MAR VISTA
INVESTMENT PARTNERS

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The Voting Machine

The nature of risk is such that, in the succinct words of Professor Elroy Dimson from the London School of Economics, “more things can happen than will happen.” A poker player estimates the odds of various outcomes and bets accordingly, but once the next card is revealed, the probabilities and payoffs can change dramatically.

The election was just such a (Trump) card revealing moment for the markets. The surprising Republican sweep and their pro-business agenda altered the potential trajectory for the US economy while leaving a gaping hole around the issue of global trade. After lagging since the Great Recession, businesses with underutilized capital (i.e., low ROIC), reliance on weak economic trends and high U.S. tax rates spiked on the potential for business-friendly changes. Banks, long suffering from low interest rates, anemic loan demand and burdensome regulations, rallied 20%+ in a few weeks anticipating the inverse of those factors. On the other end of the spectrum, companies less dependent on macro drivers for growth – those with global secular trends, high returns on capital and lower tax rates – generally trailed the benchmarks in the weeks after the election. [1]

As Ben Graham suggested, the market is a voting machine in the short-term with prices being determined by popularity, momentum and emotion, not necessarily a rational analysis of intrinsic value. But, over time, the market is a weighing machine that gets fair values generally correct. Businesses benefiting from an inflection in GDP growth or interest rates may enjoy a quick revaluation as expectations reset, but a company’s moat, incremental returns on capital and growth plans are what drive sustainable value creation over long periods.

Our outlook for the new environment and its impact on our investment universe’s future is balanced. We recognize the pivot to a pro-business agenda could lift both animal spirits and interest rates from historically low levels. But we also acknowledge the depressing impact higher interest rates have on valuations. Unlike the early 1980s, when interest rates were double-digits and multiples were at single-digits, we begin this era with basement-level interest rates and attic-level market valuations (see Shiller P/E, Total Market Value to GDP, median P/E). The economic cycle is now approaching eight years in duration with sub-5% unemployment and accelerating wage growth. Adding stimulus this late in the cycle could have unintended consequences for inflation, currencies and interest rates.

With that in mind, Mar Vista’s decision-making process at these inflection points has been consistent over the last fourteen years. Our focus is not to figure out the next turn in government policy, the economy or the market – the odds of doing that consistently are extremely low. Instead, we use our extensive fundamental research and valuation

[1] We found the following data from Eric Bush, CFA of Gavekal Capital interesting: January 9, 2017

“The fundamental factor that has had the highest r-squared value to the stock market over the past three months is return on equity (ROE). The top three deciles of stocks with the highest ROE have only returned about 0.4% (in USD) while the bottom three deciles of stocks with the lowest ROE have returned 4.7%. Similarly, stocks with the lowest sales growth have outperformed stocks with the highest sales growth by nearly 8% in just three months. Stocks with the lowest sales growth have returned 7% while stocks with the highest sales growth have returned -0.9%. Lastly, stocks with the highest net debt as a % of total capitalization have completely trounced all other stocks during this period as well. The decile of stocks that have the most debt have returned 9% over the past three months while the average return for the other nine deciles is just 1.3% and stocks with the least amount of debt have fallen by -1.4%. **All in all, the rally in developed market equities over the last three months has been clearly led by stocks with the shakiest fundamentals.”** http://blog.gavekalcapital.com/?p=12540 analysis to identify competitively advantaged businesses that have copious reinvestment opportunities, smart capital allocators at the helm and a disconnect between their stock price and our estimate of intrinsic value.

Portfolio Changes

With the turn of the new election card, our revised scenario analysis bumped up fair value on most of the cyclical, interest rate sensitive and high U.S. tax paying businesses in our investable universe. Among these businesses, no material changes were made to the portfolio as the stock prices largely reflected our revised analysis. For example, our higher return on capital and growth assumptions for *U.S. Bank*, as well as the other wide-moat banks in our universe, increased our estimated value by approximately 15-20% but the stocks generally moved commensurately.

After only two new purchases in the first three quarters of 2016, three businesses were added to our portfolio in the fourth quarter:

Buy: Fortive Corporation

Fortive Corporation was added to our universe in June when it spun off from its parent company, Danaher Corporation. Its portfolio is comprised of market-leading brands and businesses with exposure to positive secular trends such as environmental regulations, energy efficiency, safety and security, connected devices and software and digital services. The company boasts a strong margin and free cash flow profile. Gross margins are in the high 40% range and operating margins are in the high teens/low 20s while free cash flow converts at a rate greater than 100% of net income.

A hallmark of the "Old Danaher" business strategy was identifying and acquiring high margin quality businesses with a large percentage of recurring revenue and employing the Danaher Business System (DBS) to improve them each year. Most of the M&A activity was done in the Life Sciences segment over the past decade while activity in the industrial (Fortive) segment was on hold for close to five years. With its new independence, Fortive will restart the acquisition engine. As part of its strategy for future growth, management will adopt DBS and rename it the Fortive Business System employing the same principles as its predecessor.

The management team had a long tenure with Danaher prior to the spin off and is well versed in the art of value creation over the long-term. CEO Jim Lico ran DBS at Danaher for a stint of time, which will give them a leg up as they restart the acquisition flywheel. Most importantly, they view themselves in partnership with shareholders and are compensated on their ability to grow returns as opposed to empire building.

Buy: Moody's Corporation

After a multi-year hiatus as shareholders, we re-initiated a position in Moody's. Their competitively advantaged "toll booth" model generates high margin fees for assessing the creditworthiness of global borrowers. We believe concerns over the debt cycle and the impact new tax policies will have on the cost of and demand for debt caused the stock to trade at a modest discount to fair value.

Moody's secular growth opportunities are long-tailed. Demand for debt ratings should exceed global GDP growth as credit markets in both the developed and developing markets replace unrated bank loans with bonds. Currently, only approximately 20% of outstanding debt in Europe is in bonds with the remainder from bank loans. In the U.S., almost half of all debt are rated bonds. Moody's Analytics will add another 2-3% to overall growth as they sell more data, products and services to their financial institution client base.

Moody's multi-faceted moat was bent and bruised during the financial crisis, but not broken. First, barriers to entry are prohibitively high as the fragmented number of issuers and investors only want to deal with the established rating agencies. The market coalesced around Moody's and S&P (80%+ market share) with Fitch (14%) and others (4% share) distant competitors. Regulators and competitors have tried to break the duopoly by easing the entry for new competitors with little success. Second, Moody's offers a very clear value proposition to issuers providing cover for sustainable 3-4% pricing power. Issuers pay around six basis points for Moody's rating and save 25 to 50 basis points on their interest rate compared to an unrated bond. Finally, Moody's enjoys a network effect as wider usage of a "standard" ratings system by investors increases the value of the rating. This has a larger impact on the yield, further increasing the ratings' utility and value.

Ray McDaniel (CEO) and Linda Huber (CFO) have proven their operating and capital allocation skills since they started their roles in 2005. Moody's gushes about 30 cents of every $1 in revenue as free cash flow that is returned to shareholders in the form of share repurchases. Management has reduced shares outstanding by more than one-third over the last decade, adding Moody's to our long list of "cannibal" businesses.

Buy: Facebook

Facebook connects and engages 1.8 billion monthly active users, almost half of the world's internet population, providing a powerful network effect that can be monetized through native advertising. Corporations use Facebook's content platform to build brand awareness and interest among global consumers. As users interact with these advertisements, network effects improve their marketing effectiveness. This virtuous cycle drives up data asset values leading to additional advertising allocations for Facebook. Approximately 40% of all incremental digital advertising budgets are currently being directed towards Facebook.

Since brand marketing represents the largest share of advertising, we think Facebook's 14% digital market share can double by taking allocations away from linear TV. Historically, brand advertising mainly occurred on television. As time spent online surpasses TV viewership, advertisers are migrating their marketing budgets online. With increasing evidence that Facebook campaigns generate higher returns on advertising capital, the company is well positioned to compound intrinsic value by 15-20%.

Facebook's stock declined over 14% in the quarter after management informed investors that the law of large numbers will cause revenue growth to slow in 2017. Additionally, the company announced that it will aggressively invest in several new revenue growth drivers such as digital video, artificial intelligence, and messaging monetization. Although shortsighted investors were clearly disappointed by these announcements, we applaud management's commitment to investing in new monetization opportunities. Effective capital allocators should be willing to invest in value accretive projects at the expense of short-term profits. In our opinion, the 38% decline in Facebook's valuation multiple over the past year substantially undervalues the company's reinvestment opportunities.

Sold: B/E Aerospace

In October, Rockwell Collins announced their intention to acquire B/E Aerospace for a 20%+ premium to its closing price. While we appreciate the combined companies' broader scale, the full valuation led us to sell the position.

Performance

For the 4th quarter and the full year, Mar Vista's Strategic Growth strategy (-0.57% and +6.31%, respectively, net of fees) lagged the returns of both primary benchmarks (Russell 1000® Growth Index and S&P 500® Index). Most of the underperformance occurred during the few weeks after the election when many of our wide-moat serial compounders underperformed the price spike in lower-quality cyclical businesses. Please see the attached table for more performance metrics.

As is the nature of highly concentrated strategies, our performance can be decidedly out of step with the market when our types of businesses are not in favor. The following group, which we have owned an average of five years and comprise almost one-third of our portfolio, each declined between 3-10% during the quarter: *American Tower, TransDigm, Markel, Pepsi, Unilever, Allergan, Adobe Systems, Visa and Ecolab*. We believe the earnings power for each of these businesses will be substantially larger and their stock prices will more appropriately reflect the value creation over our long time horizon. Our investments in energy and financials rallied during the quarter: *U.S. Bank* (+20%), *Berkshire Hathaway* (+13%), *Schlumberger* (+7%) and *Core Laboratories* (+7%). B/E Aerospace appreciated 17% on the Rockwell Collins acquisition announcement.

Over time, the expected returns of our portfolio should reflect two components: (1) the intrinsic value growth of our businesses and (2) the discount we are paying relative to fair value. There will be times when the sentiment pendulum swings towards optimism; portfolio returns exceed the underlying intrinsic value growth, and margins of safety contract. Conversely, fear, skepticism and lower stock prices provide opportunities for both higher expected returns and less risk. Judged by our relatively narrow average margin of safety, or discount to intrinsic value, we think the pendulum sits on the more optimistic side of the scale. The 15% portfolio average discount continues to be at the lower end of the last decade and the number of stocks that are trading below our estimate of fair value is smaller than is typical.

Our team claims no special skill in predicting the market's direction but, in the fullness of time, we believe a patient, high-conviction portfolio comprised of competitively advantaged business with stock prices that represent an appropriate margin of safety will generate excess risk-adjusted returns. We remain diligent in adjusting our scenarios for new information and patiently waiting for uncovered opportunities in our wide-moat universe.

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 may 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 December 31, 2016

	Net	S&P 500®	Alpha	R1000®G	Alpha
1 Year	6.3%	12.0%	-1.80	7.1%	1.66
3 Years	8.5%	8.9%	1.00	8.6%	0.79
5 Years	14.3%	14.7%	0.25	14.5%	1.31
10 Years	8.2%	6.9%	2.24	8.3%	1.39
Since Inception	8.2%	7.7%	1.69	8.0%	1.87
"Peak-to-Peak"	8.5%	7.1%	2.35	8.0%	1.94

Focus Annualized Returns as of December 31, 2016

	Net	S&P 500®	Alpha	R1000®G	Alpha
1 Year	5.8%	12.0%	-2.27	7.1%	1.09
3 Years	8.8%	8.9%	0.66	8.6%	0.20
5 Years	13.8%	14.7%	-0.12	14.5%	0.67
10 Years	8.4%	6.9%	2.53	8.3%	1.49
Since Inception	9.8%	9.1%	2.03	9.4%	1.94
"Peak-to-Peak"	8.6%	7.1%	2.50	8.0%	1.90

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

Global Equity Annualized Returns as of December 31, 2016

	Net	MSCI World (Net)	Alpha
1 Year	1.4%	7.5%	-2.85
3 Years	3.1%	3.8%	0.76
Since Inception	9.1%	10.4%	1.08

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. 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 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 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 September 30, 2016-December 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.