Suncoast Equity Management, Inc.

January 2, 2014

Dear Client:

The equity markets booked a significant gain for the year and SEM managed to achieve its goal of outperforming the market, with SEM clients +36.2% versus the S&P 500 +32.4%. The market's return this year ranks within the 20 best annual rate of returns during the last 85 years or so since reliable data began in 1926. With market strength the last two years and SEM's outperformance, there may be concerns of significant overvaluation. We believe the better characterization is that we are at "fair valuation" levels and returns should be more reflective of earnings gains from here. We share some thoughts to support this conclusion as well as cover finer points of qualitative analysis with two of our portfolio holdings.

Fair Value - Not Bubble Territory

The great investor John Templeton once said: "*Bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.*" At present we have left behind dire pessimism. The economic mood and general investor sentiment seems to be of caution, so you might say we are in the "grow on skepticism" phase, but we are certainly short of the euphoria stage. Doubts still linger at the individual investor level and from our corporate leaders. Most large businesses have been hoarding cash and then returning it to shareholders in the form of dividends or stock buybacks, instead of heavily investing it towards new growth. Investors still wear the scars of the financial crisis of 2008-2009 as reflective in the lopsided demand for fixed income investments in spite of an extremely low return environment for most opportunities here, with the exception of some muni bond segments.

Sayings are cute but we shouldn't rely solely on generalizations. The numbers provide a picture. During extreme market dislocations such as the financial crisis of 2008-2009 or the dot com bubble in the late 1990's, we can identify with confidence that the market is materially undervalued or overvalued. Below we share the average price to earnings ratios and earnings yield at the top of the 1999-2000 time periods, at the absolute lowest level of the 2008-2009 time period, and the current valuation for a few representative companies:

		P/E			Earnings Yield	
	High **2000**	Low **2009**	Current **2013**	High **2000**	Low **2009**	Current **2013**
Cisco	99.7	12.9	11.1	1.0%	7.8%	9.0%
Coca-Cola	47.5	12.7	18.2	2.1%	7.9%	5.5%
Disney	46.0	8.3	18.9	2.2%	12.1%	5.3%
General Electric	40.1	5.5	16.3	2.5%	18.1%	6.1%
Johnson & Johnson	31.6	10.0	15.8	3.2%	10.0%	6.3%
Microsoft	49.8	9.2	14.0	2.0%	10.9%	7.2%
Average	**52.5**	**9.8**	**15.7**	**2.2%**	**11.1%**	**6.6%**

Reviewing the above table we can conclude that we are not at either the extreme high or low valuation. We would currently characterize the market as "fairly valued" at present and would conclude that gains from here are much more dependent on earnings progress than a closing of the gap between current stock price and "fair value" where we came from in part since 2009. When we say we are hovering around "fair value" we should make a few points here. First, assessing fair value is not an exact science. With our example of Coca-Cola, if you asked Warren Buffett and I to each write on the back of a paper napkin what we thought the fair value is we would likely reach different conclusions and this is in spite of a key aspect that we use a similar approach to achieve investment success. So why can our estimates of fair value differ? Well, a reasonable amount of uncertainty is inherent when predicting the future cash flows of a business and the future cash flows of the business translate into the present value of the business. Of course the more predictable the future of the business, the closer we will come in our valuations. Importantly, we both value the cash flows to come up with a fair value and then we compare this to the current stock price quotation to gauge our interest in buying it today. Many participants in the stock market don't do this work or even consider this common sense approach.

Intrinsic value is also a moving target. Over time, intrinsic value rises as company earnings grow and then so does the stock price. That is why we focus on growth businesses and also attempt to identify companies with increasing competitive advantages. So when we identify "fair value", if earnings for our businesses are growing then the "fair value" will be higher at the end of next year and the year after that. Stock prices will bounce all around fair value, sometimes at extreme variances. However, the key takeaway is that our portfolio of businesses continue to increase their intrinsic value (even though intrinsic value is not a precise figure) and that the portfolio is not meaningfully overpriced. Over the long term we expect our future returns will come more from growth in the fair value than from appreciation from a discounted purchase price to fair value.

Finer Points of Business Analysis

As we seek companies with the characteristics to steadily increase intrinsic value, the **SEM-Disciplined Investment System** (SEM-DIS) engages a two-part, quantitative and qualitative analysis. The quantitative review has two important components, fundamental review of the business financials and relative price to value of the stock. Once we determine the company has passed our financial strength review, we need to review the quality of its competitive advantages and review management's ability to allocate capital within the interest of its shareholders. As in our reference above to how we would value Coke, we need to judge if this business is chugging along, picking up steam or is struggling and in need of a lot more coal just to keep up.

Google (GOOG) is an important portfolio holding and plays a part in each of our daily lives. It has the most pervasive mobile operating system (Android), commands a leading position in web search, and runs a very popular browser (Chrome) and email service (Gmail). It provides various products and services so we all don't mind engaging in its customers advertising messages. GOOG gets high marks from its users which lead to an increasing number of people using its services and this leads to a network effect of positive growth. One recent qualitative clue includes reports that GOOG's new "product-listing" strategies on its search page are attracting major advertisers such as Wal-Mart. By retooling its search page, GOOG is helping its retail advertising clients take sales volume from digital leaders such as Amazon. It specifically addresses shoppers who know what they want to reduce the number of clicks to get to the "buy" button. I put this to work during my holiday shopping this season and can report a good experience.

Overall, GOOG captures a third of the world's $115 billion plus in digital ad spending. As the time spent by consumers with digital media surpasses TV viewing for the first time this year, GOOG will continue to expand the value it provides to its customers. Companies like Procter & Gamble are paving the road with digital ad spending and promotions nearing 35% of its current marketing budget, well beyond the estimated 20% share that is average for most companies. You can see from current penetration rates that digital ad spending versus traditional media like TV and print still has gains ahead.

GOOG has demonstrated keen capital allocation skills with acquisitions over the years such as YouTube. Purchased in 2006 for what seemed like a big number at $1.65 billion, especially during the days of grainy and amateurish videos, YouTube has grown to become an empowering service that showcases a wide variety ranging from young musical talent, all sorts of instruction videos, to attempts by large corporations to create viral success with a product promotion be it a car or mop. This year YouTube should ring up over $4 billion in revenues and represent over 10% of total sales. Now on deck for GOOG is the midsummer purchase for $1 billion or so of Waze, an interactive mapping and navigation service start-up. I'm a personal fan of Waze and started using the service early this year on my smartphone. It is used in about 190 countries and draws from both GPS information and its broad user base to provide drivers with better routes around traffic jams, identify road hazards such as accidents and snow/ice, and for the speedy, radar trap locations. Its core members help edit maps and can add details such as gasoline prices at nearby stations. You can also develop social relationships with fellow "Wazers" that pop up on the software as you use it. It will take some time to become a success and to see if Waze can become nearly as valuable as YouTube or for that matter other social media sites such as Facebook. So far GOOG has a pretty good record at creating value.

GOOG is a clear example of a company that has high opinions from its customers and is leading its marketplace. The company is expanding its competitive advantages and combined with strong financials, it deserves to be an important position in our portfolio.

As many of our companies lead their respective markets, we have to watch for competitors storming the castle. We need to observe the attacks on the moat and the capable strategies of the underdog that threaten the potential soft underbelly of a company that may have become complacent in serving its customer, or in some cases too greedy. **Express Scripts** (ESRX) has built a very successful business over the years though it is a fairly young investment for us, with an ownership period of only eighteen months. We are watching recent developments closely and believe sharing our thoughts will give you additional insight into our qualitative research process. ESRX is the largest prescription benefit manager (PBM) in the country serving over 100 million people and along-side CVS Caremark and OptumRx, controls about 70% of all U.S. prescriptions. The industry evolved from simply processing medical claims in the 1970's to essentially acting today as middlemen to negotiate pricing from pharmaceutical companies, manage drug benefits for its corporate customers and dispense medications from its mail-order pharmacy. PBMs grew from both organic efforts and a major consolidation through mergers and acquisitions. Today the PBMs are as large as or larger than their clients with ESRX now at the No. 24 spot on the Fortune 500. Along the way they have built major advantages of scale and distribution facilities to maximize efficiency and assisted patients by minimizing errors in dispensing and labeling of medicines. With size came power and the ability to have a heavy hand in which drugs people take, in part because they studied how best to manage the patients taking the product.

ESRX and other large PBMs have also most certainly had a helping hand in attacking the high cost of medicine. But there is some recent concern that the spreads between what they purchase and then sell at has become too large, as covered in a very good article by *Fortune* columnist, Katherine Eban. For sure pricing of pharmaceuticals can be opaque with the mix of various payees like Medicare and the rebate strategies of pharma manufacturers all playing a part. It is also easy to conceive however, with human nature being what it is and profit as a motive, that PBMs can put themselves intentionally or unintentionally into a position of benefiting too much at the expense of their clients by expanding the "spreads" as their market share expands. Of course this invites competitors with new strategies and opens the industry to criticism as a very large target for regulators, since it is an industry that is front and center of public policy. Competitively, the industry is experiencing the emergence of a number of "transparent PBMs" that just add a flat administrative fee to the cost they pay for the drug, instead of a markup. We will be monitoring the progress of these companies. We obviously prefer to own companies that lead their market, but also want to own businesses with satisfied clients. So we are paying attention to another observation that recently surfaced. With year after year of enduring steadily rising healthcare costs, it is hard to garner a positive opinion from customers. But when your own industry group, the PBM Institute, puts out a 2013 customer satisfaction report and ESRX is ranked by your customers as lowest in overall satisfaction, and second to last in delivering promised savings and having no conflict of interest issues, it raises an eyebrow. We will look for improvements at ESRX in this regard or make a decision about our long-term ownership commitment as more information develops.

Looking Ahead

Returning to sentiment and market opinions, ignore the pundits that forecast slow to negative growth and the "expert" on CNBC that says it feels like a "correction" is due. Predicting the near term direction of the economy or the next market movement, rarely is done with any accuracy. In fact, it has never been a part of our process that created satisfying results since our inception. Likewise short term performance is never our objective. Our yearly rate of return rarely, if ever, matches our since inception annualized rate of return of 8.5% net versus the S&P 500 of 6.0%. So regardless of whether the market is up 30% or down 30% we recommend that you continue to focus on the long term results in which in the first sixteen years, our original investment grew to 3.7 times versus 2.6 times for the S&P 500. At SEM, we will keep working on building this relative value for you as our client.

We always remain practical optimists, positive when the public mood is negative and measured when the good times are rolling along. If you look back over the sixteen years of client letters posted on our website you will see us often write about the positive. Today the entrepreneurial spirit is alive and well when you consider the explosion of mobile communications and social media. We also see strong trends in additive manufacturing like robotics and advances in biotechnology, which prolong or enhance the quality of life measurably.

We stick to our discipline, investing in companies which demonstrate the ability to grow intrinsic (earnings) value and lead to above market investment returns, while taking less risk over the long-term. It's ok to pay a fair price for a company with strong, growing competitive advantages and a long runway for growth. With this as our mantra we are confident in the soundness of our investment philosophy and process. We will work hard to do well for you as our client.

Many thanks for your confidence and trust. Best wishes for a peaceful and successful 2014.

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**
One Year 2013	+36.2%	+32.4%	$ 1,361,800	$ 1,323,900
Three-Year	+19.2%	+16.2%	$ 1,694,000	$ 1,568,200
Five-Years	+17.7%	+17.9%	$ 2,257,700	$ 2,281,900
Seven-Years	+8.2%	+6.1%	$ 1,737,900	$1,516,600
Ten-Years	+7.7%	+7.4%	$ 2,105,000	$ 2,042,900
Inception (16 Years)	***+8.5%***	***+6.0%***	***$ 3,696,600***	***$ 2,552,800***

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