Suncoast Equity Management, Inc.

October 1, 2012

Dear Client:

In the face of Europe's financial crises and China's slowdown, the U.S. economy, though sluggish, has held up well. The equity market staged a meaningful advance this quarter and year-to-date, as well as the SEM client portfolio. Year-to-date the SEM client portfolio is +21.6% versus +16.4% for the S&P 500.

From an economic perspective, the year has yielded few surprises. U.S. growth is sluggish, Europe is weak and has serious fiscal debt issues, and China's growth is slowing as it transitions from an export led to a bit more domestic consumption driven economy. Economic forecasts are not our specialty (and we don't put much faith in those that claim they can predict) but if this environment continues, we know where our focus will be, as it always is, finding growth businesses with competitive advantages.

<u>Growth, Competition and Innovation</u>

Throughout the global economic landscape are various pockets of secular growth. While SEM is fundamentally a bottom-up investor, we often own companies that participate in this type of growth. One secular growth trend is the increasing love affair with "smart" phones as a communication, productivity and entertainment device. Today, smart phones make-up over 20%, or 1 billion of the 5 billion global handsets. In terms of new sales in 2011, smart phones had roughly a 30% share of 1.8 billion total units. Industry analysts expect there to be 2.8 billion global smart phone users by 2014. Direct beneficiaries in our portfolio include **Apple** (AAPL), **Google** (GOOG) and **Qualcomm** (QCOM**).** AAPL in particular should benefit when and if China Mobile, the world's largest mobile phone service provider with 688 million users, offers its device once the new 4G system is complete in the second half of 2013. By comparison, AT&T and Verizon subscribers total 105 million and 94 million, respectively.

Another secular growth trend is the conversion of cash and check to electronic payment methods. **Visa** and our recent addition of **eBay,** are stars in this strong trend. The Nilson Report projects that the share of electronic payments will reach 65% of total payments by 2014 and the share of card sales will expand to 50% from the current level in the mid 40% range. In regards to these two very strong secular growth markets, our investments in this area represent nearly one-third of our portfolio.

As you know, our preference is for businesses which boast competitive advantages because, that yields better economics and investment returns. However, competitive forces surround businesses and attack regularly and it is one of the important factors we are constantly on the lookout for. We have a keen eye for both positive and negative developments. We recently reviewed a report that businesses are getting more comfortable buying technology from start-ups and small outfits, which could translate into less growth for the industry giants such as Hewlett-Packard, Oracle, Cisco and **Microsoft (**MSFT). Among the reasons supporting this new direction is that small companies reportedly move more quickly and make customers feel more important. Also, small companies enable easier product deployment and embrace new models sooner than large companies, which tend to lag or lack in new product offerings.

With competition, new industries emerge and old ones can die off, especially in markets like technology. We watch with great interest the battleground in "cloud" computing with the key participants being Amazon, GOOG, MSFT and Rackspace. Companies moving to the cloud are aiming to reduce IT costs and add technical capability. What we look for when this happens is that the customers often benefit more than the supplier. The customers that may benefit the most from these infrastructure or back-office advances are the ones that are in less competitive space or have strong franchises that enable them to take the cost savings to the bottom-line instead of passing it on to their customers. The providers of this critical service, such as MSFT, are quickly scaling and it will be interesting to see if it becomes a profitable business line. One area to watch is pricing trends among the competitors.

We've found that a lot of growth and innovation occurs in health care and technology and it is one of the reasons why we own several businesses in these two industries. Also the valuations are attractive. One of our holdings, **Gilead Sciences** (GILD) received approval this quarter for its HIV medicine that brings together four ingredients into a single pill. In recent years patients needed to take multiple pills daily but now this single pill is easier. GILD has been a leader in HIV medicine and with a recent acquisition, now also gains a strong position in future Hepatitis C treatments. GILD is a smaller weighting in our portfolio mostly due to the dependency on its single product, its HIV pharmaceuticals.

Even though a brand can first carry over to an international market, the competitive environment can undergo a change that produces negative results. For years consumer product companies offering items such as toothpaste and laundry detergent, dominated foreign markets such as China. Recently however, companies such as Procter & Gamble and Unilever have lost share to homegrown brands. An herbal toothpaste from a local firm has seen its market share grow to 8.8% from 1.1% during the past five years while P&G's share fell to 19.7% from 20.8% and Unilever to 9.9% from 12%. And this is in spite of the Chinese manufacturer's price point, which is about double the P&G Crest product. We fortunately have a few companies whose brands and products travel well and are undergoing increasing demand; AAPL, **Nike** and **Visa** come quickly to mind.

Entry into new markets can be profitable or be a dud. Some products and services travel well while others don't. Cultural adjustments are almost always necessary. One unsuccessful example is the efforts of Home Depot's expansion into China six years ago through the acquisition of twelve stores. The company recently announced it will take a charge of $160 million and that it is closing its remaining seven stores. The explanation is that the citizens of China are "Do it for me" instead of "Do it yourself." Home Depot is hoping a shake-up in its China strategy by focusing on specialty stores such as painting and flooring will help. Other major U.S. firms that closed stores recently in China include Mattel and Best Buy.

<u>Either an Owner or Lender be, but never a Renter</u>

I have heard from a lot of frustrated and upset individuals who after going through the recession and the stock market declines of 2008, feel as though the market is not a level playing field, that it is dominated by the "professionals," that it is "rigged," they don't trust it and the little guy doesn't stand a chance. It is true that it is dominated by the "professionals" if you prefer that label. According to John Bogle (Vanguard founder) ownership of US stocks by financial institutions has leapt to 70% from 8% since World War II when individuals dominated. With this shift in ownership, "stock trading" has replaced "investing," as the average holding period declined to seven months from eight years in 1960, as long time market analyst Bryon Wein observed. So the change in ownership to mostly institutions doesn't seem to be that "professional" to us. In fact, it is mostly dominated now by "renters" and not "owners." Along with the vast media reporting, the "renting" crowd has clearly pumped up the volatility that the individual investor should ignore. Warren Buffett recently wrote, *"Assets can fluctuate greatly in price and not be risky as long as they deliver increased purchasing power over their holding period."* At SEM we are "owners" and our average holding period is in excess of five years. Our portfolio of companies clearly demonstrated their economic strength prior to, during and post the difficult market of 2008. Our investment philosophy of "ownership" may be in the minority now and forever more but it is what works in our service to preserve and grow your capital, and our own since we eat our own cooking and own the same companies.

With "renting" out of the way, we believe that successful investing boils down to "owning" and "lending." We will make this brief because we have mentioned it in nearly every quarterly letter for the past year or so. "Lending" does not offer a competitive return today when considering bonds of highly rated corporations, U.S. Treasury and some municipalities. In fact it can be downright dangerous to your net worth if for example you buy a thirty-year highly rated bond of PepsiCo paying you 3.6%. With long-term inflation at nearly the same rate of 3.4% you are standing still at best. And although you would regain your investment at par plus that interest rate return in 30 years, along the way when rates eventually rise you will feel the pain that can be significant. Did you know that if interest rates increase by one percentage point, a 30-year bond with a 4% coupon will decline in price by about 15%? A two percentage point increase in interest rates would cause a drop in price of about 25%, while a three percentage point increase in rates would push the bond down by about 35%,

<u>Looking not too far ahead to 2013</u>

With SEM's portfolio of hand-picked businesses, we are confident in the growth and relative valuation levels as compared to the overall market and fixed income. The early earnings outlook for 2013 for the SEM portfolio is growth of +12.9% compared to the S&P 500 +6.9%. So greater growth is obviously more desirable, but are we paying too much for this growth today relative to the general market? The answer is no. The price to earnings ratio (P/E) for SEM and the S&P 500 looking forward is 13.9 and 13.2 times, respectively. The inverse of P/E is earnings yield. What this essentially means is that for every dollar we invest, SEM portfolios generate a 7.2% earnings yield versus a 7.6% earnings yield for the S&P

500. So SEM clients are getting a significantly higher growth rate, for almost the same price. One other complementary component and statistical measure connected to higher growth is the return on capital for our portfolio companies versus that of the general equity market. The average return on capital for companies in the SEM portfolio is 24.8% versus an average of only 12.5% for companies in the general equity market (as represented by Value Line index of 1700 companies). It is the interaction of our comparable earnings yield compounding at a much higher return on capital, which gives us the major advantage.

<u>Spark Smart Thinking and Execute</u>
With the election only 30 days or so away, we need to revisit with all voters that despite the occasional shortcoming, capitalism really works and it has been snuffed out by government lately. So simply what is capitalism? *Wall Street Journal*'s John Bussey suggested in July a brilliant idea to consult the Merriam-Webster dictionary: *"An economic system characterized by private or corporate ownership of capital goods, by investments that are determined by private decision, and by prices, production, and the distribution of goods that are determined mainly by competition in a free market."* The recent Affordable Care Act is not capitalism at work; in fact it is the exact opposite. Ordering people into a national health-insurance pool is not free market forces. As *Wall Street Journal* columnist Daniel Henninger added, *"There is a disconnect nearly everywhere between governments and the way life is lived by the people they govern.* In the new world of social media, the central processing of health care is out of step with our current universe and behind the curve.

We need to let capitalism, not government, lead the way. Capitalism is capable of smart thinking and sparking key investments in such important economic areas as infrastructure. For example, our transportation infrastructure is deteriorating. About one-third of the nation's highways are still in poor or mediocre condition, reports Clifford Winston of the Brookings Institute. Our governments nearest answer supported by President Obama and recently led by state officials such as California Governor Jerry Brown, is to waste billions on bullet trains. At the same time, the free market solution is being led by GOOG which is developing a driverless car. A much less costly option than building bullet trains is rethinking highway design, as noted by Winston in his recent book. He emphasizes the driverless car can take advantage of the current infrastructure and save billions versus bullet trains. Add innovative technology improvement such as short-range transmitters, reduced lane separation between cars and trucks, and major improvement in signal timing based on real-time traffic flows (instead of historical data) will vastly improve safety and quality of life. Here is the kicker, the solution would not require taxpayer funds and could be implemented by privatization, much like the private highway companies which have leased the Indiana toll road, Chicago Skyway, and Dulles Greenway.

It is our hope that the next administration improves upon the morass of the last few years and puts in place policies and reforms that support investment, production, and incentive to work. Undoubtedly we will get some direction on the "fiscal-cliff", the combination of tax increases and spending cuts that will go into effect at the beginning of 2013 if nothing is done. We need incentives and programs to strengthen the recovery, reduce regulation, and chart a clear path towards getting the fiscal house in order.

<u>Concluding Thoughts</u>

The equity markets have made a strong advance so far this year. Where they head in the final three months is not predicable or worth the attempt. As famed investor Peter Lynch was quoted in 1989, *"all the major advances and declines have been surprises to me."* At SEM we don't try to predict the up/downs of the market, rather we focus on the "ownership" of high quality businesses over the long term to preserve and grow your capital. Sid Cottle, who is the editor of later editions of Graham and Dodd's seminal text book *Security Analysis*, summed it best by saying that "*investment is the discipline of relative selection."* At the present time equities are still reasonably priced on an absolute basis and in comparison to most fixed income. In the meantime we will continue to follow the progress of our businesses and review new opportunities for investment. We welcome your call at any time and we offer continued thanks for your support.

Sincerely,

Donald R. Jowdy
President

Suncoast Equity Management, Inc.

Performance results versus the Standard & Poor's 500 Index

Time Period	SEM % Return*	S&P 500 % Return	SEM - Value of $1,000,000	S&P 500 - Value of $1,000,000
Nine Months	+21.55%	+16.44 %	$ 1,215,500	$ 1,164,400
One-Year	+32.62%	+30.20%	$ 1,326,200	$ 1,302,000
Three-Year	+13.42%	+13.20%	$ 1,458,900	$ 1,450,700
Five-Years	+3.34%	+1.05%	$ 1,178,500	$ 1,053,700
Ten- Years	+6.69%	+8.01%	$ 1,910,500	$ 2,161,500
Inception (14 3/4 Years)	+7.14%	+4.58%	$ 2,767,100	$ 1,935,500

* Composite results of all SEM managed accounts, net of all fees.
Note: Performance results for the three, five, ten and since inception year periods represent the annual average rates of return.