SUNCOAST EQUITY MANAGEMENT, LLC

October 4, 2016

Dear Client:

The scoreboard for **SEM-Disciplined Investment Process** (SEM-DIS) so far this year is up against investors reach for yield and the popularity of any security paying out a yield above the 10 year U.S. Treasury bond of 1.58%. Investors are reaching for yield because of these historically low global rates in fixed income and the perceived uncertainty in the global economy. Through the first nine months of this year, as SEM observes solid advances in the intrinsic value of its portfolio, it has experienced slightly negative price action. Our composite results are at -2.3% versus +7.8% for the S&P 500 year-to-date, one of the largest calendar year gaps in our nearly 19 year history. SEM believes in transparency when it comes to reporting our results, but human nature can lead us to jump to conclusions. SEM utilizes a high conviction approach to investing and on occasion it can result in short term results that are out of sync with the market, as we are seeing today. Anyone interested in a negative rate security? Some Europeans and Japanese bought it! We discuss these items and just how low rates have gotten recently. We see meaningful appreciation potential for our portfolio due to above market intrinsic growth outlook and an attractive valuation. We share the support for our belief and validation from a respected industry source below as well.

<u>Portfolio Highlights</u>

Portfolio changes were minimal in the third quarter. We initiated a small weighting in **Facebook** (FB) in July and look forward to increasing our position over time. FB's success is no secret, boasting more than 1.7 billion active users worldwide. We believe its financial acceleration of scale may be just gaining steam. With mobile being the enabler and an increase in allocation of marketing and advertising dollars towards online, the leader in the social-networking space is driving revenues by providing additional features and apps to keep members engaged in the FB ecosystem. The services outside of its namesake FB include Instagram, Messenger and WhatsApp. FB is also incorporating video, chatbots, artificial intelligence and virtual and augmented reality. All of these increase user engagement and further enhance the business advantage referred to as the network effect. The network effect can be best described as when each new user joins FB's many services, it increases its value to the existing users. For FB, more users allow the firm to scale its fixed costs. Last quarter FB achieved higher overall margins from both higher gross margins and a decline in operating expenses as a percentage of revenue. These financial results confirm FB is gaining greater advantages of scale.

We have several other companies in the portfolio whose brands and success benefit in a similar manner of the network effect. These include **Alphabet** (formerly Google), **MasterCard**, **Visa, PayPal, Nike, Starbucks** and **Priceline** (PCLN). PCLN's expansion in both developed and emerging markets, through its Ctrip partnership in China and Hotel Urbano in Latin America, are the key to strengthening its network. As PCLN has steadily increased its list of hotel property offerings and other services, it has attracted more satisfied users. With its primary strength in Europe through booking.com, replicating its offerings of boutique hotels is nearly insurmountable for competitors. PCLN's critical and growing scale can be seen by the company's 23.7 million rooms on booking.com, which compares to the largest hotel brand at 1.1 million rooms (recently established through the merger of Starwood and Marriott just two weeks ago). Its property offering and growth of 1 million and 30% is much higher than the second largest online global travel network Expedia (EXPE), which has 300,000+ properties and growth of 20%. Though bookings and travel can be seasonal and can fluctuate between quarters, PCLN's latest results reflect its enormous scale with bookings and room night growth of 19% and 24% respectively, ahead of EXPE of 8% and 12%. The network effect and advantages of scale are very powerful and beneficial economic concepts that we look for and own in our portfolio. Companies with these characteristics make up over 40% of our portfolio.

High Transparency / High Conviction

At SEM we believe in a high degree of transparency about our performance results as we publish the table at the end of each of our quarterly letters. While transparency is a fundamental belief at SEM, sometimes human nature can get in the way. Many times investors are quick to judge without a longer term perspective or jump to a conclusion without seeking more information. When we provide the table at the end of our letter, it is a proper guide to our performance for the period ending that particular quarter. What it does not show you is the year by year recent history which may provide more insight, and which we have displayed below:

	SEM Composite (Net of Fees)	**S&P 500 Total Return**
2011	4.3%	2.1%
2012	19.2%	16.0%
2013	36.2%	32.4%
2014	10.1%	13.7%
2015	3.9%	1.4%
2011 to 2015	93.6%	80.8%

Looking back we have nearly doubled the value of client accounts since 2011. SEM outperformed in four of last five years leading up to 2016 and achieved a total return of 93.6% versus the S&P 500 of 80.8%. With the focus on the recent nine months, investors can easily forget that we still accomplished a solid return.

We have a lot of other market experiences to draw on, given our 18+-year history and beyond at predecessor firms. In the past, our performance table has driven some clients to totally give up on investing in the equity market. At the end of 2008, our letter indicated that the 10 year annualized return for SEM and the S&P 500 was at +2.6% and -1.4% while since inception returns were +4.6% versus +1%, respectively. Indeed, very low performance numbers for such a long period. Our experience is that those clients left investing and let human nature get the best of them at a market bottom. They in essence became a victim of “recency bias,” or the tendency to think that trends and patterns observed in the recent past will continue in the future.

Of course 2016 has been a very interesting year for the reasons we discuss below in the “negative yields” section of our letter. While we would prefer better short term results, we just wanted to put it in proper context and reaffirm that long term investors should not focus too much on the short term. SEM has not changed its approach to investing and we have a high degree of confidence in our process. In fact, we are invested alongside you with our families’ money and profit sharing plan.

As you know, we are long term investors in high quality companies. We manage a high conviction portfolio with 20 or so businesses, compared to large capitalization growth mutual funds with an average of 110, per industry source Morningstar. Portfolio weightings range from 2% to 10% and reflect our level of confidence. At certain times it will be more concentrated than it appears when we own two holdings in the same business, as those business economics are favorable. In our portfolio today we have a concentration in **Visa/MasterCard** and **Accenture/Cognizant,** which combined make up over 20% of our portfolio. In the short run a high conviction portfolio may not be in sync with the general market as we are seeing this year. This is also referred to as having high active share, which is a preferred attribute in the institutional market since it means we are not “closet indexers.” We believe at SEM it is our responsibility to share with you the outlook for our businesses and where our portfolio is positioned in terms of price to value.

	Intrinsic Value Growth		*Valuation*		**Stock Price Performance**
	2016	**2017**	**Price to Earnings ratio**	**Earnings Yield**	**YTD**
SEM	11.5%	11.4%	16.5	6.1%	-2.3%
S&P 500	-0.7%	9.5%	16.9	5.9%	7.8%

Our business outlook remains favorable and our portfolio is at a very good relative and solid absolute value. You can see in the table above that we have higher earnings growth prospects for 2016 and 2017 versus the general market yet we are valued at a similar level from a price to earnings (p/e) and earnings yield level (inverse of p/e). We excluded our recent purchase of Facebook from the table just to be conservative in our intrinsic growth outlook, as it carries a high growth rate. Throughout our history our portfolio has nearly always traded at a higher valuation than the S&P 500 since we only own 20 companies with on average better economics and financial strength in the balance sheet. In terms of price to value, Morningstar validates this belief by estimating that the overall market is at fair value and on average our companies are selling at 20% below their fair value.

Over time we expect our portfolio to appreciate in line with intrinsic (or earnings) growth rate of 11%. At some point our stock price performance will catch up with our earnings growth and our valuation should also rise to a premium versus the market. We can't predict the exact time period when our performance will catch up, though we have confidence it will. If we were asked to speculate, it would likely only occur in the near term if rates rise back to the level they were at the beginning of the year.

<u>Wow! Negative Yields</u>

Can you imagine a world in which you lend someone your hard earned savings, say $1,000 for a period of 10 years, and you agree up front to get only $997 in return? Well, parts of the globe including Japan, Switzerland and Germany offered just that opportunity recently, if you want to call it that. This very unusual and abnormal circumstance in bonds has had a meaningful influence on the short term demand for equities, with investor appetite heavily skewed towards the chase for any yield they can find.

While the U.S. offers one of the highest yields among developed economies, the yield has fallen sharply this year and it is still at an alarmingly low level. Low rates are not just in government issues, our portfolio holding **Disney** (DIS) recently sold 10 year bonds that yield 1.85%, the lowest corporate rate in recorded U.S. history. Of course you will get all your money back plus that rate of interest if you hold to maturity; but investors in these bonds are already feeling less rich because if they wanted to sell them today they would lose two years of income since the price has fallen.

With the U.S. ten year bond rate at 1.58% we have observed that any stock with a 3% yield or higher has been in high demand this year. As the **SEM-DIS** prefers growth companies, our companies reinvest most of their free cash into new and existing growth opportunities within their business. Some of our companies that do pay a dividend have not been caught up in the huge demand for yield because their dividend yield is lower than the 10 year. Staying with **Disney**, its dividend yield at 1.5% is close to the yield on the bonds they just issued. Over the next decade, just like the previous decade, DIS will grow its earnings and its common stock is almost certain to be a better investment than its bonds. The choice is straightforward, own the bond that pays less than 2% for ten years or own the common stock which is a part ownership in the future earnings and believe that DIS has a reasonable growth opportunity going forward. In the last decade it more than doubled its earnings and its dividend grew 370% from $.30 cents per share to $1.42.

We have been through an unprecedented 35 year decline in interest rates from the peak of a 15.8% yield on September 30, 1981 to the record low 1.37% in July of this year for the 10 year U.S. Treasury. Some influential officials believe that the economy's "natural rate" of interest has fallen and should remain low. The natural rate is seen as the level that produces full employment without excess inflation. Others have referred to this historically low rate period as an interest rate bubble. We would heed caution about the risk of owning bonds at low rates. If they have a place in a portfolio, such as to reduce volatility, we would advocate buying individual bonds versus bond funds and recommend you hold to maturity. Also, investors need to be aware of the enormous sensitivity and price quote loss that can occur when rates rise.

We don’t have a crystal ball to know when rates may begin to climb towards historical norms. Every time the Fed gets together to discuss short term rates it makes global headlines. At some point rates should at least revert back to levels that represent a fair return for investors that lend their money to others, be it government or corporations. After all, today’s price of credit for the saver who lends to the borrower seems utterly unfair.

Rounding out the Year

If the reach for yield continues, our portfolio of growth stocks may remain relatively undervalued. We need to have patience and wait through yet another episode of Ben Graham’s greatest observations about all markets. Father Ben would say, so far this year this market is a voting machine, gravitating towards what is popular; in the long run it will ultimately be a weighing machine, assessing the substance of an investment.

This particular year may require even more patience than normal as we make our way through the Presidential election. Bond prices seemed to be stretched to extraordinary valuations even in the context of a slow growth economy so that is where most of the risk in today’s markets may be. Yields can stay low by historical standards, but they don’t have to be as low as they have been. If rates rise one point or so, that may be enough to reverse the chase for yield and could negatively impact the “safe” higher dividend- paying companies investors were counting on. SEM’s attractive portfolio valuation and the lack of overall investor optimism usually support a good entry point for new deposits. We thank you for your continued confidence.

Sincerely,

Don
Donald R. Jowdy
President

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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	+1.9%	+15.4%	$1,019,300	$1,154,300
Three-Year	+7.9%	+11.2%	$ 1,256,800	$ 1,373,600
Five-Years	+14.6%	+16.4%	$ 1,978,200	$ 2,134,400
Ten-Years	+7.4%	+7.2%	$ 2,050,100	$ 2,011,400
Inception (18 3/4 Years)	***+7.8%***	***+6.3%***	***$4,127,600***	***$ 3,172,900***

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