MAR VISTA

Focus

Portfolio Commentary | March 31, 2024

Summary

- The S&P 500® Index ("S&P 500®") had its best first-quarter performance since 2019. Resilient corporate profits, enthusiasm around AI and expectations for interest rate cuts drove stock prices higher.

- Everything from stocks to bitcoin to gold marched higher. Over half of the S&P 500® companies hit new 52-week highs, with AI-related firms leading the charge. Nvidia's stock price surged over 82%, adding more than $1 trillion to its market value in the first quarter.

- Mar Vista's Focus strategy returned +5.53% net-of-fees in the first quarter of 2024. The Russell 1000® Growth Index and the S&P 500® Index returned +11.41% and +10.56%, respectively.

- The first quarter's top contributors were Walt Disney, TransDigm Group, and Microsoft. The top detractors were Adobe, Nike, and Apple.

- We established a new investment in Danaher and added capital to Adobe. Apple's robust performance over the years led to a modest trim, while lower conviction in Honeywell prompted liquidation.

- The stock market's early surge surpassed even optimistic predictions. Historically, strong first quarters for the S&P 500® often translate to positive years, making the current situation promising.

Commentary

The first-quarter performance of the S&P 500® was its best since 2019. Resilient corporate profits, enthusiasm around AI and expectations for interest rate cuts drove stock prices higher. The economy continues to defy expectations and recession worries have weakened.

In a broad market rally, everything from stocks to bitcoin, and even gold, saw significant gains. Over half of the S&P 500® companies reached new 52-week highs, with artificial intelligence (AI)-related firms leading the surge. Nvidia, a frontrunner in developing AI chips, is a prime example of this trend. Nvidia's stock price soared over 82%, adding more than $1 trillion to its market value in the first quarter. This gain represents roughly one-fifth of the total gains for the global stock market during that period.

A Goldilocks economy underpins equity markets. Consumers are spending and unemployment remains below 4%. Investor sentiment remains optimistic and monetary policy is turning more favorable. Solid corporate fundamentals are expected to translate into a third consecutive quarter of earnings growth for S&P 500® companies. Analysts project a healthy 11% increase in S&P 500® profits for the entire year, suggesting that the stock market rally has room to run.

Performance Review

Mar Vista's Focus strategy returned +5.53% net-of-fees in the first quarter of 2024. The Russell 1000® Growth Index and the S&P 500® Index returned +11.41% and +10.56%, respectively. Stock selection within information technology, industrials, and real estate negatively impacted performance during the quarter. **Walt Disney, TransDigm Group,** and **Microsoft** were among the portfolio's top contributors for the quarter, appreciating +35.52%, +21.75%, and +12.09%, respectively. Alternatively, our investments in **Adobe, Nike**, and **Apple** were among the portfolio's bottom detractors for the quarter, detracting -15.42%, -13.12%, and -10.82%.

Walt Disney's latest financial results displayed considerable progress, leading to an increase in stock price. The most noteworthy factor was the improved performance of its streaming business. With media profitability recovering, management is optimistically guiding for 20% earnings growth in 2024. This positive outlook is also supported by lower costs and robust performance from its parks division.

Walt Disney's streaming service is on track to become profitable by its fiscal fourth quarter. This aligns with our original investment thesis, which expected the direct-to-consumer (DTC) business to move from a loss of $2 billion to a profit of $1 billion. Even after the recent stock price increase, Walt Disney remains undervalued relative to Netflix. We expect this gap to shrink as its streaming business matures and becomes increasingly profitable over the next few years.

TransDigm delivered another impressive quarter, exceeding analysts' expectations for both earnings and profitability. Its gross and EBITDA margins widened significantly, driven by strong performances in commercial aerospace and defense. Revenue growth in commercial aerospace aftermarket parts (+27%) and new defense orders were key contributors to this outperformance. Management responded by raising the full-year 2024 forecasts for revenue and profitability.

Continued growth in both defense and commercial aftermarket should be fueled by recovering passenger traffic, higher aircraft utilization, and a strong bookings backlog. With domestic travel exceeding pre-pandemic levels and international travel nearing full recovery, TransDigm appears well-positioned for continuous growth. This, combined with its efficient operations, should drive long-term stock price appreciation.

Microsoft continues to occupy a strong position, poised to capture market share as businesses navigate the transition to a digital-first landscape and embrace generative AI-driven solutions. The company's commanding presence in the enterprise arena, combined with its comprehensive product portfolio encompassing Infrastructure-as-a-Service (IaaS), Platform-as-a-Service (PaaS), and Software-as-a-Service (SaaS), establishes it as a crucial provider of IT solutions for companies of all sizes.

Microsoft is effectively executing its strategy in a sizable market by offering a roadmap for digital transformation and adoption of AI-driven solutions, such as ChatGPT, while enhancing productivity and reducing costs. Consequently, we anticipate that Microsoft's solutions should exhibit resilience even in a more challenging macroeconomic environment, supporting low double-digit growth in intrinsic value within our investment horizon.

Despite underperforming during the quarter, **Adobe** remains a powerful player in the creative professional market. We believe the company is well-positioned to capitalize on two key trends: the ongoing shift towards digital commerce and the rise of generative AI.

Adobe stands out as an early leader in generative AI, offering both standalone solutions like Firefly and integrated features within established products like Photoshop. This puts them ahead of the curve, attracting both creative professionals and marketing teams within corporations. As a result, Adobe is experiencing strong bookings growth in the mid-teens, which translates to healthy revenue, earnings, and cash flow. Based on these factors, we project continued intrinsic value growth for Adobe in the low-to-mid-teens range over our investment horizon.

Nike's recent earnings report was a mixed bag. While revenue met expectations and earnings exceeded them, the stock price dipped due to management's cautious outlook for fiscal 2025. The company is currently undergoing a period of internal restructuring and product line adjustments, which is expected to lead to flat revenue growth in the first half of the coming fiscal year. However, this transition aims to position Nike for long-term success.

Our conviction in Nike remains high, and we expect it to emerge stronger and more competitive once the restructuring is complete despite the softer revenue forecast. Nike still anticipates earnings will grow around 10% in calendar 2024 and will accelerate to 15% in 2025 as execution normalizes.

Apple's stock was pressured in the quarter as investors fretted over softening demand for smartphones, regulatory action from the US Department of Justice, and the Chinese government mandates restricting iPhone use by government officials. Despite these near-term headwinds, we continue to believe the company remains competitively advantaged and benefits from the Apple ecosystem, which has an installed base of over 2 billion devices and over 1 billion paying subscribers. We believe the Apple ecosystem will support a more predictable cash flow stream, which should grow intrinsic value high-single-digits over our investment horizon.

Portfolio Activity

During the quarter, we initiated an investment in **Danaher** and added capital to **Adobe. Apple's** robust performance led to a modest trim, while lower conviction in **Honeywell** prompted liquidation.

Danaher has long checked three of Mar Vista's qualitative boxes for investment: durable competitive advantages, above average compounding of intrinsic value, and a superior capital allocation strategy. Recently, after material underperformance over the last two years, the fourth criterion was met: stock trades at a discount to our estimate of fair value. This global leader in biotechnology, life sciences, and diagnostics has established strong barriers to entry for each of its businesses. These include a loyal customer base, recurring revenues, and proprietary technology protected by patents and copyrights.

Once Danaher's tools are selected for the clinical trial process of a new drug, they tend to remain in use throughout a successful drug's lifecycle. Moreover, Danaher's well-defined culture, rooted in the Danaher Business System ("DBS"), provides lasting advantages through a focus on continuous innovation, margin expansion, efficient marketing practices, and capital efficiency, all of which have consistently increased shareholder value across a diverse range of businesses.

We anticipate several secular growth trends that should drive high-single-digit revenue and double-digit free cash flow growth over time. While the bioprocessing industry is currently undergoing a temporary adjustment following the COVID-era boom, a secular shift towards biologics and genomics in medicine is expected to significantly expand Danaher's market opportunities. The continued innovation and adoption of molecular diagnostics, the demand for faster and more accurate test results, and a growing installed customer base should fuel strong demand for Danaher's diagnostic products.

Danaher's well-defined capital allocation strategy is poised to further accelerate intrinsic value growth. The company has a proven history of acquiring assets, optimizing their returns on capital through the DBS process, and often divesting these assets to benefit shareholders. The spinoff of Veralto, Danaher's water quality and product quality/innovation division, has reshaped the company's revenue mix. Biopharmaceutical manufacturing tools account for almost one-third of revenues post-spinoff.

Challenges such as excess inventory from the COVID-era boom, reduced biotech funding, delays in gene and cell-based therapies, and softer demand from China have all pressured Danaher's fundamentals and stock price since late 2021. However, we view these headwinds as primarily cyclical rather than secular, and we anticipate growth to regain momentum in the coming year. Given the stock's modest discount to estimated fair value, we established a new position in our portfolio.

After nearly 14 years of owning shares in **Honeywell**, we decided to sell our investment during the quarter. This decision was based on a combination of issues that threatened our investment thesis for the company. The main challenges were related to organic growth and capital deployment. Specifically, we have concerns about Honeywell's future organic growth and its indecisive approach to capital deployment. Even with a strong balance sheet, cash surplus, and low leverage, its capital deployment process lacks direction. Additionally, Honeywell is heavily invested in cyclical and short-cycle businesses which can be volatile. For these reasons, we sold our investment in Honeywell.

Outlook

Many investors entered 2024 with high hopes, buoyed by the previous year's gains in technology stocks. Yet, the stock market's early surge surpassed even optimistic predictions. Historically, strong first quarters for the S&P 500® often translate to positive years, making the current situation promising.

While valuations are currently above historical averages, a strong underlying economy continues to fuel market momentum. However, remaining vigilant against potential risks like persistent inflation or disappointing earnings is crucial.

As long-term investors, we favor businesses exposed to secular trends that will shape the next decade. Our portfolio prioritizes moated companies with strong financials, positioning them to excel in the current environment. Even though the market anticipates a controllable economic slowdown, we believe our holdings hold significant potential for outperformance.

Through patient investment in high-conviction companies and disciplined capital allocation, we aim to deliver favorable risk-adjusted returns over time. We believe this strategy will allow our portfolio to benefit from both the intrinsic value growth of our holdings and the attractive entry points we secured.

Focus Annualized Returns as of March 31, 2024

	Net	**S&P 500® Index**	**R1000®G Index**
1 Year	23.91%	29.87%	38.99%
3 Years	9.38%	11.49%	12.50%
5 Years	13.62%	15.05%	18.52%
10 Years	12.92%	12.96%	15.98%
Since Inception	11.35%	10.92%	12.52%

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 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, 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. 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.

The primary benchmark is the Russell 1000® Growth Index, defined as an unmanaged, capitalization weighted index of those Russell 1000 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 gross-of-fees composite returns shown herein was measured using an asset-weighted standard deviation formula. Performance results presented reflect the reinvestment of dividends and other earnings. 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 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.

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 sector performance and securities mentioned in this letter were held in the account of a Focus 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, 2023-March 31, 2024. 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. A Focus GIPS® Composite Report is available upon request by contacting Mar Vista directly at (800) 993-1070 or via email at info@marvistainvestments.com. Past performance is no guarantee of future results. Not FDIC insured, no bank guarantee, may lose value.