SUNCOAST EQUITY MANAGEMENT, LLC

July 2, 2016

Dear Client:

SEM results for the first half of 2016 are below the general market, as our composite results of fully invested portfolios are -4.1% versus +3.8% for S&P 500. Investor uncertainties, mostly about the economies outside the U.S, persisted and were exacerbated by British citizens' vote to leave the European Union (Brexit) at the end of the quarter. Brexit caught investors by surprise, creating great volatility and declines in some groups of equities, especially those with global, financial and European exposure. The equity index is being mostly supported by the upward bounce in energy prices, oil in particular, and the higher prices investors are willing to pay for dividend paying stocks as interest rates decline. Market leadership by utilities, energy, and materials last took place ten years ago in 2005-06. The market can be influenced in the short run by wild fluctuations in commodity prices or political events, and longer term fundamentally by the level of interest rates.

At SEM we believe the combined publicly owned equity in corporate America moves forward over time with only a few significant setbacks in terms of time or amount. The alarming short-term drop in stock prices has very little effect on the long-term intrinsic value growth and valuations of businesses. During the quarter the **SEM-DIS Disciplined Investment System** called for the sale of two companies from our portfolio, and we feel very confident in the new additions. We discuss the portfolio update, "Brexit," energy, and the impact of reduced interest rates below.

<u>Portfolio Update</u>

SEM welcomed two companies to the portfolio this quarter, **C.R. Bard** (BCR) and **Starbucks** (SBUX). Started by Charles Russell Bard in 1907, BCR pioneered the development of single-patient use (consumables) medical products for hospital procedures and distributes its products globally to hospitals, healthcare professionals, extended care and alternate facilities. Its main segments are Vascular, Oncology, Urology and Surgical Specialties. Over the last 3 years, BCR has shifted its portfolio to faster growing industries and geographic markets. As a result, organic revenues and margins are increasing. BCR should generate free cash flow in excess of $750 million, after a low dividend payout to shareholders of approximately $70 million. Over the last decade, BCR's preference has been to apply much of its excess cash, after its investment in research and development and acquisitions, towards shrinking the ownership pool as shares outstanding have fallen 29%. We are very comfortable with this strategy since it increases our ownership over time and reduces the taxes we might pay from the dividend payout.

Starbucks is no stranger to any of us. But you might not know that it also owns the popular Teavana tea shop and Tazo tea brands in addition to Seattle's Best Coffee, strong brands in their own right. SBUX has approximately 8,800 company-owned stores in the Americas, 3,650 elsewhere and 11,500 licensed stores worldwide. SBUX's initial genius, besides its product offering, came by developing its locations as choice destinations within their respective communities. It was something McDonald's only realized and strived for after it witnessed what SBUX accomplished. The current chapter for SBUX, which is supporting organic domestic growth in the mid single digits, may be the customer's addiction to its products and their satisfaction with service. SBUX is very forward thinking when it comes to using technology and service innovation to improve the customer experience and loyalty. Overseas holds another significant opportunity long term; in mainland China SBUX has over 2,000 units, which should grow to 3,400 by 2019, and possibly 10,000 over a longer horizon.

We let SBUX elude us in the past as we have been sensitive to valuation. We became owners now as it is our view that SBUX, as one of the best *global* consumer businesses, can deliver solid long term growth in an otherwise muted global growth environment. We also believe we are taking advantage of the recent lull in the stock price as loyalty program changes earlier this year have created short term investor uncertainty. SBUX changed its program to reflect rewards on dollars spent versus the number of transactions. Since the initial media concern, over 500,000 customers have signed up for the program.

In our letter just last quarter, we gave accolades to Apple (AAPL) for making the strategic decision to install its latest technology across all its iPhone offerings. After that positive comment, you may be wondering why we recently sold

AAPL from the portfolio. In mid April AAPL reported soft business results in China and at roughly the same time the Chinese government announced that they shut down AAPL's online iBooks and iTunes movie services offering. China was on its way to becoming AAPL's most important market growing to 25%+ of revenues from 12% in 2011. However, the recent overtones by the Chinese government make it a much more challenging and uncertain business environment. In fact another hurdle arose for AAPL in Beijing after we sold it. In mid June, a little known startup Shenzhen Baili won an injunction, albeit it was stayed pending appeal, against AAPL's latest phones on a claimed patent violation. China is very protective of its local technology industry and AAPL had largely escaped most of the scrutiny up to this point. While it is possible that demand could recover with its next generation phones, these recent regulatory restrictions, permanent or temporary, can impact the Chinese consumer's decision and may make the iPhone a less desirable device. The value of AAPL's ecosystem is dependent on keeping users engaged in its own apps and services.

In terms of **SEM-DIS**, AAPL's issues and these business data points weakened the *Margin of Safety (MOS)*. MOS is an important element in investing first phrased by Benjamin Graham. Most investment managers that have embraced the intellectual village of Benjamin Graham and Warren Buffett, associate MOS with the gap between price and value, or on an entirely quantitative basis; the lower the price in relation to value, the greater the safety. While SEM acknowledges and shares this view, we have extended the Margin of Safety to the qualitative side of the analysis. On the qualitative side, MOS is the judged clarity of the particular business economic moat and advantages. If the environment shifts or business developments occur that may signal structural uncertainty or a negative direction, then margins of safety have been compromised. That is why the SEM-DIS called for the sale of AAPL, in spite of the potentially perceived wide gap between AAPL's price to value. Qualitative Margin of Safety out trumps quantitative Margin of Safety for SEM.

We sold our position in Abbott (ABT) shortly after it announced its intention to purchase St. Jude Medical (STJ). Although St. Jude's businesses seemed to be gaining a bit of momentum the last two years and it was on our close watch list, our opinion is that ABT essentially may get caught dating too many girls at the same time. In February, ABT announced its intention to buy Alere, a point of care diagnostic company, but wanted out of that transaction when it announced the intention to buy STJ. Alere does not want to let ABT out and if both of these large businesses get merged into ABT, it may be too much to handle. It also signaled to us the possibility that the STJ transaction was to save ABT's chances of being relevant in the medical device business, when we were thinking it was going to exit this business knowing it had a weak hand at present. If ABT buys both companies, the materially higher debt load may be a bit of a strain and we prefer companies with strong balance sheets. We applied the proceeds of our sale from ABT to our purchase of CR Bard discussed above.

<u>Déjà vu? With One Exception</u>

The year so far looks a lot like ten years ago for SEM; the one difference at the end of the quarter was the UK's vote to leave the European Union, termed "Brexit." The only thing markets hate worse than uncertainty is surprise. Fears from Brexit's surprise pushed down stock prices in general, and specifically any company with a strong European footprint or exposure to the financial industry. Immediately following the vote, a few of our portfolio holdings suffered price declines more in line with the double digit declines of the European market. **Priceline** (PCLN)**,** with its booking.com origins in Europe, has approximately 15% of total bookings from the UK. While forecasting the exact economic impact is not possible, as a comparison PCLN and travel bookings in general remained resilient between 2011 and 2013 when sovereign debt and financial unity uncertainty existed in the Eurozone and drove down GDP growth. **Accenture** and **Cognizant Technology** also were hit as these companies provide technology consulting and outsourcing services in which 20% and 40% of their businesses serve the financial industry. While some projects could get delayed, we believe the early innings of digital and the global shift to cloud computing keeps the long term growth outlook for these two well intact. We believe the price declines for these holdings and a few others in particular were overdone.

The S&P 500 is up 3.8%, gaining nearly all its strength from four of the of ten industry sectors, including telcos at +21.8%, utilities at +21.2%, energy +13.1% and materials +6.7%. SEM is underperforming the general market index in 2016 for nearly the same reason we did in the two consecutive years of 2005-06 when energy, materials and utilities led the market. These industry groups do not qualify as long term wealth builders under **SEM-DIS**. We are not concerned about our current underperformance and we will not chase those industry groups. We also can't predict how long their lead will last.

SEM-DIS's past, and with near certainty its future, will exclude energy companies from consideration due to the commodity related nature and the historically heavy capital expenditure components of the industry. The **SEM-DIS** favors businesses that generate consistent earnings growth and that earn above average returns on capital for long periods.

Energy companies have never achieved either, as both earnings and returns on capital fluctuate wildly and can go deeply negative as they have recently. Energy and materials related businesses are a slave to the market price of their product, which they have no control or influence. In stark contrast, companies we own set the price of their product such as **Disney** on park admission or **Honeywell** with its aerospace or turbocharger products. For as long as we can see and has been in the past, the wide swings of commodity prices such as oil, can have a dramatic short term impact on the industry's stock prices.

Concerns about the global economy have driven yields down to record low levels. Yields are negative in some areas of Europe and Japan, guaranteeing you will get less back than you invested. This flight to safety, as it is referred to, has also occurred in the U.S., driving up the prices of bonds (lowering yields) and nearly any equity paying a dividend, especially utilities. Today the ten year U.S. treasury is yielding 1.5%, and will lose against inflation if the Federal Reserve achieves its 2% inflation range. A year ago the ten year yielded 2.3% and ten years ago you could earn just over 5%. Good quality corporate bonds have also seen yields come down and prices go up, with a maturity of 20 years or more, corporates are at 3.25% today versus one year ago at 4.25% and ten years ago at 6%.

As interest rates have dropped, we have seen a meaningful rise in common stocks whose dividend payouts and yield rival bond yields, even if the companies are posting flat to down earnings growth. McDonalds's (MCD) is a great example of this as its stock price is up nearly 30% in three years in spite of the decline in net income. In 2013 MCD earned approximately $5.6 billion and in 2016 expectations are in a range of $4.9 billion, or $700 million less. So why has MCD common stock increased? Because as interest rates have dropped investors have scrambled for income and yield. MCD's dividend yield is currently 2.9% down from 3.7% last year but still well above its bond at 2.3%. The company has raised the dividend by 15% since 2013 in spite of the decline in net income. Of course you can't have this scenario continue forever, rising dividends and earning less income. Dividend paying companies, telcos and utilities especially, have been in in very high demand and may be rich in price.

Without getting too deep into MCD's fundamentals, suffice it to say it is a stock that has been in high demand recently and may continue to be with rates at such low levels. Interestingly, investors are willing to pay as much for McDonald's common stock because of its higher dividend payout, as they are for **Starbucks** even though SBUX has a much better outlook for growth. We would rather own the company with a much brighter intrinsic value growth outlook and sacrifice the partial earnings payout of MCD today.

<u>Enjoy the summer</u>

The underlying message from "Brexit" loud and clear is concern about economic wellbeing and frustration with unproductive political leaders. We have a similar issue here as we head towards the uncertainties of the 2016 election. Brexit is much more of a political than economic event. The UK represents 3-3.5% of global gross domestic product and it accounts for only 4% of US exports. It has also been reported that the "Brexit" process will take a few years to complete. Market volatility may continue to be great in the near term, but this too shall pass and the world will move on in a positive way.

We wish all our clients a safe and happy summer. We send our thoughts and prayers to the victims of the attacks in our nearby city of Orlando. We will always have a long term optimistic view of mankind, as well as the direction forward of improving the world and the underlying economic circumstances of all its citizens. As much as technology has increased the influence and capability of bad acts around the world, we are hoping big data can help us better manage these risks, rather than a call to arms by all its citizens.

We have the highest confidence that the long term direction of stocks is upward as innovation is alive and well. Our portfolio offers good overall value and most importantly is made up of companies we believe have strong fundamentals, durable advantages, solid balance sheets and free cash flow growth. The competitive instincts that drive human nature seek to make our world a better place to live, be healthy in and extend our life expectancy. We thank you for your continued confidence.

Sincerely,

Don	***Amy***
Donald R. Jowdy	Amy Lord, CFA
President	Senior Vice President

Suncoast Equity Management, LLC

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	-4.7%	+3.9%	$ 952,800	$1,039,900
Three-Year	+9.7%	+11.7%	$ 1,320,400	$ 1,392,000
Five-Years	+11.9%	+12.1%	$ 1,760,800	$ 1,770,200
Ten-Years	+7.7%	+7.4%	$ 2,100,400	$ 2,046,500
Fifteen-Years	+6.5%	+5.8%	$ 2,600,800	$ 2,314,700
Inception (18 1/2 Years)	***+7.9%***	***+6.2%***	***$4,051,200***	***$ 3,055,200***

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