Suncoast Equity Management, Inc.

October 2, 2013

Dear Client:

The markets rallied back toward the highs for the year as news that the Federal Reserve's stimulus will not likely come to an abrupt end, as well as everyone took a deep breath that the situation in Syria did not escalate for now. Through the first nine months, SEM accounts are +21% versus +19.8% for the S&P 500. With the strong rise in stock prices in the quarter, we believe that the equity markets, in general, are at fair value. Fundamental support for further advances will need to come from earnings and also revenue growth, which has been elusive for many companies in a mixed economy. Our portfolio is in a better position, given higher quality holdings and a stronger growth profile, than the equity market as a whole.

Investing While Growing Older – Keep up the Optimism and Rationality

I just celebrated my 47th birthday and I'm starting to feel it a touch with a recent trip to the drug store for my first pair of reading glasses (1.25x magnification) and my first introduction to Advil for a lower back ache following a bucket-list golf trip. They say that young folks are eternal optimists and as you age you tilt towards pessimism. We always have a positive attitude here at SEM and learned from two great investors that *optimism* combined with *rationality* is always the best course. Two recent articles, one by *Wall Street Journal* columnist Jason Zweig and another by noted author/investor Robert Hagstrom, explained how our two favorite investors Warren Buffett and his lifelong friend Charlie Munger, in their 80's and 90's respectively, keep up the optimism and rationality.

As we have come to learn, and is explained by Hagstrom in his short article, eternal optimism is not about being a "perpetual bull" on the stock market. But rather as Buffett is, unabashedly bullish on the opportunities living in the U.S. can provide and about being upbeat, cheerful and optimistic about life in general. This mindset is a big value to Buffett and to us as we guided our clients through very difficult times and markets during the last 15 years, including 2000-2002 and 2008-2009. During those difficult periods with events such as terrorist attacks and a housing and financial crisis, most had seen pervasive negativity accompanied by falling stock prices. Most damaging is that many folks concluded that stocks and businesses would never rise again. Our viewpoint and that of the optimist and rationalist at that time, was that great businesses were experiencing a temporary range of business results from small declines to slower growth and at the same time selling at awesome discounts to intrinsic value.

Rationality is the single most important trait to Buffett's and Munger's success, self described by Munger and as identified by several folks close to Buffett including Munger, Carol Loomis of *Fortune* and author, Roger Lowenstein. Rationality is about thinking in terms of probabilities rather than certainties. It is about making good decisions through an understanding of the present and possible future scenarios, but not about predicting the future. As Zweig quoted Munger's friend, he explained that Munger "doesn't get confused about the difference between an emotional feeling and an intellectual understanding." It entails a lot of thinking and tuning out distractions, including times when people don't agree with you. Rationality is an approach that involves forming a process for making decisions or to achieve a goal, whether it is buying a car, a training regiment to lose 50 pounds or a sound strategy to produce worthy investment results, such as what we do with the **SEM-Disciplined Investment System.**

Optimism and rationality are what we put in practice at SEM; and like Buffett and Munger, we rely on what has been proven to us and what we have studied over the years. We can't predict exactly what will happen tomorrow but try to make good decisions and judgments based on what may happen.

<u>“Safety” and “Growth”; Berkshire Hathaway – the Right Path</u>

We balance our portfolio holdings between what we label as “safety” and “growth” businesses. Of course each of our holdings meet our stringent operational qualifications and financially strong characteristics such as great balance sheets, above average returns on capital and abundant free cash flow. “Safety” is identification that the business itself has a low likelihood or probability of permanent change or erosion. Businesses in our portfolio that meet these criteria include **Abbott Labs**, **Berkshire** (BRKb), **W.W. Grainger** and **Nike**. Companies we label as “growth” have strong economics today, but their business models inherently face greater business risk and industry change. These include companies such as **Checkpoint**, **eBay** and **Varian**, among others.

BRKb is one of our best “safety” businesses. We have owned the company for over twelve years for our client portfolios and it is an over-weight position. Led by Warren and his partner Charlie Munger, these guys are not spring chickens. So an important concern for owners of BRKb is and has been, can anybody replace the team of Warren and Charlie? The answer is of course no, or at least not exactly. This has been a concern for the better part of a decade or more and so it is not an issue that snuck up on us. We are feeling more comfortable that when the time comes, BRKb can carry on as a successful business holding company without the dynamic duo and should continue to be a worthy investment holding.

We can still hope that the reality of a management transition is five or more years out, but it is the successful handling of another hurdle by Buffett that gives us the confidence that this holding company can generate returns in excess of the S&P 500 moving forward. The hurdle is the law of large numbers. Buffett has always shared his concern and belief that above average performance cannot be maintained with large sums of money. From his 2013 letter to shareholders, to writings dating back nearly forty years ago including a recently released memo written to Katherine Graham in 1975, Buffett offered the same advice to the *Washington Post*’s pension plan.

Buffett’s actions within the last five years or so, such as the well known purchase of Burlington Northern and more recent acquisition of NV Energy (a Nevada utility), mark a shift towards greater investment in “operating” companies versus investment holdings. The shift towards purchasing “operating” businesses and devoting less capital earmarked for securities that are temporarily mispriced, cements a permanent foundation for an increasing base of intrinsic value growth over long business cycles and addresses both the law of large numbers and the succession issue.

These large “operating” company acquisitions meet all the Buffett criteria, especially consistent earnings power over the long term and they are run by solid management teams that Buffett does not have to micro- manage. The focus areas thus far have been in railroads, utilities and energy (via MidAmerican Energy Holdings). Superb execution allows these entities to leverage advantages, such as scale and low cost of capital, to drive profitability.

Other “operating” acquisitions, that are equally important, have been diverse. Buffett invested $12 billion for a 50% equity stake, alongside 3G Capital, to take H.J. Heinz private. As part of the deal, Berkshire invested an additional $8 billion and received preferred stock earning 9%. Previous acquisitions include McLane (food distribution), Marmon (manufacturing), and Lubrizol (chemicals), all leaders in their respective markets. These complement existing Berkshire companies such as Benjamin Moore, Dairy Queen, and See’s Candies.

Make no mistake that Buffett and his team will take advantage of mispriced securities when the opportunity presents itself, as the balance sheet boasts over $30 billion in cash. Even with the latest emphasis on “operating” companies, we would estimate that half of the value of BRKb resides in successful insurance companies, which are global leaders in terms of large risk underwriting. Regarding the overall valuation for BRKb, Warren himself gave guidance last December when he bought back $1.2 billion in Berkshire stock at 1.2 times book value, implying a support level of $100 per BRKb share based on quarter end book value at June 30th. If he is willing to purchase a lot at that price, than he likely believes the true intrinsic value is meaningfully higher.

Growth via Security

An important holding mentioned above as one of our “growth” holdings is essentially in the security guard business, though not the heavily armed personal type. Check Point Software (CHKP) develops software and integrates hardware to protect computer networks and data from outside intrusion and hackers, including internet security solutions. The company accumulates a lot of excess cash, has a market valuation of $11.6 billion and boasts over $3.5 billion in cash with virtually no debt. It is on track to generate $650 million in excess cash this year and potentially $725 million in 2014. Software updates, maintenance and subscriptions make up 65% of total revenues. These are numbers we like a lot. The playing field is competitive and includes relatively younger companies such Palo Alto Networks and old stalwarts trying to move into the field such as Cisco. The business experiences frequent change because Cybercrime is constantly evolving, plus we are in the early to mid stage movement of corporate networks from on-site to the cloud. We keep a close eye on business developments, but have confidence that CHKP should continue to be among the leaders.

DJIA Reset

The committee of the Dow Jones Industrial Average (DJIA) index decided to replace two of the companies in the index; Alcoa and Hewlett-Packard, with two companies **- Nike** and **Visa** that we have owned for more than seven years and three years, respectively. The third new member of the DJIA will be Goldman Sachs, which will replace Bank of America. The Dow and S&P 500 share similar performance since 1930 with total annualized returns of 9.4% and 9.6%, yet the construction of the index is quite different. Notably the Dow is made up of only 30 stocks and is price weighted, while the S&P 500 (you guessed it) contains 500 stocks but is weighted by market capitalization (shares outstanding multiplied by stock price). The key message the DJIA committee is sending is that they want a diverse set of companies representative of U.S. business success. They certainly chose well!

Fall Follow-Through

Moving forward we will likely encounter continued volatility, especially in the face of a slower growth economy. Economic growth and investment will likely remain subdued until business leaders see that our government presents a clear path towards pro-growth initiatives and addresses the national debt. Less regulation and entitlement reform, including raising the eligibility age for full benefits of Social Security, as well as phasing in Medicare as life expectancy has increased, would be a good start. That combined with tax cuts at the corporate and personal level would even the playing field with our international competitors and promote incentives to spend and invest in entrepreneurial activity.

As always, we will be working hard to preserve and grow your capital. 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 2013	+21.0%	+19.8%	$ 1,209,900	$ 1,197,900
Three-Year	+17.2%	+16.3%	$ 1,607,800	$ 1,571,600
Five-Years	+10.3%	+10.0%	$ 1,630,600	$ 1,611,800
Seven-Years	+7.2%	+5.6%	$ 1,631,200	$ 1,464,300
Inception (15 3/4 Years)	+7.8%	+5.5%	$ 3,284,200	$ 2,309,900

* 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.