Conference Call Transcript: October 5, 2016

Hello Everyone,

I am Ludo Thomasson, director of wealth management at Ensemble Capital. Thank you for joining us to our Fall conference call. Today, the focus will be on the current market and economic, the Presidential election, and two of our portfolio companies, Netflix and First Republic bank.

Here is Sean.

Good afternoon. Thanks for joining us today. As always, my comments today will be general in nature and are not a replacement for the individual investment advice we provide during in person meetings and one-on-one phone calls. Importantly, not every security we talk about on these calls is held by every one of our clients given the wide range of goals, objectives and risk tolerances of the people we work with.

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The third quarter of 2016 was relatively positive and stable for US stock market. The S&P 500 rallied 3.9% and closed the quarter within 1% of its all-time high. Unlike the first half of the year, which was characterized by some significant declines, even while the market managed to post modest gains, in this last quarter there were few declines of any size.

The one moment of instability occurred on September 9th, as the market began to read Federal Reserve communications as possibly signaling an interest rate hike at the September meeting. On that day, the S&P 500 declined 2.5%. While this event was isolated, the activity on that day in various types of stocks was interesting and something I'll discuss a bit more in a moment.

Our equity accounts on average had a much, much stronger quarter than the broader market. In fact, we had our strongest quarter relative to the market in over 15 years. After seeing our strategy underperform in the first half of the year, our equity accounts jumped by about 10% on average, exceeding the S&P 500 by over 6%. This leaves our year to date equity returns up approximately 9% or almost 2% ahead of the market.

Investment managers like ourselves often pay tribute to the virtue of being a long-term investor. But what is often not discussed is the degree to which an investment manager can only be as long-term oriented as their client base allows them to be. Over the years, Ensemble Capital has been extremely lucky to cultivate an extensive client base that is generously patient with us during the inevitable periods of underperformance. While no one (including us) is satisfied during periods when our strategy is out of favor, it is our ability, fueled by our clients' patience, to stick to our convictions that has led to recovery and a return to robust results.

Far too many investment managers, and their clients, are simply unwilling to tolerate even very short-term periods of underperformance. In an attempt to reduce the emotional pain, they tend to capitulate when their strategy falls out of favor. This inability to accept short-term pain in exchange for long-term gain is the primary reason that so many extremely smart and talented investment managers do not end up building strong long-term track records.

Time and again during the first half of the year, when we discussed our underperformance in calls and meetings, our clients voiced confidence in our team and our strategy. So while we make every effort to maintain our own focus and investment discipline, we want to acknowledge that our clients' and their long-term, patient outlook is a major competitive advantage for us. Thank you.

In our prior call, we discussed the fact that despite the fact the market was up on the year, it was the most defensive stocks that were posting the best returns. At the time, we noted that the utilities sector was up over 23% for the year and consumer staples had returned almost 10%.

While our portfolio was trailing those sorts of returns, our concern was that those sectors were generally overvalued and not likely to produce superior long-term returns. On our last call we cited our view that falling bond yields was driving investors to pay irrational prices for defensive stocks, saying at the time, "At Ensemble we believe that investors are falling into a relative value trap. While offering better current income than bonds, defensive stocks currently trade at record high valuations. No matter how safe of a business a company might be, if investors pay too much for the stocks of these safe businesses, they run the risk of severe future underperformance."

Sometimes it is better to be lucky than good and at the time we made that statement, we could not predict when this trend would reverse. However, it was the immediate, abrupt reversal of this trend that lead to our strong third quarter results.

Since June 30, the Utility sector has been down almost 10%, a significant decline for a supposedly "safe" sector, especially in the context of a generally rising market. The Consumer Staples sector is down 5%.

If you are interested in reading a case study on why high quality, defensive companies are currently risky bets due to their historically extreme valuations, you might be interested in a blog post we wrote in August on the Intrinsic Investing blog about the company WD-40. The maker of the ubiquitous household product that people use to make things stop squeaking, is a very solid company. But it is currently trading at a PE multiple that exceeds the stretched valuation that the S&P 500 traded at during the peak of the Dot-Com bubble.

As we look forward, we believe that the more defensive sectors of the stock market continue to offer little value to long-term investors while technology, industrial, consumer discretionary and other more economically cyclical stocks are trading at very attractive levels. While we don't know when interest rates will move materially higher, we do think that the rising attractiveness of bond yields over time will cause defensive investors to flee defensive stocks once they can earn a more reasonable return via fixed income investments.

Recall at the beginning of my comments I noted the 2.5% decline in the stock market on September 9th. This decline was caused by a sudden increase in the outlook for interest rates to move higher in the short term. While defensive stocks are meant to protect investors from market declines, on that day, low volatility, high yielding, defensive stocks declined more than the market while historically more volatility stocks outperformed.

While the Federal Reserve did not raise interest rates at that meeting, they did indicate that they expect to raise rates this year and in fact believe that the most likely path forward is for them to raise interest rates consistently, and significantly in each of the next three years.

Now, before I move on to discuss some of the stocks in our portfolio I feel I should comment on the pending US presidential election. While presidential elections are extremely important to the future of our country and the outcome is rightly of great concern to everyone who cares about our future, historically the stock market has seen little impact from politics.

The stock market is not a mechanism for passing judgement on everything that happens in the world. Instead, the market is simply a way for investors to trade ownership of various companies whose value is primarily a function of how much those companies will earn in the future. The majority of the issues debated by our political parties, has little impact on the earnings of public companies.

If a republican or a democrat inhabits the While House, it would seem to have little impact on how many iPhones Apple sells, how many searches people run on Google, how many pairs of undergarments people buy at L Brands or how many nature documentaries people watch on the Discovery Channel to use some examples from our portfolios. Indeed, historically, long-term market returns have shown no material correlation to which party has gotten a fleeting upper hand in the battle for political power.

Republicans who bemoaned the election of Barack Obama in 2008 would have done better if they had set aside their concerns and bought stocks. Similarly, democrats who viewed the election of Ronald Regan as a harbinger of disaster would have missed out on massive stock market gains if they let their political views steer their portfolio.

That being said, we do recognize that this election is more unusual than most. Our advice to not let politics drive your investment behavior is not meant to suggest that investors stick their heads in the sand and ignore what is going on in Washington. The outcomes of elections can have a material impact on important market drivers such as interest rates, corporate tax rates and regulation. But by focusing on the economic outputs of politics rather than simplistically thinking about which party claims victor in the current election allows investors to evaluate the attractiveness of the specific companies they hold in their portfolio rather than trying to guess which way the market will bounce next.

If you have any doubt about this approach, just remember the example of Brexit. The decision by the people of the United Kingdom to leave the European Union is a far more radical economic outcome than your typical US election result. It was widely expected that the vote would dramatically damage the UK stock market. Yet, today UK stocks are flat for the year, down only modestly since the vote and investors brave enough to buy UK stocks the day after the vote are now sitting on gains of over 13% in just three months.

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Many of the companies in our portfolio are idiosyncratic in that they operate within a niche market with limited direct competition or they pursue a differentiated business model in an otherwise competitive industry. First Republic bank is an example of the latter.

We believe that the banking industry as a whole is ultra-competitive. At the end of the day, banks buy and sell money and therefore lack any true differentiation in what they provide. For most people, if for instance they are taking out a mortgage, care almost exclusively about the interest rate (or effectively the price) of the loan. In this way, most banks are essentially commodity businesses. Like other commodity-based industries, the winners in this situation are the low cost providers, which generally means the largest players in the market. That's why you've seen such significant consolidation in the banking industry that has given rise to the "Too Big to Fail" dilemma. These sorts of companies do not typically qualify as the types of businesses we find attractive.

In First Republic Bank however, we believe we own what we like to call "a customer service franchise disguised as a bank". First Republic provides simple, plain vanilla banking services. They offer checking and savings accounts, and they make loans, mostly mortgages and business related loans. They do not engage in Wall Street-style big bank activities like structured products, proprietary trading, or making exotic bets on esoteric financial derivatives.

But First Republic does serve a unique market. Founded in San Francisco in 1985, half of their clients are in the Bay Area with the rest concentrated in New York, LA, Boston and Portland. This focused geographic strategy isn't accidently. The company primarily serves high net worth individuals and provides them with exceptional levels of customer service. While even the very wealthy are given 800 numbers to call when they have problems at the big banks, at First Republic every client is assigned a relationship manager whose job it is to take care of them. From personally visiting clients at their home or work to open an account, to the fresh baked cookies made every morning in their offices to their disarming habit of proactively waiving fees related to wire transfers or other routine activities, First Republic stands apart from the rest of the banking industry.

According to third party customer service rankings, the banking industry has a pretty terrible reputation and customer satisfaction scores that put them in a peer group with cable companies or even congress. First Republic is in an entirely different league. For their clients who identify them as their lead banking relationship, First Republic's customer satisfaction scores are higher than Apple or Amazon.

Let that sink in for a minute. Think about your experience as a customer with Apple and Amazon. Now think about how it feels to apply for a mortgage loan, transfer bank accounts or interact with most banks in any way. There's a reason why ATMs and online banking have been so successful, they both allow customers to engage in self-service and minimize the need to depend on the bank's own customer service.

The successful execution of this strategy has led to First Republic growing rapidly over the years and recently it exceeded $50 billion in assets deeming it a "big bank" in the eyes of regulators. But because the company's customers have much larger bank accounts than the average bank, they are still small in terms of the number of customers they serve. Remember, they only operate in a small number of metro areas across the country.

Of course, while the offering at First Republic is a differentiated service experience, the basic business model is still a bank. Therefore, it is important to be sure that they are conservative in managing this aspect of the business and don't take on too much risk.

In this area, First Republic also shines. While, over the past 15 years their 50 largest competitors have had to write off almost half of a percent of their home loans due to customer defaults and this number spiked to 1.4% in the midst of the housing crisis, First Republic has seen home loan write offs of just 0.03% or 1/14th the default rate of their peers. Even at the very peak of the housing crisis, their charge off rate never exceeded a tenth of 1%.

This is due to careful underwriting, but is also due to their incentive packages for their bankers. While many banks incentives their employees to rack up as many fees and charges and write as many loans as possible, First Republic knows that they are going to work with their clients for decades and they compensate their bankers to cultivate these long term relationships. This focus on long-term relationships extends to the company's employees as well. Amazingly, 90% of all of the loans underwritten by the bank since 1985 have been originated by bankers who still work at the company.

While First Republic is a very traditional bank augmented with good old fashion customer service, one of the newest holdings in our client accounts is a company we think is building the future: Netflix.

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On the surface, this business might appear to be different from the typical Ensemble core holding. We do think that the opportunity for this company will play out over a longer time frame than our average holding and the higher degree of uncertainty that is connected to longer time frames has led us to target a smaller position size for Netflix than we might more typically hold. But we do believe that far from the speculate, emerging business that many investors view Netflix as, we think the company benefits from a number of very important competitive advantages and has proven that their model can be highly profitable over time.

As a basic thesis when approaching the media space, we believe that linear television being broadcast on a set time schedule is quickly losing relevance. In the not too distant future, internet TV -- on demand, personalized and on any screen – will be the only way that video content is consumed. As you can see based on our investment in Discovery Communications, an owner and creator of TV content, we do not think this shift will be a negative for everyone in the media industry. The fact is that as people move from linear TV to streaming internet TV, the demand for high quality video content is remaining constant. Humans have loved storytelling since the dawn of humanity. In fact, some anthropologists argue that the key distinction between humans and other animals is that we tell stories and organize our society around these stories.

But the shift from linear to streaming TV will change the business models of media companies and only those that fully embrace the shift, rather than denying it is happening will survive and live to thrive in the years ahead.

Only a couple of years ago, Brian Roberts, the CEO of Comcast argued that only poor people "cut the cord" switching from traditional linear TV to internet, streaming video. Yet today, 40% of US households subscribe to Netflix with half of all cable TV subscribers enjoying Netflix in addition to their traditional cable subscription.

While a couple years ago people talked about "cord-cutters", those people that dropped their cable subscription in favor of Netflix, today the focus is on "cord-nevers", those people in their 20s who as they formed their own households never subscribed to cable. Since 2010, every age group except for people over the age 65 have reduced the amount of time they are spending watching traditional TV. But the shocking shift is in people under the age of 24 where traditional TV viewing has dropped 40% and those in the prime 25-34-year-old age bracket has reduced time viewing traditional TV by almost 30%. This is a generation of Americans who we believe view streaming TV not as a low cost alternative to cable but as a fundamentally superior service offering.

The trend is so compelling -- we would argue inevitable -- that in July Comcast struck a deal to enable their subscribers to stream Netflix via their cable set top box. If you can't beat 'em, join 'em.

Today, Netflix delivers twice as many minutes of video content to viewers than Disney, Fox or NBC. The bandwidth consumed by Netflix viewers represents almost 40% of all internet usage in the US during peak evening hours. And while Netflix is far cheaper than subscribing to cable, their US business is already very profitable. New subscribers in the US generate incremental profit margins well in excess of current US margins as the company leverages the significant investments they've made in content and infrastructure across a wider client base.

But Netflix isn't just looking to get every US household to subscribe to their service. They've been growing internationally for some time and in January they announced they would immediately be available in every country in the world except for China.

John Malone is a billionaire who made his money creating the cable TV industry. Last weekend he was profiled on the cover of Barron's which noted that his media companies have collectively generated higher returns than Warren Buffett at Berkshire Hathaway over the past decade. Malone has said publicly and repeatedly in recent years that the big opportunity in media is for companies to take content that they've historically only been able to sell in local markets and scale it to global distribution. Today, only Netflix is doing this in a dominant way.

Their international business today is losing money as they invest heavily in the future. But the profitability of their US business and their huge head start in building a global subscriber-based business model gives us confidence that the company is making smart investments and that over time the international business will mature into an ever bigger contributor to profits than the US. Indeed, we expect that the international subscriber count will exceed US subscribers for the first time next year.

The path to their long-term success is longer than many companies in our portfolio. But we think the company is as competitively well positioned as the majority of our holdings. We've controlled for the risk of the long growth path by limiting how much of the stock we own in client accounts, but we do think the company offers strong potential returns in the years ahead.

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Thank you all for joining our call today. Like all investment managers, we go through periods of under and outperformance. We appreciate the opportunity to speak with our investors in this format to explain our thinking in good times and bad. But I'm glad to be able to report that at this point on a year to date basis, our portfolio has been performing strongly.

During this call we made reference to our portfolio holdings and performance. If you'd like a copy of our historical equity composite performance or our 13F holdings disclosures, please send an email request to info@ensemblecapital.com.

I look forward to speaking with you next time and thanks for listening.