Portfolio Activity Q4 2020

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The following discussion mentions stocks that are widely — but not universally — held by clients of Horan Capital Management. Client portfolios are customized, so this commentary may or may not be directly applicable to any given client or account. Our intention is to provide general insight into portfolio holdings and into our overall approach and to highlight situations of interest, both positive and negative. The mention of any stock is neither advice nor a solicitation to buy or sell any particular investment and our opinions regarding securities are subject to change without notice. Investing involves risk of loss. See the legal disclosures at the end of this publication and on our website for more information.

BUYS

Mastercard Incorporated (MA)

Mastercard is one of the largest payment processing companies in the world. The company offers a range of payment solutions and services with its Mastercard, Maestro, and Cirrus brands, and its core business is its credit and debit card networks. Like Visa, Mastercard has built an open-loop network where it serves as the middleman between four parties to form the "rails" of the payment industry. In addition to payment processing, Mastercard also offers payment-related services on top of the card networks, including consulting, data analytics, fraud prevention, and cybersecurity. Mastercard generates most of its revenue by earning flat fees on each transaction, as well as percentage-based fees on the total volume processed on its networks.

As the network that powers the payment ecosystem, Mastercard has a structurally advantaged business model. Further, it also benefits from a bevy of secular growth trends, including (1) a shift towards a cashless economy, (2) mobile and e-commerce, (3) contactless payments, (4) a connected economy, and (5) improved access for the underbanked population. All these drivers funnel sustainable growth to Mastercard, which effectively collects a toll on this increased global consumption. From a quality perspective, we believe this is among the best businesses in the market today. Mastercard generates sustainable high-margin revenue, requires very little capital to fund its growth, and has a wide economic moat due to its impenetrable network, strong brand, and scale advantages.

A key element of our due diligence centered around the idea of owning both Mastercard and Visa. Ultimately, we determined that we want to invest in the best businesses we can, and we believe Visa and Mastercard rank near the top. We could make a case for owning either one, but holding both gives us better exposure to a very attractive payments industry. Also, while the two are similar, their approaches are different, making their investment cases highly complementary. For example:

- Visa has greater scale, arguably a wider economic moat, greater pricing power, and more of a stronghold on developed markets. It is investing heavily to route new payment flows to its existing networks to fortify its competitive position.
- Mastercard, by comparison, has more global exposure to emerging and cash-centric markets. It also appears to be more forward-looking in its strategy by partnering with modern fintech partners. The company's services business gives it a more diversified revenue base, which adds high-margin revenue and enhances consumer stickiness. Lastly, Mastercard is investing in owning and controlling the new payment rail networks in addition to routing these payment flows to its existing networks.

The pandemic has hurt Mastercard's business in the near-term, specifically in its cross-border volume, where Mastercard charges a much higher rate. We see this as temporary and a potentially strong catalyst once the pandemic passes and global travel normalizes. As such, we are happy to begin building a position here in what we believe is one of the better long-term compounders. (Matt Holman)

Take-Two Interactive Software, Inc. (TTWO)

Take-Two Interactive develops and publishes video games through four labels: Rockstar Games, 2K, Social Point, and Private Division. Its portfolio of intellectual property includes *Grand Theft Auto (GTA), Red Dead, NBA 2K,* and *BioShock.* In our view, the video game industry is undergoing structural changes that are improving the economics of content creation. In addition to Activision Blizzard (one of our current holdings), we view Take-Two is a beneficiary of these changes since it owns some of the most valuable IP in interactive entertainment.

Take-Two's crown jewel asset is the *Grand Theft Auto* franchise. The franchise's current iteration, *GTA V*, is the best-selling entertainment product of all time. Its success has been aided by *Grand Theft Auto Online* – an online version of the game that allows players to share experiences with each other in real time. These players can complete pre-designed missions, or they can enjoy the freedom to do almost anything they want in the open-world environment. This virtual world has become more than just a game; it has become a place for friends to share social experiences. *GTA*'s open-world format and sandbox-style gameplay are ideal for facilitating socially driven network effects and generating continuous player engagement.

Take-Two currently monetizes player engagement by selling downloadable content and in-game virtual items like clothes and vehicles, which players use to express personalities and improve their experiences. The cost to develop a virtual shirt or car is mostly fixed, and the incremental cost to sell and distribute it to millions of players is low. With such strong unit economics and operating leverage, we think that Take-Two can significantly expand margins across its entire business as it establishes scale. Take-Two should also realize wider margins as more full-game distribution moves to digital channels and competitive dynamics potentially push distributor take rates down. Lastly, as the owner of a "virtual theme park" like the world of *Grand Theft Auto*, Take-Two has the authority to raise prices at its discretion and introduce new forms of monetization (e.g., advertising). In our opinion, this is a potential source of revenue upside.

Traditionally, the company has thrived by focusing on quality over quantity. We are optimistic that, after years of investment into its development pipeline, Take-Two will now be able to produce quality *in addition to* quantity. In our opinion, the company's profit-sharing agreement with its developers aligns incentives and attracts the highest-quality creative talent. We expect that this will also contribute to a better-than-average hit rate on its development pipeline.

We feel that Take-Two complements the Activision (ATVI) position in portfolios that hold both companies. Activision's intellectual property is also exceptional, but it contains franchises under different genres. Most Take-Two games are console-based, while Activision generates a higher percentage of revenue from PC and mobile content. We want to maintain an overweight exposure to this industry, and we feel that TTWO and ATVI are attractive and complementary ways to achieve our desired allocation. We were pleased to purchase shares of TTWO at prices below our estimate of intrinsic value. (Louis Foxwell)

Fair Isaac Corporation (FICO)

FICO is a data analytics company. It sells decision-making tools that enable customers to minimize risk, cut costs, and comply with regulations. FICO's crown jewel asset, and the principal reason that we are attracted to the business, is the FICO Score – a three-digit score that summarizes a consumer's credit risk based on their credit history. It is the industry standard and is used in almost every U.S. consumer lending decision (mortgages, credit cards, car loans, etc.).

The economics of the business are very attractive. FICO licenses its scoring algorithms to the three credit bureaus, who sell credit scores to financial institutions, telecom providers, marketers, property managers, etc. Every time this happens, the credit bureaus pay FICO an associated fee (i.e., a royalty). FICO does not own the underlying data, or the infrastructure used to collect and distribute the data; it simply owns the algorithms. The costs of operating the business are therefore mostly fixed, as licensing the algorithm to produce ten million scores costs roughly the same as licensing it to produce ten *billion* scores. In our view, FICO is a toll collector on consumer lending. This toll, which is less than a dollar per score, is very small relative to the size of the underlying loans. As a result, we think FICO has latent pricing power (even after targeted price increases in recent years).

The financial, regulatory, and reputational risk of switching to another credit score is high for lenders. Additionally, the incentive to take this risk is low, with these scores only costing a few cents on average (compared to tens of thousands of dollars on the underlying loans).

The company also sells scores to consumers who wish to monitor them – both directly and through distribution partners. This is more than just a revenue source; it is a pull marketing strategy that increases switching costs for banks.

The attractiveness of the scores business is currently masked by the company's software businesses, as it is reinvesting earnings from the former into the latter. FICO's software products offer applications for fraud monitoring, collections, decision-management, and customer communications. Management wants to expand into other verticals, so it is building a platform that will enable third-party software developers to build decision management applications for B2C companies. This requires heavy investment, which we believe is currently concealing the true profitability of the business. We also view this ancillary business as a source of potential upside, and we are confident that FICO will be able to generate attractive economic returns for a long time. (Louis Foxwell)

S&P Global

S&P Global Inc. (SPGI)

S&P Global currently 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, which express an opinion on the ability and willingness of an entity to meet its financial obligations, are critical decision-making tools for market participants.

Indices: S&P Dow Jones Indices (SPDJI) owns a world-class portfolio of financial indices that includes the S&P 500 and Dow Jones. It is a joint venture with CME Group, and S&P Global owns 73% of the venture. SPDJI makes money every time one of its indices are tracked by passive funds, used as performance benchmarks for active managers, or referenced in derivatives contracts.

Platts: Platts is a price reporting agency (PRA). It publishes price assessments every day on various commodities, which market participants use to settle contracts and monitor market conditions.

Market Intelligence: This segment is subscription-based and sells analytics, data feeds, and third-party research. Its desktop software is used in the front office of many financial firms.

Ratings, Indices, and Platts all share a common trait: they turn massive amounts of raw data into easy-to-understand benchmarks. These benchmarks are the standard units of measurement in their respective industries. This creates a common language across the customer base so that everyone in the industry can conduct business more seamlessly. For example, when an oil company needs to settle a contract with a power plant, the two parties may disagree on a fair price for the product. Therefore, they need a standardized reference price from an objective third party to execute the agreement. Platts provides this reference price through its Dated Brent benchmark, and it sells the price to both customers.

We are attracted to businesses that sell benchmarks because their products can become ubiquitous if they become the standard. They enjoy a positive feedback loop in which increased product adoption begets even more adoption since customers have no choice but to use the products that their competitors and partners use. This is why Ratings, Indices, and Platts face limited competition. Furthermore, the cost to operate these businesses are mostly fixed, so selling one more rating, index, or price benchmark generates revenue that mostly falls to the bottom line. Lastly, they require very little capital to operate, and they grow on the back of other companies' investments. The Market Intelligence segment augments the exceptional economics of Ratings, Indices, and Platts by providing a consumer-facing distribution channel for their data.

During the quarter, S&P Global announced its plans to acquire IHS Markit in an all-stock deal. We think this acquisition (which is expected to close in the second half of 2021) will be beneficial to S&P Global's shareholders in the long term, as there are numerous potential revenue and cost synergies. It will add more benchmark-like assets to the portfolio (iBoxx indices and the Purchasing Managers' Index), as well as cornerstone data assets and products related to transportation (CARFAX) and natural resources (oil well data). S&P Global will be able to cross-sell these products to existing customers in most segments, and it will be able to utilize its distribution in Market Intelligence to "double-dip" on the data assets. With the acquisition, S&P Global will be a data behemoth in a world increasingly reliant on standardized and refined data. We purchased shares of SPGI during the quarter and view the stock as a core long-term holding. (Louis Foxwell)

Visa Inc. (V)

We have discussed Visa a lot in 2020, and our thesis remains the same. Throughout 2020 we have been outlining Visa's structural advantages and the strength of its economic moat, from which it can defend its competitive lead. Visa captures consistent and sustainable growth as its revenue grows with global consumer spending and the secular shift away from consumers using cash. This makes its revenue streams inflation-resistant and resilient in most economic recessions. This combination leads to growth with minimal reinvestment needs – the optimal combination for compounding capital invested into the business.

The investment thesis should sound a lot like the discussion on Mastercard. In the Mastercard discussion, we touched on why we believe it is best to own both Mastercard and Visa. But to reiterate, we believe this industry is one of the most attractive to do business, and these are two of the strongest businesses in the world. The two are similar in many ways and benefit from the same structural advantages and secular tailwinds. They have their differences, which we outlined above. Still, both have pulled back on declining cross-border fee revenue while international travel is restricted. These fees are much higher than domestic fees, with virtually no incremental expense, making them very accretive to the bottom line. We continue to view this segmented slowdown as transitory and see this as a great opportunity to build positions in businesses positioned well for a COVID-related recovery. (Matt Holman)

SELLS

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

Alphabet, Inc. Cl. A (GOOGL)

Alphabet is a company we are excited about long-term and has three share classes, two of which are publicly traded. The main difference between the class A shares (GOOGL) and class C (GOOG) is voting rights for the class A shares. The other share class (class B shares) is unlisted and owned primarily by the company's co-founders, Larry Page and Sergey Brin. These class B shares carry ten times the voting power as the class A shares. Therefore, Page and Brin effectively control the majority vote, thus diluting the class A shares' benefit. Further, class A shares' voting power should allow them to trade at a premium to the class C shares – and, historically, they have. However, that spread has diminished over time, and the class A shares now trade roughly on par with the class C shares. Some clients held both share classes, which has led to an overweight combined allocation. Therefore, we decided to consolidate our Alphabet position by trimming positions in class A shares, thus allowing us to reposition the overall portfolio. (Matt Holman)

BERKSHIRE HATHAWAY INC.

Berkshire Hathaway Inc. Class B (BRK.B)

Berkshire has long been a staple in clients' portfolios. In the past, we have written about Berkshire's structural advantages and Warren Buffett and Charlie Munger's investment prowess. However, Berkshire has a different investment profile today, and our thesis on the company has been changing. We will briefly dive into a few of our reasons:

1. The business has grown so large that it will struggle to continue to grow at historical rates. Berkshire has a history of purchasing smaller companies like Dairy Queen, Fruit of the Loom, Precision Cast Parts, among others. These were attractive acquisitions at the time, but deals of this size no longer equate to material growth for the giant conglomerate. Further sustained growth will require much larger deals, which are harder to find at discounted prices.
2. Berkshire is accumulating cash on the balance sheet as Buffett and Munger are reluctant to invest at current prices. Their inactivity during the early stages of the pandemic is concerning. While they did repurchase their shares at depressed prices, the missed investment opportunities could have stimulated growth, while the cash is generating little value at historically low-interest rate levels.
3. The profile of Berkshire's operating businesses and investment portfolio are drifting away from the types of business we find most attractive. For example, many of Berkshire's largest businesses include insurance companies, banks, railroads, utilities, and energy businesses. These are industries we have been shifting away from because they tend to (1) have inferior unit economics, (2) be heavily tied to macro-level commodities, or (3) have weaker economic moats while being challenged by modern business models. Consequently, Berkshire's investments have not performed as well over the past 5-10 years.

4. We have concerns over the succession plans for when Buffett and Munger move on from Berkshire. With both Buffett and Munger now each in their 90's, it is not clear what changes will be made once they leave, if any.

With this in mind, we have been opportunistically paring this position back. Some accounts held overweight positions that we trimmed to a more prudent portfolio weighting. In other cases, we used Berkshire as a source of cash to re-allocate capital to other investment opportunities. We will continue to monitor Berkshire as our investment thesis evolves while looking for opportunities to move more capital into other businesses that we believe offer greater upside potential. (Matt Holman)

The Charles Schwab Corporation Inc. (SCHW)

We decided to exit Charles Schwab mainly because of the businesses that we are more excited about long-term. Schwab is an unquestioned leader in the asset management industry. Still, we believe these businesses are structurally limited and of lesser quality than other industries. For example, Schwab's largest revenue source comes from net interest income earned on its' cash balances. The main drivers of this revenue are (1) total assets held, (2) the percentage held in cash, and (3) net interest rate margins. Schwab can gather more assets, but it cannot control how much is invested versus held in cash, nor can it control interest rates. There is also competitive pressure in its trading and asset management fees, which will require these businesses to find new sources of revenue to offset these headwinds. Therefore, we have concerns over the business's projectability and the quality of its growth – especially compared to some of our newer investment ideas. (Matt Holman)

Discovery, Inc. (DISCK)

We sold shares of DISCK for select accounts during the quarter. These were primarily taxable accounts that had an unrealized loss in the position. As we have discussed in the past, we sometimes sell shares of a company when it generates a positive tax-related outcome. We weigh this positive outcome with other factors, like the intrinsic value of the stock and the presence of attractive destinations for the associated capital. In accounts that qualified for the sale, we determined that the benefit of realizing the tax loss outweighed the benefits of keeping the stock.

For those accounts that still hold DISCK, we feel that it deserves a place in the portfolio in the current environment. While the company faces structural headwinds, we are optimistic about its ability to monetize its niche content through alternative distribution channels. During the quarter, Discovery announced the launch of its streaming service, *discovery+*. This service, which was released on January 4th, will take time to penetrate the market, and we will continue to monitor its success. In the meantime, we feel that the cash flow from the existing linear business provides a nice margin of safety and potential capital return opportunities for shareholders. (Louis Foxwell)

Vail Resorts, Inc. (MTN)

We trimmed MTN in non-taxable accounts that were overweight the position. Vail remains a core holding in client portfolios, and we reiterate our thesis that the company will emerge from the pandemic in a stronger position. However, we felt that we needed to pare down our heavy exposure to the travel industry. Since these accounts were non-taxable, we were able to efficiently accomplish this goal and reallocate the capital to the ideas presented in the "Buys" section. (Louis Foxwell)

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