Suncoast Equity Management, Inc.

January 2, 2015

Dear Client:

In spite of a volatile fourth quarter for equity prices and other markets, we finished the year with SEM clients +10.1% versus the S&P 500 +13.7%. The rapid descent in oil prices in the second half of this year by 50% from a high of $115 in June to $56.50 in late December, the corresponding collapse in the Russian ruble, and stability of the country itself drove the financial headlines. The big fall in oil, in particular, led to greater worries about an economic slowdown nearly everywhere outside the United States. Pundits pondered whether the collapse of oil signals deflation and recession ahead. Other concerns included the flare-up of what might be our first very visible public example of cyberterrorism. Sony was held hostage so to speak by hackers that released private company data and scared the company into temporarily limiting the planned distribution of a comedy movie about North Korea's leader. Back here at home, the current strength of the US dollar, which dampens reported sales and net income for US based business with international operations, also shared the headlines on financial TV talk shows.

When it comes to oil, quite frankly we have an opposite view, as we believe that lower oil prices are a holiday present for us all, especially helping lower income consumers. Turning towards investments, although challenging economic conditions exist abroad, there will be companies that excel because their products or services are in demand. Importantly, our fundamental approach to preserving and growing your capital is from the bottom-up, watching and evaluating the earnings progress for our businesses and for prospects that are on our watch list. We believe earnings growth for many of our businesses in particular remains robust and positive overall. Currency strength is impacting near term results but it does not carry a lot of weight when it comes to the long term valuation process.

Recent earnings reports from two of our core holdings reflect our point that companies can excel despite near term headwinds such as currency exchange. Both **Nike** and **Accenture** reported solid results for their recent November quarter end. For Nike, future orders growth of 7% was made up of unit orders +5%, average selling prices +6% and currency impact of -4%. One business in particular that is exceling for Nike is the direct to consumer business which is now 20% of its total revenues. Accenture provides management and technology consulting and outsourcing services to its global Fortune 500 clients and others with the support of over 300,000 employees based in over 120 countries. With its fiscal year ending in August and this being just the first quarter for fiscal year 2015, the company had to lower its earnings growth forecast as it revised its foreign exchange assumption to -5% from -2%. We paid less attention to this but more attention to the news that Accenture seems to be picking up market share and gaining strength in its digital platform offerings, including cloud based ERP (Enterprise Resource Planning).

Below we cover noteworthy portfolio updates in the quarter and reveal that in any given year market returns are anything but average.

Portfolio Update

During the quarter we initiated two small positions, **Hanesbrands** (HBI) and **Middleby Corporation** (MIDD). HBI is a global apparel company that sells 1.9 billion units a year of innerwear and activewear. Brands include Hanes, Playtex, Wonderbra, Maidenform, L'Eggs, and Champion. HBI is executing well on its *Innovate to Elevate* strategy with revolutionary new products like X-TEMP cooling technology for men's underwear/socks and ComfortFlex Fit bras for women. These products sell at a premium and are gaining market share. It has a self-owned global supply chain and combined with its scale, HBI is gaining operating leverage. Two recent acquisitions should also help boost profitability such that the company expects to generate double digit revenue and earnings growth over the next few years. I speak from personal experience when I say that Hanes' Champion brand dominates as the value version of Nike's athletic performance apparel.

MIDD is an industry leader in commercial food service, food processing, and residential kitchen equipment, with its recent acquisition of Viking. On the commercial side, one-third of restaurants have MIDD equipment in them including clients such as McDonald's, Starbucks, Chili's, Subway, and KFC to name a few. The company should benefit from several macro trends like wage hikes, Obamacare, food safety, and sustainability as restaurants look for ways to manage costs by automating as well as save water and energy. Innovative new products like waterless steamers and waste to resource technology will drive growth and increase margins as MIDD expands internationally.

Both these companies share financial characteristics that highlight their operational strength. Both earn very high returns on invested capital and generate free cash flow in excess of their working capital as well as capital spending needs. Recently improving operating margins are the result of gains in scale and brand innovation at HBI and MIDD.

As we have described in the past, all companies, including what we own, are living breathing organisms whose competitive advantages over time can stay the same, strengthen or weaken. One of our portfolio holdings, **Gilead Sciences** (GILD) released the first cure for Hepatitis C and due to its approval ahead of competition, had the market all to themselves in 2014. On December 22nd, nearly in concert with Abbvie's (ABBV) approval of its competing cure for Hepatitis C, pharmacy benefit manager **Express Scripts** (ESRX) announced that it would remove GILD's cure from its formulary and replace it with ABBV's product.

In spite of ESRX's vocal objection of GILD having the only cure in 2014 we focus on the data points at hand. It was known for some time that ABBV's product would get approved and it would have an opportunity in the marketplace beginning in 2015. But no one could predict with complete certainty what kind of deals companies will form. These are business data points that once they are announced, we make every effort to determine if the competitive landscape for our company has materially changed for better or worse per our expectations. As it relates to our investment decision we engage our margin of safety analysis which includes an assessment of the price (the current stock price) to value (based on our analysis) equation. We will not get it right one hundred percent of the time but our **SEM-Disciplined Investment System** (SEM-DIS) has done well over time.

To give you an understanding of the business data points, GILD's product is commonly believed to be superior since ABBV's product in some cases must be taken with ribavirin and this can have undesirable side effects. Also a GILD advantage is that its product is once a day whereby ABBV requires patients to take four pills daily (three in the morning and one at night). ABBV's regimen is a disadvantage because if patients don't adhere 100% to the four pills daily, they may have to be treated again.

ESRX boasts roughly 30% share of the U.S. prescription market and 30% of ESRX's customers follow its formulary, which translates into an approximate maximum 10% U.S. market share loss for GILD. We expect information in the next few months to possibly reveal what price ESRX clients are paying that company for ABBV's product and how that compares with what other PBMs, such as CVS's customers, are paying for GILD's product.

Back to the subject of data points in general and for GILD in particular. The fact that we observe data points and make judgments and not speculate on what might be, is an important point. GILD announced in September, which we could not have predicted either, a positive development that it signed licensing agreements with eight Indian based pharmaceutical manufacturers to expand access to its chronic Hepatitis C medicines in developing countries. On the same topic but a different company, **Accenture** shared a business data point that led us to only recently conclude that its competitive position may be gaining strength. So no one can predict each and every business data point, but rather observe as it develops and make the best qualitative judgment possible.

We have owned GILD for over five plus years and have done well with returns exceeding over three hundred percent from our original cost. ABBV and ESRX were also former holdings and these companies also have financial strength. We are not emotionally tied to our portfolio holdings, and we will make portfolio decisions accordingly as more data points arrive.

<u>What will the market do in 2015?</u>

What will the market do next year? We get asked this question at the beginning of every year and our answer is the same; *we have no idea!* We often comment in our letters about the volatility in the past quarter and this letter is no exception. But many investors have never reflected upon the volatility in the annual returns as well. You will in fact be amazed! So as a baseline we showed SEM's history. SEM has outperformed the market since our inception, with our composite accounts earning an annualized rate of return of 8.6% (after fees) versus the benchmark S&P 500 of 6.5%. The S&P 500 return for our first seventeen years of 6.5% is below the long term average by a few percentage points or so but nonetheless acceptable in our minds, and we are comfortable with this return for long term planning. But how many years since our inception came within the average? You might venture a guess and say half (if you did not sneak a peek at the table below). And how close would you be to the correct answer? Not at all close. You would surprised to learn that only <u>three</u> calendar years for SEM and only <u>one</u> for the S&P 500 fell in the +5% to +10% range.

	Calendar Years	
Annual Performance Range	**SEM**	**S&P**
-40 to -30%		2008
-20 to -30%	2008	2002
-10 to -20%	2002	2001
0- to -10%	2005	2000
0 to +5%	2000, 2001, 2011	2005, 2011
+5 to + 10%	2006, 2010, 2014	2007
+10 to +15%	2004, 2007	2004, 2006, 2014
+15 to +20%	2012	2010, 2012
+20 to +25%	1999, 2003,2009	1999
+25 to +30%	1998	1998, 2003, 2009
+30 to +35%		2013
+35 to +40%	2013	

So why can't we guess next year's return? The public stock market is constantly adjusting to new information, usually judged or interpreted on a short-term basis. This in turn influences the buying and selling activity of many participants, resulting in wild swings at times which can last a day, a month or a year or more. Much of the new information is not of significance, and therefore should not be acted upon. But some things will never change. Mood swings will always have a major impact on annual returns as most market participants continue to ignore the primary rule of investing, to think of yourself as a part owner of business and act accordingly.

The longer you hold your investments, or act as a part owner of businesses, the more likely you will get close to or outperform the long term average returns. A recent JP Morgan report covering return data from 1950-2013 first reveals that the stock market returned as much as 51% and declined 37% in a single calendar year during the study period. If you held that investment for any 5 year period, your portfolio would have done no worse than an annualized rate of return of -2% to a top return up to 28% annualized. For the ten year rolling returns, you could expect a low of -1% and a high of 19% annualized. Extending to 20 year periods, an investor would have done no worse than +6% while getting a very high rate of 18% annualized in the best case. The average annual rate of return for holding stocks for the twenty years ended 2013 was 11.1%, above the long term average according to the JP Morgan study.

SEM is not quite at the 20 year anniversary and many of our clients have lived through periods where the 10 year annualized rate of return was basically flat. At the end of 2008 for example (just 6 years ago), SEM had a 10 year annualized rate of return of +2.6% versus the S&P 500 of -1.4%. Our first 17 years have had two major negative periods (2000-2002 and 2008) which have kept the S&P and SEM below the 20 year average. The longer we manage your assets the better your results.

Looking ahead

Heading into 2015, our opinion is not much different than at the beginning of 2014 (so rereading January's 2014 letter still applies). We generally believe that the market is within a fair value range and appreciation in stock prices could track earnings progress, Earnings progress is still strong, especially for our portfolio; however we are coming off of a very strong five year average annual market return of 15%. Stock market returns in any single calendar year are unpredictable, as we talked about above, and the market (which is always impacted by human emotions in the short run) could end 2015 in any range from -10% to +10% or something outside of this. It is prudent to remain conservative in our expectations.

We believe that the equity value of publicly-owned corporate America increases over time with only a few significant setbacks in terms of time or amount. Investing in prosperous businesses with fairly clear and defined positive long-term outlooks, as we do with the **SEM-Disciplined Investment System** (SEM-DIS), will produce solid rates of return for our clients. Our gains against the market, while taking measurably less risk, come cumulatively and not in any single calendar year. We take satisfaction in reporting that *$1,000,000* invested with SEM for 17 years grew to *$4,006,820* (net of fees) versus approximately *$2,902,200* for an investment in S&P 500 (this figure does not include fees but does require a minimal cost not reflected).

As always, we continue to work hard to do well for you as our client. We take great pride and joy in knowing we are supporting the needs, well-being and growth of your family, future generations or your charitable pursuits. We are invested right alongside you with both our personal assets and our company profit sharing plan in the same portfolio. We thank you and are grateful for your confidence and trust. Best wishes for a peaceful and successful 2015.

Sincerely,

Don *Amy*

Donald R. Jowdy
President

Amy Lord, CFA
Senior Vice 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 2014	+10.1%	+13.7%	$ 1,100,500	$ 1,136,900
Three-Year	+21.4%	+20.4%	$ 1,787,100	$ 1,746,000
Five-Years	+14.8%	+15.4%	$ 1,991,700	$ 2,051,400
Seven-Years	+8.2%	+7.3%	$ 1,736,700	$1,634,500
Ten-Years	+7.5%	+7.7%	$ 2,058,800	$ 2,094,700
Fifteen-Years	+6.6%	+4.2%	$ 2,597,700	$ 1,864,800
Inception (17 Years)	***+8.6%***	***+6.5%***	***$4,068,200***	***$ 2,902,200***

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