



October 9, 2020

To Our Clients & Friends:

The widely followed technology analyst Toni Sacconaghi, Jr. of Sanford Bernstein published a report in mid-September noting the increasing resemblance of the current market to the technology bubble of the late 1990s. Tech stocks have outperformed the overall market for eight consecutive years, and recently that outperformance has been driven more by multiple expansion than earnings growth; the Nasdaq index, which is heavily weighted to tech, has compounded at 23% per year for seven years; the 12 largest tech stocks were up 170% over the past year; about one-third of publicly-traded tech companies are unprofitable. And so on.

Calling inflection points in the stock market is hard. But the balloon does seem to have quite a bit of air in it. I had a few head-scratching conversations this summer on the topic of stock valuations, one of which stood out. In July, I sat in on a conference call with a respected sell-side analyst who covers technology, media and telecommunications companies, known as TMT. This particular analyst had spent the first portion of his career in the MT portion of TMT, meaning he was used to covering film studios, cable operators and wireless companies that earned a lot of money and traded for relatively low multiples of their cash flow. Now, he found himself covering companies that traded not for multiples of earnings, but for multiples of sales, owned by investors who aren't especially interested in earnings or cash flow, at least for now.

Rather, they're focused on a very long game of creative destruction – replacing existing “analog” business models with more efficient, technology-driven “digital” models that may not be profitable until the analog model collapses, but eventually should benefit from a winner-take-most dynamic that has turned a handful of older tech giants into the most valuable businesses in the world.

The analyst first said the obvious, that the valuation spread between the haves and have nots in TMT is “off the charts,” and unlikely to narrow so long as interest rates are this low. There is very little opportunity cost of holding the stock of a fast-growing business that makes little or no money when the risk-free alternative of US Treasuries yields next to nothing. After all, the fast-growing business should generate more income with time, and potentially a lot more; the US Treasury will not.

He also noted that in technology, the right strategy for a decade has been to be in consensus. Own what everybody likes. Do not be contrarian. Buy things that trade for 30 times earnings, or more, and short things that trade for single digit multiples. He disclosed with some wonderment that no one ever calls him about the cheapest stocks in his coverage universe.

To be clear, he continued, the level of conviction among tech investors is very high. This is not a cynical investor base pumping up stocks in the belief that a greater fool will come along. Rather, tech investors

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believe that we are still in the early stages of a revolution in the economy, such that buying software-as-a-service (SaaS) stocks for twenty times the value of their current sales feels comfortable, because in the future most US businesses will be running their businesses using licensed software over cloud-based computer networks, and that software will become like electricity, or running water, only with unregulated pricing.

This theory may well be correct, but the math on many current stock valuations is daunting. Think about the risk of paying \$20 for a business that has \$1 of sales and loses money. The investor must have extraordinary confidence in his or her ability to apprehend the future. To me, it feels like walking a high wire over a distant city street: something I'll never forget if I make it to the other side and something I won't remember if I don't. Are SaaS subscriptions as inviolable as interest payments on debt? COVID-19 likely will put that theory to the test. We know companies are asking for relief on all sorts of payments, including rent. What would happen if customers asked for relief on their SaaS payments?

The most remarkable comments during the call were about Amazon, a stock GCAM owns. He described conversations with Internet specialists, "the kind of guys who can talk for two hours about Pinterest." When he asks these specialists about Amazon's valuation, they stare at him blankly. "No one thinks about valuation," they tell him. "You just have to own it."

No one has been overly focused on Amazon's reported earnings for a long time, and that hasn't been wrong. This is an extraordinary business that is constantly investing ahead of growth. There appears to be no end to Amazon's runway, as it still has just a single-digit market share of US retail sales. We've chosen to hold on to our small position even as Amazon trades for nearly 100x forward earnings.

But the rationale of "you just have to own it," is one that over time will work about as well as explaining that Jupiter is in Third House.

Against that backdrop, GCAM in its first six months of life has generated a respectable return while following a different path. For the third quarter, GCAM's model portfolio, which is a Poppe family account, generated a 6.50% return, net of fees,¹ vs. 8.93% for the S&P 500 Index.² For the six-month period from our inception on April 1, GCAM has returned 27.3%, net of fees, vs. 31.3% for the Index.

We always want to outperform, but we view our early results as acceptable given our eclectic portfolio includes a heavy weight to high quality financial businesses and a relatively low weight to technology. When we run a portfolio attribution analysis on FactSet, we see that relative to the S&P 500, GCAM is modestly overweight consumer stocks and industrials, and very overweight financials. Our stocks in those three sectors have outperformed the Index components.

¹ The family account does not pay a management fee. The returns presented herein assume the deduction of an annual management fee of 1% to show what a client account's performance would have been if it had been invested the same as the family account during the period. Past performance is not necessarily indicative of future results.

² The S&P 500 Index returns include the reinvestment of dividends and other earnings. The Index is an unmanaged, capitalization-weighted index of the common stocks of 500 major US corporations. The Index does not incur expenses and is not available for investment.

We are underweight technology, with an average portfolio weight of about 24% in tech vs. 30% for the Index. On top of that, our tech stocks returned 28% from our inception on April 1 through September 30, while the Index's components – as reflected by the SPDR S&P 500 ETF – returned 45%.

GCAM vs. SPDR S&P 500 ETF	GCAM			SPDR S&P 500 ETF		
	Portfolio average weight	Portfolio Total Return	Contribution	Portfolio average weight	Portfolio Total return	Contribution
Technology stocks	24.3%	28.1%	7.0%	29.9%	45.5%	12.5%

Source: FactSet

It's not exciting to report that we are underweight the most dynamic sector of the Index and that our technology stocks have underperformed their counterparts in the Index. The source of the underperformance is easy enough to explain: our largest tech stock is Alphabet, which is the worst performer this year among the so-called "FAANG + Microsoft." [Facebook, Apple, Amazon, Netflix and Alphabet (fka – Google), plus Microsoft].

We are not predicting a repeat of the tech bust in 2000, when the Nasdaq index declined 80% over a two-year period. Today's tech giants today are among the most impressive companies in the world and, importantly, do in fact possess "winner-take-most" characteristics, including substantial cash flows. But we believe there is an enormous amount of capital at risk in earlier-stage tech companies that have market caps suggestive of emerging dominance without having the earnings trajectory to support that notion.

Our top performer for the quarter was the medical and environmental testing company Eurofins, up 25%, followed by Berkshire Hathaway, Progressive Corp., Five Below, Facebook and Liberty Broadband, all up more than 15%. Other double-digit gainers included Mastercard, Amazon, Ametek and TJX. Our two largest holdings, Alphabet and Carmax, both rose modestly and lagged the Index. We would caution that the quarterly zigs and zags of individual securities don't mean a whole lot.

Eurofins is a European testing company with a diverse customer base across the life sciences, food, environmental and industrial sectors. It has benefited this year from heavy demand for COVID-19 testing, which likely is a one-time bump and could create challenging 2021 comparisons. Longer-term, however, demand for testing continues to rise and founder and CEO Gilles Martin has done a brilliant job of expanding Eurofins' network of labs and testing capabilities to maximize efficiency.

We'd note our largest holding Carmax continues to generate admirable performance that is heavily discounted by the market, which believes Internet-based competitors like Carvana and Vroom have superior business models for selling used cars. For its quarter ended August 31, Carmax reported 28% growth in earnings per share, yet the stock declined after that announcement on concerns that its brick and mortar car lots may soon be obsolete. We're confident in Carmax's consumer proposition and in the viability of its omnichannel approach to selling cars, whereby it can serve customers in stores or online.

As for our second largest holding, Alphabet, it has been hurt this year by lower online advertising spend, especially on travel. But analysts still expect Alphabet to grow revenue by about 15% per year through 2025, with free cash flow margins rising from about 20% to 25%. By comparison, the firm Empirical Research expects the S&P 500 to grow revenue by 4%-5% through mid-decade, with free cash flow margins at less than half the level of Alphabet.

Our third quarter results were hurt by two very weak performers in a2 Milk (-22%) and Credit Acceptance (-19%).

For its fiscal year ended June 30, 2020, a2 generated outstanding results, with sales up 33% and earnings up 34%. A2 sells a popular infant milk formula powder in China. Many Chinese visitors to Australia actually buy a suitcase worth of a2 formula and bring it home to resell it. And small businesses have sprung up that buy a2 formula in bulk in Australia and resell it in China. This channel is called *daigou*, and it has been an important part of a2's growth story. Many Chinese parents view a2's formula, which is produced in New Zealand and labeled in English, as safer, healthier and perhaps more prestigious than formula produced in China.

Recently, a2 has been expanding its distribution rapidly within China, selling formula labeled in Chinese language in retail stores and E-Commerce channels. With COVID-19 putting a halt to most international travel, it comes as no surprise that the daigou channel would shrink. But for the year ended June 30th, a2 reported surprisingly good growth in daigou along with spectacular growth in Chinese retail. Shortly after those results came out in early August, senior management sold a large amount of stock. The stock reacted poorly to this news, and we responded by adding modestly to our position.

Flash forward to September, and a2 reported that its larger daigou partners had purchased too much inventory in prior months and had slowed their buying. The Australian state of Victoria went into COVID-19 lockdown in September, bringing international tourism to a complete halt, which also impacted demand in the daigou channel.

A skeptic might say this daigou fiasco looks a bit like channel stuffing. That puts the strong recent earnings report and the subsequent insider stock sales in an unflattering light. The market reacted violently, with a2 stock down by about one-third in two months. Three factors keep us from selling the stock and walking away: first, the key executives who sold stock continue to hold substantial economic stakes in a2, although in some cases they sold nearly all the vested stock they were eligible to sell. Second, demand in Chinese retail outlets remains very strong, at healthy pricing. Third, the Victoria lockdown was a genuine surprise that hurt cross-border commerce.

Credit Acceptance offers automobile financing programs to car dealers who sell to financially struggling customers. A Credit Acceptance borrower in many cases has been rejected by every other subprime lender for a car loan, and literally has no other options for financing a used car. The Credit Acceptance customer is so shaky that when pandemic first struck in March, one prominent short seller predicted the company would quickly go bankrupt. Instead, government stimulus stabilized the market. Credit Acceptance's stock reached an all-time high of \$539 in August.

Credit Acceptance loans people money on punitive terms. The customers are often buying from sketchy car lots and may overpay for clunker autos, which they then finance at high cost. Some of them will end

up defaulting on their loans, and when they do, CACC is a tough adversary, pressuring borrowers to keep paying even if their car is not running.

We've owned this stock personally for some years and have met management several times. We think management is responsible and note that Credit Acceptance is a regular member of Fortune magazine's 100 Best Places to Work list. Customers who pay off their loans rebuild their credit when no one else would loan to them and the investors who put their capital at risk earn good returns.

Over the years, numerous critics have assailed Credit Acceptance for exploiting vulnerable borrowers. In September, it was sued by the state of Massachusetts. The stock plunged after the suits were filed and on Sept. 30 it closed at \$338, down \$200 in a month. Lawyers will have no trouble finding sympathetic borrowers who felt pressured to pay off loans on awful cars. The defense may have a harder time persuading a jury that because most of those borrowers had defaulted on other loans they could not have financed a car without a lender willing to take significant risk. If Credit Acceptance is prosecuted or legislated out of its niche, it seems unlikely that its borrowers will find better alternatives.

In early October, Credit Acceptance disclosed in a regulatory filing that its loan collections this year are above expectations and that it may raise money in a debt offering. We notice that the company's debt is stable; it appears to have ample access to low-cost funding. The credit market is calmer about this than the stock market, in other words.

As far as changes to the model portfolio, we bought a small position in the British store chain B&M Value Retail. B&M sells low-priced items to value-conscious shoppers, with a mix of consumables and general merchandise. Run by Simon Arora, whose family owns 15% of the business, B&M has an extremely frugal culture that keeps expenses low combined with a treasure hunt that rotates around 100 new items into the store every week. We paid a mid-teens multiple for a business that has grown net income by 22% annually over the past eight years. We're fans of both extreme value retail and the treasure hunt concept, as we also own TJX Companies and Five Below. All three retailers have managed to appeal to a broad demographic and grow despite the rise of Amazon.

Otherwise, our activity was mostly tweaks. We added modestly to Arista Networks and Liberty Broadband. In the case of Arista, we believe it has the best offering of cloud networking solutions for large-scale data centers run by customers like Microsoft and Facebook, largely because it also offers a software operating system for managing rapid growth of those centers. Arista's "cloud giant" customers took a breather on capacity expansion this year, but we think demand for cloud computing will continue to grow, creating a tailwind for Arista.

Liberty Broadband is a holding company that owns shares in the cable operator Charter. Each Liberty share essentially holds 0.295 shares of Charter. Based on a recent market price for Charter of \$620, Liberty shares should be worth about \$180. Instead, they've been trading for about \$140. The discount strikes us as too wide, so we added slightly to our position.

We sold a small amount of Berkshire Hathaway during the quarter. We still hold a meaningful position in Berkshire and believe it is quite reasonably valued, but we believe the stocks we bought offer better appreciation potential.

We finished the quarter with a 3% cash weighting. However, for most of our first six months we have had a cash weighting of about 7%. With the Index rising 30% in six months, the cash weighting has hurt GCAM's performance by roughly two percentage points.

This has been a strange and difficult year. The pandemic has isolated us, kept us from friends, family and the gratifying routine of being in the office. My father will turn 80 in a few weeks and my wife and I will not be there with him and my mother to celebrate, which is depressing. Many people have faced far worse predicaments, we know, but it still stinks. The country is angry and increasingly uncivil, without consensus even on taking precautions to protect one another from COVID-19.

And yet ... we're encouraged by our interactions with the people who manage our companies. We truly believe in our mission to be long-term holders of high-quality businesses, run by people who don't just think like owners but who *are* significant owners. We misjudge people from time to time, but virtually all of our managers are responsible actors on behalf of their communities, customers, employees and shareholders. GCAM is holding its own, performance wise, by owning the best quality businesses we can find at reasonable valuations, with special focus on profitability, returns on capital and owner-oriented management.

Finally, in mid-September we opened our new office. I've enjoyed being able to work at least a few days each week with my colleague Al Munro, after four months of working with him remotely. Rest assured, we are maintaining social distance and keeping the windows open! We look forward to welcoming visitors when it is safe to travel again.

Sincerely,

A handwritten signature in black ink, appearing to read "D. M. Poppe". The signature is fluid and cursive, with a long horizontal stroke at the end.

David M. Poppe