingrained shareholder-focused culture and competitive advantages (economies of scale, intellectual property, switching costs) manifest themselves in clearly superior financial results. While earnings per share have grown more than five-fold since 2004, only 44% more capital is invested in the business. As a result, returns on capital have expanded from 13% to 32% during that time period. Using Buffett's framework, under CEO Olivier Filliol's leadership since 2008, Mettler has generated $1.9 billion in excess capital or 65% of the total capital invested. Nearly all the capital was redeployed towards repurchasing undervalued stock (shares outstanding are down by more than 20%) driving sustainable mid-teens per share intrinsic value growth.

While in a completely different industry, *Intuit*'s financial model is similar to Mettler's. Software platforms in tax (TurboTax) and small business accounting (QuickBooks) require minimal capital creating a powerful engine that has provided $7.5b of cash since 2008. CEO Brad Smith has returned 85% of the excess capital to shareholders via repurchases and dividends helping to drive mid-teens per share intrinsic value growth.

TransDigm's capital deployment strategy is decidedly different from Mettler and Intuit's, but even more effective. An aggressive series of moat-expanding and value-creating tuck-in acquisitions has built TransDigm into an aerospace giant. During CEO Nicholas Howley's ten-year tenure, the capital base has increased four-fold as operating profits have expanded seven-fold lifting returns on capital from 7% to over 13%. TransDigm's formula for success: rapidly expanding excess capital generation + high incremental returns on reinvested capital = high-teens compounding of intrinsic value.

Following Berkshire Hathaway's well-designed blueprint, *Markel* has built a unique compounding machine that combines intelligent underwriting of risk with disciplined investing. This tax-efficient, levered investment vehicle benefits from the power of permanent and negative-cost capital (i.e., insurance float) and the talents of a capable and honest management team that reinvests all the excess capital back into investment portfolio. Tom Gayner, Co-CEO, and Steve Markel, Vice Chairman, have developed a long track record of prudent underwriting and tremendous investment returns. The public equity portion of Markel's investment portfolio has outperformed the S&P 500® Index by 2% per year for the last twenty years. As a result, book value has compounded at a 20% rate since 1986. Despite a more challenging insurance and interest rate environment, we think Markel can grow per share intrinsic value at 10-15% annualized rates over the next decade.

Portfolio Changes

During January, our portfolio's down market capture was only 65-75% of the market so the risk-reward across the portfolio did not change materially and our cash levels remained elevated. Our process triggered no new buys and we only deployed

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[2] Thorndike, William. *The Outsiders: Eight Unconventional CEOs and Their Radical Blueprint for Success*. Boston, Harvard Business Review Press, 2012

more capital in one stock, *U.S. Bank* (USB), below $40. Our USB thesis remains that, even in our more pessimistic scenarios with 1-2% GDP growth and depressed interest rate spreads, the bank's industry-leading 14%+ return on equity, conservative underwriting policies and substantial 75% payout ratio will produce high-single digit total returns. Scenarios that are more probable skew toward meaningfully higher gains as loan growth, interest rates, fee income and returns on equity improve over our investment horizon.

After huge stock appreciation, we trimmed most of our *Amazon* position in November and we liquidated the rest of the investment on the first trading day of this year. We also trimmed *TJX* as recent gains reduced expected returns. Finally, we received cash for *Precision Castparts* on the completion of Berkshire Hathaway's acquisition.

With the relatively flat performance during the quarter, our average margin of safety, or discount to intrinsic value, remained 15%, which is at the low end of historical ranges. Valuations for both our universe of durable franchises as well as the market overall suggest more muted returns over our investment horizon. As a result, we continue to expect the compounding of per share intrinsic value (10%-12% average) will drive future returns with less impact from the convergence of stock price and fair value.

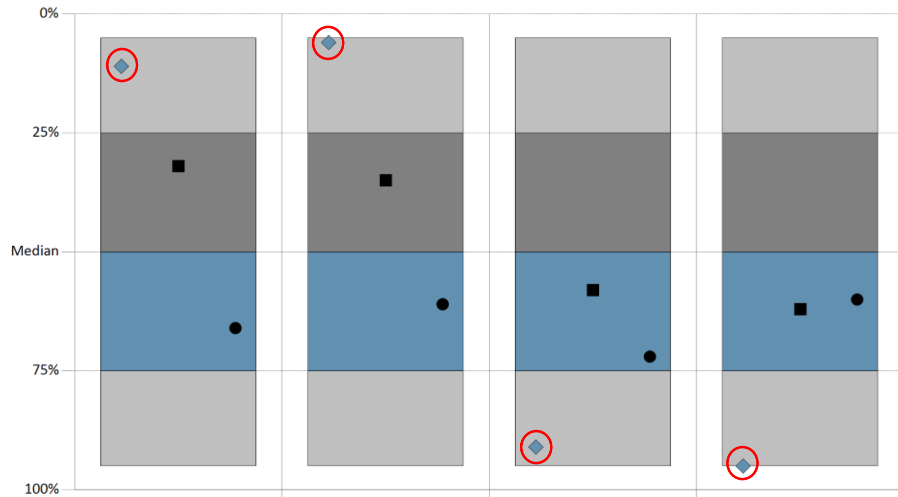
Performance

After a historically tumultuous start to the year, equity markets around the world staged a massive comeback to end the 1st quarter of 2016 on a positive note. Boomeranging sentiment over global growth, particularly in China, diverging central bank policies and the risk of an extended earnings recession caused the S&P 500® Index to experience its first intra-quarter decline of 10% with a finish in the black since 1933.

We should highlight that in late April the ***current bull market will become the second longest in history***, exceeding 2,607 days. Only the October 1990 through March 2000 tech-led, uber-bull market exceeds the current duration. Since the bottom in March 2009, the market's resiliency and lack of a sustained correction despite economic uncertainties and weak profit growth has been both remarkable and concerning.

For the 1st quarter, Mar Vista's Strategic Growth portfolio (+1.5%, net of fees) exceeded the returns of both the Russell 1000® Growth Index (+0.7%) and the S&P 500® Index (+1.4%). Our leaders were *Kansas City Southern* (+15%), *TJX* (+11%) and *Berkshire Hathaway* (+7%), while *Allergan* (-14%), *Sensata Technologies* (-16%) and *Mondelez* (-10%) lagged.

Judging whether our, or any manager's, returns are due to skill or luck is a challenging task. Over shorter periods, returns are largely a random walk. Over the longer term, the road to alpha generation is bumpy and typically marked by extended periods of underperformance. However, a manager's skill should be more evident over a full market cycle, which we would define as "peak-to-peak." The chart on the next page is an unambiguous report card of Mar Vista's peer ranking for each of the key components of our outcomes since the prior market peak: Total Returns, Alpha (excess returns relative to the level of risk incurred), Beta (volatility relative to the market) and Down Market Capture or "DMC" (measure of protection of capital).



	Returns	Rk	Alpha[1]	Rk	Beta[1]	Rk	DMC[1]	Rk
5th percentile	9.60		2.20		1.20		121.10	
25th percentile	8.26		0.50		1.07		110.02	
Median	7.34		-0.58		1.02		102.68	
75th percentile	6.07		-1.76		0.96		96.54	
95th percentile	4.10		-3.72		0.83		79.41	
# of Observations	287		287		287		287	
Strategic Growth	9.00	11	2.15	6	0.85	91	79.61	95
Russell 1000 Growth	7.91	32	0.00	35	1.00	58	100.00	62
S&P 500	6.49	66	-1.07	61	0.97	72	100.51	60

Results displayed in US Dollar (USD)

[1] Russell 1000 Growth

The risk-return profile is consistent with the goals of Mar Vista's process: generate value for our investors (Alpha = 6th percentile) through superior compounding of capital (Absolute Returns = 11th percentile) while incurring less risk (Beta = 91st percentile) and better capital protection (DMC = 95th percentile).

Mar Vista's 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
- 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
- Expand our circle of competence and latticework of mental models
- 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 Returns as of March 31, 2016

	Net	S&P 500®	Alpha	R1000®G	Alpha
1 Year	2.2%	1.8%	0.89	2.5%	0.18
3 Years	13.5%	11.8%	2.31	13.6%	1.02
5 Years	12.9%	11.6%	1.92	12.4%	1.34
10 Years	8.4%	7.0%	2.42	8.3%	1.68
Since Inception	8.3%	7.4%	2.11	8.0%	2.00
"Peak-to-Peak"	8.7%	6.5%	3.04	7.9%	2.15

Focus Annualized Returns as of March 31, 2016

	Net	S&P 500®	Alpha	R1000®G	Alpha
1 Year	2.3%	1.8%	0.76	2.5%	-0.03
3 Years	13.6%	11.8%	2.18	13.6%	0.56
5 Years	13.0%	11.6%	1.93	12.4%	1.23
10 Years	8.8%	7.0%	2.84	8.3%	1.91
Since Inception	10.0%	8.8%	2.50	9.5%	2.13
"Peak-to-Peak"	8.9%	6.5%	3.30	7.9%	2.22

** Peak-to-Peak represents returns generated January 1, 2008 through March 31, 2016.*

Global Equity Annualized Returns as of March 31, 2016

	Net	MSCI World® (Net)	Alpha
1 Year	-2.0%	-3.5%	1.86
3 Years	7.4%	6.8%	2.22
Since Inception	10.4%	10.4%	2.54

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 Mar Vista jointly owns its back office service provider, Roxbury Capital Management, with Hood River Capital Management, a registered investment advisor. Roxbury provides various administrative, operational and business services. 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.

Mar Vista claims compliance with the Global Investment Performance Standards (GIPS®).

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 Focus composite was created 12/01/07, with an inception date of 12/31/02. 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, taxable and tax-exempt portfolios with no minimum or maximum account value, managed in accordance with Mar Vista's Focus strategy, which is a concentrated portfolio invested in 15 to 20 equities, and that paid for execution on a transaction basis. Effective 10/1/05, portfolios with directed commissions were excluded from the composite. Prior to 4/1/04 the composite was defined to include tax-exempt portfolios with a minimum portfolio value of $500,000. From 12/31/02 forward, the composite includes portfolios without restrictions and also portfolios with minor restrictions that affect up to a maximum of 5% of the portfolio's value based on the cost of the restricted securities at the time of purchase by other similarly managed portfolios. One non-fee paying portfolio is included in the composite for the following periods: 16% of the composite's assets for year end 2004; 100% of the composite's assets for year end 2005 and 2006. Three non-fee paying portfolios are included for the following periods: 42% of the composite's assets for year end 2007; 17% of the composite's assets for year end 2008; 19% of the composite's assets for 2009; 0.1% of the composite's assets for 2010; 0.1% of the composite's assets for 2011; 0.1% of the composite's assets for 2012; 0.1% of the composite's assets for 2013; 0.1% of the composite's assets for 2014; 0.1% of the composite's assets for 2015; 0.1% of the composite's assets for Q1 2016. The results in the column marked net of fees for the periods 4/01/04 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. 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 is fully invested. Investors cannot directly invest in an index. 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 S&P 500® Index is 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. The firm's Strategic Growth and Focus fee schedule is as follows: First $25 million – 0.75%; Next $25 million - 0.60%; Next $50 million – 0.50%; Over $100 million - Negotiable. Special circumstances may cause fees to vary from this schedule and Mar Vista reserves the right to negotiate fees with clients. Fees are payable quarterly in arrears or advance based on 1/4th of the annual rate.

The Global Equity composite was created in 2012, with an inception date of 12/31/11. 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, taxable and tax-exempt portfolios with no minimum or maximum account value, managed for at least one month in accordance with Mar Vista's Global Equity strategy, which is a portfolio invested in 15-30 equities, and that paid for execution on a transaction basis. The benchmark is the MSCI World Index. Two non-fee paying portfolios are included in the composite for the following periods: 100% of the composite's assets for 2012; 100% of the composite's assets for 2013; 100% of the composite's assets for 2014; 100% of the composite's assets for 2015; 100% of the composite's assets for Q1 2016. The results in the column marked Net of Fees for the periods 1/01/12 through the present, include a standard management fee applied to any non-fee paying portfolio for performance calculation purposes. The benchmark is the MSCI World Index, defined as a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 23 developed market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. In addition, unlike the composite, which periodically maintains a cash position, the MSCI World Index is 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. Three non-fee paying accounts are net down by the maximum fee. 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 and a presentation that complies with GIPS® for each strategy mentioned are available upon request by contacting Mar Vista directly at (310) 917-2800 or by emailing at info@marvistainvestments.com. 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 December 31, 2015-March 31, 2016. 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, Focus and Global Equity GIPS® performance presentations, which are available upon request. Past performance is no guarantee of future results. Not FDIC insured, no bank guarantee, may lose value.