Suncoast Equity Management, Inc.

October 2, 2014

Dear Client:

The SEM portfolio gained on the overall market during this quarter but lags year-to-date, with our SEM accounts +6.2% versus +8.3% for the S&P 500. Our portfolio remains very attractive on a relative basis (which we discussed in detail last quarter) as we enter the fourth quarter and look towards superior earnings growth again in 2015. There was only minor portfolio activity this quarter as Oracle bought **Micros,** so our shares were tendered for cash. We redeployed the proceeds to our newer holdings **Honeywell** and **Priceline** and also added to **eBay**.

Market at All Time Highs – Time to Take Profits?

The daily conversation is that the market is near all time highs. So the immediate question is should investors take profits? The right answer is no. Long term investors should only consider cutting back if valuations are extremely stretched both *absolute* and *relative.* On a *relative* basis, low yields across much of the high quality corporate and treasury fixed income markets continue to support an overweight position in equities whose earnings stream is in a position of growth.

On an *absolute* basis, we look at valuations relative to current and forecasted earnings. The market is near an all-time high because earnings are at an all-time high. Earnings have doubled from the depths of the economic recession reached in 2008, and can be viewed in the Actual Next Year Earnings column below.

S&P 500 Index

At Year End	Price Level S&P 500	Next Year Forward Earnings Estimate	Price to Forward Earnings Ratio	Actual Next Year Earnings	Variance Between Forward and Actual Earnings
2006	1420	83	17.1	83	-1%
2007	1470	91	16.2	50	-46%
2008	890	71	12.5	57	-20%
2009	1125	76	14.8	84	10%
2010	1260	94	13.4	96	3%
2011	1250	102	12.3	97	-5%
2012	1460	108	13.5	107	-1%
2013*	1850	117	15.8	117	----
2014 - Sept 30th	1975	127	15.5	???	

* Actual Earnings for 2014 still have two remaining quarters.

Though we invest in individual stocks, which should be priced at the discounted present value of the future net earnings of the business and not “the market”, we can still look at an aggregate measure of businesses and their earnings trends to get an idea if the market is overvalued or undervalued. The conclusion from the above table is if the S&P 500 earnings advance by about 8% or so in 2015 as predicted, then the market is in a reasonable valuation range assuming continuing earnings growth. Taking a step back, you can also see from the table that as the economy entered that very difficult period in 2008-2009, next year forward earnings estimates varied considerably from actual earnings results. Out of the recession and into the present, which is characterized as a low growth (and not robust) economic environment, the variance between forward earnings and actual earnings have narrowed considerably.

Looking forward, we always observe (but never try to predict) the pillars of the economy to understand if earnings erosion might be on the horizon. And although earnings will undoubtedly not hit the exact estimate for 2015, we don’t expect them to be too far off. So if we remain in a slow growth economic environment, with the market priced at a 15.5 times earnings ratio, we are getting a 6.5% earnings yield which is line with the long term history of the markets.

Creating Scale

It was a very quick summer and it is much too early to be thinking about fall and winter; never mind the fast approaching holidays ahead. What is even more amazing is the quickness in which a few companies have built scale and profitability and been rewarded with some of the highest global capitalizations in just a short time period. Several of these companies are in the technology space and I can't recall another time in history quite like this. These companies are having a major impact on commerce and our daily lives, and they have only been in existence for as little as ten to fifteen years. All the rage this past month was the initial public offering of Alibaba (BABA), China's largest e-commerce company and among the top 15 valued companies on this earth. BABA's valuation soared 38% on the first day of trading and closed at a market valuation of $230 billion, exceeding that of Facebook and Amazon at $200 and $150 billion respectively. **Google's** (GOOG) market valuation at $400 billion is nearly twice BABA's; however put in perspective, GOOG's revenue and operating income is significantly higher at $65 and $15 billion versus BABA's at approximately $9.5 billion and $4.3 billion, respectively.

The two companies can be congratulated on their success and it will be interesting to watch them leverage the scale they have gained going forward. BABA's public offering will give it capital to try and create greater scale but it will need to grow its intrinsic value at a very high rate, at least in the thirty percent range for the next few years to support the current enthusiasm. BABA has 80% market share in China, a country with 600 mm citizens online (twice the U.S. population), and the new capital has led founder and Chairman Jack Ma to express his intention to expand in the U.S. and Europe. That could prove difficult given established players with their own scale in the U.S. such as Amazon, **GOOG** and **eBay**.

We have been owners of **Google** (GOOG) for nearly seven years as the company has been publicly traded for ten. The success of its core operation has provided significant cash that has led to additional investment creating great scale. We have described in the past many of the successes of GOOG's investments including YouTube. You are likely bored with us writing about it once again but this is an additive angle from our previous letters. YouTube is a very valuable asset and has become a disruptive force in shifting advertising spending. YouTube's internet video marketplace is a major source of content (entertainment and otherwise), drawing 1 billion views around the planet monthly. The scale it has created here and the inventive distribution medium is drawing dollars away from the old line advertising channels, including the most coveted and the largest of them all- TV. To put it in perspective, the U.S. total advertising spend is approximately $175 billion annually and TV makes up about 37% of that or $66 billion. Digital video is only 2% of the total, or about $4.5 billion (with YouTube about $3.5 bb of that), but it was barely $1 billion only two years ago. The disruptive shift which may only be in its infancy is tantamount to the shift that took place in the 1980s when cable TV channels like ESPN and MTV were just coming on the horizon, where only a few conquered the confusing new distribution landscape at that time.

So advantages of scale in and of itself can be useful, but more importantly it is how it is leveraged. While both BABA and GOOG will leverage their scale, it seems that GOOG is using its cash researching big needs and new ideas. GOOG's scale is allowing them to commit so much to research and development that they can pull off technological leaps in both scientific understanding and engineering capability that lead to specific products or services, such as its already known segment of autonomous vehicles. Advancing health knowledge and solutions is another big area for GOOG and it begins with its massive effort to collect data including the area of cancer care, which some sources estimate patient treatment data collected is as low as 4% of the total. Through an investment in a startup called Flatiron Health, if they can organize and standardize much of the remaining 96%, they may be able to help the nearly 1.7 million new Americans diagnosed with cancer this year. According to Flatiron, a 5% improvement in patient survival from treatment data information would equate to saving tens of thousands of lives this year alone.

Meanwhile BABA has essentially copied the playbook of others such as Amazon and GOOG and skillfully targeted a different geographic market. But if BABA does not create anything new and all it does is expand into geographic markets or areas such as mobile where strong competition exists, they may not be successful. They may just create greater competition resulting in lower profit margins. Good for consumers but perhaps not for shareholders of BABA. We favor GOOG at present but will keep on eye on BABA's intriguing development.

McKesson is a portfolio holding that will, like GOOG, cross the seven year ownership mark for SEM clients this fall. It has taken advantage of the scale it has built and the excess cash it generates to invest in even greater scale through acquisitions in the last few years. MCK is the largest and one of the most powerful U.S. pharmaceutical suppliers serving the likes of CVS, Rite Aid and Wal-Mart as it distributes one of every three prescription drugs in North America. The company is also the second largest specialty drug distributor with a leading position in rheumatology and second position in oncology. MCK recently entered the European market by acquiring a majority stake in Celesio, one of Europe's largest distributors and retail pharmacy chains. This acquisition will enhance MCK's global (as opposed to just North America) supplier purchasing power, which will allow MCK to achieve higher margins. In addition, MCK recently bought PSS World Medical which expands the company's reach to medical supplies, diagnostic tests, and services.

Fall Ahead?

Since emotions can drive the market in the short run, downdrafts can come at anytime. We never advocate trying to guess when a "correction" will come by selling your stocks and trying to buy back in later. No one can consistently time the market, and most that try get it wrong more than they do right. Despite hitting market highs, valuations overall are not stretched. The **SEM-Disciplined Investment System** (SEM-DIS) focuses on safety and the intrinsic value progress of our portfolio holdings. We still see favorable growth ahead, especially relative to the overall market. With our better safety profile, we are not at all concerned with our scorecard lag against the market this year, especially after three very strong years of outperformance through 2013. We welcome your call anytime.

Sincerely,

Donald Jowdy

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**
First Nine Months 2014	+6.2%	+8.3%	$ 1,061,600	$ 1,083,400
One-Year	+19.5%	+19.7%	$ 1,194,900	$ 1,197,300
Three-Year	+23.4%	+22.9%	$ 1,880,800	$ 1,860,500
Five-Years	+15.6%	+15.7%	$ 2,069,100	$ 2,073,000
Seven-Years	+7.6%	+6.0%	$ 1,671,400	$ 1,505,700
Inception (16 3/4 Years)	+8.5%	+6.3%	$ 3,924,300	$ 2,765,800

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