Portfolio Activity Q1 2021

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BUYS

Domino's Pizza, Inc. (DPZ)

Domino's is the largest pizza company in the world based on global retail sales. It generates most of its free cash flow through franchising and its supply chain business. It also owns some domestic stores, but it mostly uses these locations to test concepts/promotions and train future franchisees.

The franchising model is attractive because it is highly cash-generative without the need for material tangible investment. Domino's simply grants franchisees the right to use its intellectual property, resources, and systems in exchange for a small royalty on each sale. The franchisees pay most of the advertising expenses, which strengthens the brand at minimal cost to the parent company.

Domino's owns dough manufacturing and vegetable processing facilities, as well as general supply chain centers. It shares economies of scale with franchisees who source from these centers by offering them profit sharing on supply chain pre-tax profits. This accomplishes three things: (1) it lowers input costs, (2) it allows the company to maintain consistent food quality, and (3) it shortens the franchisee payback period.

Domino's employs a "fortressing" strategy in the U.S. which entails building out dense store networks. This creates route density for drivers, which improves customer proximity and lowers delivery times. Lower delivery times equate to better customer experiences and more efficient use of labor, which leads to revenue growth and wider margins.

Domino's is a fine-tuned machine. It has multiple moat sources (as described above) that make it difficult for competitors to match the combination of product quality, price, and delivery efficiency. The company generates more cash than it needs for growth, so it consistently repurchases its shares in the market. This gives patient shareholders a larger ownership percentage of the company over time without having to lift a finger.

The company thrived during the pandemic as the delivery business benefited from people sheltering at home. During the quarter, however, market participants became concerned that same-store sales figures would be difficult to beat in the short term. This created an opportunity to purchase shares at prices below our intrinsic value estimate. We are not focused on short-term results. We are focused on long-term earning power, which we think Domino's will sustain long after the pandemic is over. (Louis Foxwell)

Fair Isaac Corporation (FICO)

FICO's crown jewel asset is the FICO Score, which is the standard U.S. benchmark for analyzing the creditworthiness of an individual. The company licenses its credit scoring algorithms to the credit bureaus and collects a small fee every time the bureaus sell a score. FICO also sells score monitoring services directly to consumers, providing both a pull marketing strategy and an additional source of high-margin revenue. Almost every consumer lending decision in the U.S. involves a FICO Score. We like to think about this business as a toll booth on consumer credit.

The economics of the scores business are extraordinary. It requires almost no tangible capital to operate. It has latent pricing power, as the price of each score is merely a few cents on average compared to thousands of dollars usually at risk for the lender. It costs FICO almost nothing to sell each additional score, so incremental margins are astronomically high. The relevance of the score is protected by regulation and consumer mindshare. It is also deeply integrated into the risk-management operations of most financial institutions.

FICO also has a software segment that is often overlooked. Its products are mission-critical, mostly for financial institutions, and dominate their respective end markets. For example, the FICO Falcon Platform protects roughly two-thirds of the world's payment card accounts through fraud detection and prevention. The product is built on consortium data, so it enjoys network effects. It would be very costly for customers to switch to another service. This is just one example of a durable asset under the software umbrella.

FICO is investing heavily in its decisioning platform, which we believe is concealing the true profitability of the business. This platform contains an application development environment called FICO Studio that allows software developers to build applications on top of it. It leverages FICO's expertise in data analytics and decision management, offering modularized tools to build custom applications. The platform's tools are currently for internal use, but the company plans to offer them to external developers this year. We think this will enable FICO to diversify its software business into higher-growth verticals, providing potential upside to earning power. (Louis Foxwell)

Mastercard Incorporated (MA)

Mastercard is one of the world's two largest payment processing companies. It operates an open-loop network where it serves as the middleman between four parties to form the "rails" of the credit and debit card payment infrastructure. Mastercard makes money by collecting a toll on each transaction it processes and the total volume it processes. In addition to payment processing, Mastercard also offers payment-related services, including consulting, data analytics, fraud prevention, and cybersecurity.

We began purchasing Mastercard last quarter and view the investment as complementary to our investment in Visa. The two businesses are similar but have different growth strategies, which we believe helps us gain greater exposure to the structurally attractive payments industry. The payment industry is consistently growing with the help of consumers moving away from cash to digital forms of payment which must go through Mastercard or Visa's infrastructure, in most cases. As the incumbent leaders in this space, Mastercard and Visa are in prime positions to capture this growth. Further, because these two built these networks and have established such a strong competitive position, the threat of a competitor gaining sizable market share is minimal.

This biggest laggard in Mastercard's performance continues to be a slowdown in its cross-border business. Domestic payments have mostly rebounded, but the more lucrative cross-border volumes are still lagging as international travel remains muted until more economies re-open. The Department of Justice also blocked Visa's proposed acquisition of fintech competitor, Plaid, and announced a probe into Visa's debit card business, citing concerns about anti-competitive practices. We do not view these as long-term concerns for either business as inquiries like this are common for companies in such a strong competitive position. We believe that the market is holding this against the two payment processors and waiting for signs of a global re-opening before re-pricing the stock, allowing us to build a position at a time of temporary weakness. (Matt Holman)

Microsoft Corp. (MSFT)

We expanded our position in Microsoft this quarter, adding to existing client accounts and purchasing new positions for others that did not yet own the stock. Microsoft reports its suite of solutions in three segments:

> The ***More Personal Computing*** segment includes Microsoft's flagship Windows operating system, gaming (Xbox), search advertising (Bing) divisions, and its devices (e.g., Surface).
>
> ***Intelligent Cloud*** is Microsoft's newest and fastest-growing segment. This segment includes all its server products and cloud services, such as Azure, SQL, and Windows server, among others.
>
> The ***Productivity and Business Processes*** segment is headlined by Microsoft's legacy Office suite. It also includes LinkedIn and Dynamics – Microsoft's enterprise resource planning (ERP), and customer relationship management (CRM) suite.

Microsoft has realized a rapid increase in demand because of the pandemic. First, the migration of businesses moving their infrastructure and processes to the cloud has been expedited tremendously, leading to sustained growth in Microsoft's cloud solutions, namely Azure.

Second, the mass work-from-home trend has created the demand for Microsoft's OS, Office suite, and Dynamics solutions as more employees need these programs installed on their home computers. Third, the quarantine period led many consumers to gaming and social media as a means for entertainment, communication, and socialization. Xbox and LinkedIn were among the largest beneficiaries here as demand for entertainment and other means of social interaction spiked, just as Microsoft was expanding its ability to monetize them.

In short, we view Microsoft as a core holding due to its broad suite of solutions and long-standing dominance in the industries mentioned above. Microsoft enjoys a wide economic moat based on strong network effects and insurmountable switching costs inherent in its products. It is still growing at an astounding rate for a business of its size, while profit margins continue to expand with scale and a growing revenue mix of its newer products. The management team has done an excellent job of positioning the business to be a true leader in the next generation of technology. (Matt Holman)

S&P Global

S&P Global Inc. (SPGI)

S&P Global operates four business units: Ratings, Indices, Platts, and Market Intelligence. Below is a summary of each unit:

> **Ratings**: S&P Ratings issues credit ratings on corporations, governments, and structured products. Credit ratings express an opinion on the ability and willingness of an entity to meet its financial obligations, and they are critical decision-making tools for market participants.
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> **Indices**: S&P Dow Jones Indices (SPDJI) owns indices like the S&P 500 and the Dow Jones. It is a joint venture with CME Group, and S&P Global owns 73% of it. The segment makes money every time one of its indices is tracked, benchmarked against, or referenced in derivatives contracts.
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> **Platts**: Platts is a price reporting agency (PRA). It publishes daily commodity price assessments that help companies settle contracts and monitor market conditions.
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> **Market Intelligence**: The company sells analytics, data feeds, and third-party research to financial firms.

S&P Global's credit ratings, indices, and commodity price assessments are ubiquitous in their respective industries. They help markets function more efficiently, and they enjoy strong network effects. Adoption of the company's products has become table stakes for customers, and the risk of circumventing them is high. For example, a corporation that does not obtain a credit rating from S&P will pay a significantly higher interest rate on its debt. S&P Global is a gatekeeper, and customers happily pay them a toll to participate in the financial markets.

The unit economics of the business are very attractive. The cost to create a rating, index, or benchmark is mostly fixed. S&P Global can therefore sell its products at a very low incremental cost. The Market Intelligence segment complements these assets, offering a subscription-like revenue stream with high customer retention rates. It also allows the company to squeeze more value out of its data assets.

It is rare to find multiple evergreen businesses under one roof that share cost and revenue synergies. Even more rare is a collection of assets of this quality, with high returns on capital employed and deep economic moats. We expect the pending acquisition of IHS Markit to close before the end of the year. We are thrilled with the assets coming over in the deal – particularly the transportation and indices assets. We think there will be numerous synergies that have yet to be identified by the market. (Louis Foxwell)

Take-Two Interactive Software, Inc. (TTWO)

Take-Two develops and publishes video games. It has a deep library of intellectual property that includes *Grand Theft Auto (GTA)*, *NBA 2K*, *Red Dead*, and *BioShock*.

We are primarily attracted to Take-Two because of its ownership of *GTA*, which we think is currently under-monetized. In our view, the pandemic has accelerated the adoption of video games as viable social networks, and *GTA* is a primary beneficiary. We value *GTA* as a social platform and a virtual theme park. It has its own economy/currency and open-world gameplay that is conducive to countless iterations of social experiences.

The microtransaction model, which entails selling virtual goods like vehicles and clothing, is a high-margin business. The cost to create one of these virtual products is mostly fixed, and the cost to sell and distribute them to millions of players is minimal. We think other revenue opportunities will emerge on the *GTA* platform in the future, such as advertising and subscription services. We are also confident that the next iteration of the franchise will expand the player base, engagement, and monetization per user. As the facilitator of *GTA*'s virtual economy, Take-Two is both a price maker and tax collector. This is an idiosyncratic business model that we think will become more lucrative over time as it scales.

The company's balance sheet is pristine, and it has ample cash to invest in growth (likely via M&A). The company has invested heavily in its pipeline in recent years, and we are confident that these investments will bear fruit. Take-Two's management team and game developers have significant skin in the game, which aligns long-term incentives with shareholders.

We continue to believe that value will accrue to the owners of top-tier intellectual property in this space. Our investments in TTWO and ATVI reflect that belief, and we continue to add to these positions when the price is right. (Louis Foxwell)

SELLS

(The positions below were reduced or eliminated in most accounts. In some cases, positions were kept in selected client accounts for tax purposes.)

Apple Inc. (AAPL)

We continued trimming individual positions in Apple this quarter. Our investment thesis has not changed, and we still like the quality of the business. We have reservations about market saturation regarding its device sales, but we are excited about the shifting focus towards Apple's ecosystem and subscription-based sales. We initially built the position on the basis that the market was underappreciating this shift. However, Apple's valuation more than corrected for this mispricing and became overvalued, in our opinion. To compound matters, this correction came primarily via a "re-rating" of the price multiple, which signifies improved market sentiment rather than growth in the business's intrinsic value. Multiple expansion tends to be an unsustainable driver of investment returns. It is driven heavily by investors' future growth expectations and overall interest rates. Therefore, when interest rates began rising recently, many companies saw sizable contractions in their price multiples. Each time we discussed Apple's valuation, we considered this threat. We felt its current price had outpaced its intrinsic value, leading us to trim client positions in the business. (Matt Holman)

BERKSHIRE HATHAWAY INC.

Berkshire Hathaway Inc. Class B (BRK.B)

We mentioned last quarter that we were trimming positions in Berkshire and looking to exit the position long-term. Our thoughts on this move have not changed, and we continue to view other businesses as more attractive opportunities. Our primary concerns regarding Berkshire focus on a few key points. First, Berkshire is a $600 billion conglomerate that is going to have a difficult time growing at historical rates at that size. Second, the business accumulates cash on its balance sheet with few investment opportunities in which to deploy this capital. Third, Berkshire's operating businesses and investment portfolio are becoming more concentrated in what we feel are inferior industries. Lastly, we have questions about what the management transition will look like when Buffett and Munger decide to move on from Berkshire. Please refer to our fourth-quarter portfolio activity report for an in-depth discussion about Berkshire and each of these points. As such, we were finding more attractive businesses with fewer question marks and more visible growth runways and continued swapping capital into them. (Matt Holman)

Discovery, Inc. (DISCK)

We sold shares of DISCK for all accounts during the quarter, except for those which held short-term unrealized gains.

Our thesis on DISCK was simple: it owned a deep library of niche content and we thought it could monetize that content through non-linear channels. We built a position on the thesis that price and value would eventually converge. That convergence occurred during the quarter, as the price of the stock rose significantly and exceeded our intrinsic value estimate.

The company faces the risk of a rapid decline in its legacy cable business. There is also uncertainty around the unit economics of the streaming service. As we have discussed in the past, we are willing to make investments in uncertain situations when we feel there is a sufficient margin of safety (i.e., compensation for taking on the uncertainty). We felt that the pendulum swung too far in the direction of optimism during the quarter, and we were more than compensated for our original bet on the business model transition.

Ultimately, we felt that there were more attractive opportunities in the market, and we reallocated the capital accordingly. (Louis Foxwell)

Nike Inc. (NKE)

We trimmed individual positions in client accounts that were overweight Nike shares. We view Nike as a high-quality business with a wide moat built primarily on its brand strength and scale advantages. We still like the business long-term but felt that the valuation had exceeded its intrinsic value. Therefore, we opted to pare back some exposure in clients' accounts where it had grown to an outsized weighting. (Matt Holman)

TJX Companies, Inc. (TJX)

We continue to be attracted to the off-price retail business model, and TJX has mastered the "treasure hunt" experience. This has allowed TJX to remain one of the stronger brick-and-mortar retailers in a world increasingly shifting to e-commerce. Our decision to trim this position this quarter was not due to any deterioration of the business. We decided to trim positions in client accounts that held overweight positions. We redeployed that capital into newer ideas and other businesses that we thought had more upside potential. (Matt Holman)

Union Pacific Corporation (UNP)

We swapped out of Union Pacific this quarter and into a few businesses we find more attractive long-term. We view Union Pacific as a high-quality business with strong competitive advantages and a wide moat against its competitors. That said, it is a mature business, highly cyclical, and requires large amounts of invested capital. Further, the benefits of its precision scheduled railroading initiatives are mostly priced in at this point, meaning the current valuation is pricing in perfection. Therefore, we swapped Union Pacific into businesses we feel have a little more upside at this stage. (Matt Holman)

Vail Resorts, Inc. (MTN)

We trimmed MTN in select accounts during the quarter. We continuously monitor position sizes across the portfolio and periodically trim holdings when we feel they are overweight and/or overvalued. We want to reiterate that, despite this trim, we view MTN as a core holding.

We would like to also note that we support management's decision to lower the price of its pass products for the upcoming season, as we believe it will increase demand and drive incremental revenue. Vail is sharing scale benefits with its customers, and it will be difficult for smaller competitors to match the value proposition of the discounted pass. Vail has been investing in the capacity to take on additional demand in recent years, which will help drive high-margin lift revenue (due to the fixed cost nature of lifts) and ancillary revenue like ski school and dining. We think the company will ultimately acquire some of the resorts that it is pressuring with this pricing strategy. (Louis Foxwell)

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