SUNCOAST EQUITY MANAGEMENT, LLC

October 1, 2020

Dear Client:

As we head into the fall, we can see a shift towards learning to live with Covid. Six months earlier facing a poorly understood and rapidly spreading virus, the global response involved government tactics never deployed in modern times. The policy decisions regarding lockdowns inflicted severe damage to both the economy and social well-being. Today the medical, corporate and even government communities are learning from experience, taking action and making necessary adjustments. Affordable rapid testing, therapeutics and a vaccine are within sight. With further progress all three will be ready for wide distribution as we head into next year, just a short time away. The market recovery, though undoubtedly lumpy, is signaling some optimism. The SEM composite client performance is +16.3% and the S&P is +5.6% through September 30th, though both figures are down from highs achieved in early September.

With Covid and trade disputes shaping the economy, capitalism is evolving and not every company moves forward equally. Certain industries, such as the airlines, will undergo further struggle and restructuring; meanwhile other companies will seize the day and navigate to an even better strategic position, such as **Apple (AAPL)** which we discuss below. We cover our only portfolio change in the quarter along with the celebration of Warren Buffett's 90th birthday as a reminder that a long life connected to compounding interest is undoubtedly the 8th wonder of the world.

Portfolio Update

We initiated a small position in **Merck (MRK),** a global healthcare company with $47 billion in sales focused on prescription medicines, vaccines, biologic therapies and animal health products. Like many of its peers, MRK is working on a Covid vaccine and has begun human testing. But recent strong results are largely driven by Keytruda, which is an immunotherapy for the treatment of melanoma, stomach, head, neck and lung cancer. As the first to market with a treatment for non-small cell lung cancer, Keytruda is the market leader and continues to gain approvals for new indications worldwide. To further strengthen its oncology portfolio, MRK invested $1.6 billion in Seattle Genetics to co-develop an antibody drug for breast cancer and other solid tumors. In February MRK announced plans to spin off $6.5 billion in lower margin sales in women's health, generic biosimilars and legacy products. Management expects $1.5 billion in cost savings by 2024 and the ability to focus on these faster growing oncology businesses. Although the spinoff will create a more concentrated product portfolio, long term shareholders should benefit from significantly higher margins. The tax-free spinoff into another publicly traded company is expected to occur in the first half of 2021.

To make room for the purchase of MRK, we shaved our portfolio weightings in Honeywell (HON) and Nike (NKE) to the 3% range. NKE was done solely on relative valuation, while a good portion of HON's business serves industries, such as energy and aerospace, that may have a slower recovery. In both cases we feel the companies are still worth owning and continue to represent longer term growth potential, but felt it was prudent to reduce our exposure while availing ourselves to a new opportunity.

International Trade and Global Pandemic Drive Corporate Change

Corporations had their hands full pre-pandemic, navigating changes in global trade policies. Add in the pandemic, which turned global economies upside down, and we have two important forces that can imperil companies with considerable speed. We are always on watch for business data points or corporate actions that signal strength or weakness. Not surprisingly a significant tell, in this case a weakness, surfaced in an industry we have never owned in our nearly twenty-three-year history. Meanwhile, a pivotal move strengthened one of our portfolio companies, **Apple (AAPL)**.

The air travel industry is always victim of economic weakness driven by global events. Travel is a discretionary purchase and airplane travel can be substituted in many cases by automobile, boat or train service. Airlines are a high fixed cost business. The industry had been making a lengthy recovery since 2009 and companies such as United Airlines (UAL) had reported 10 years in a row of profits. This year they will be very much in the red, and the losses may be as much as three years' worth of average earnings from the past decade. Despite a recent rise in passenger activity, UAL management decided to "permanently" eliminate change fees for most domestic tickets, and it was quickly copied by American Airlines and Delta. Given the current conditions and competitive landscape (Southwest has never had change fees), UAL's announcement was clearly done out of weakness. The exact revenue loss is not known but it will have an important impact. UAL had generated $625 million from global change and cancellation fees, with some analysts estimating 55% of that related to domestic travel. According to consulting firm IdeaWorksCompany, ancillary fees have climbed fivefold over the past decade and accounted for about 15% of sales at U.S. carriers last year.

On occasion, it is just as important to talk about what we don't own as it is to discuss what we do own. Covering UAL and the airlines highlights an important strength of our **SEM-Disciplined Investment System (SEM-DIS)**. Nearly all the publicly available airlines have higher debt levels relative to free cash flow than our SEM-DIS allows. Since we have strict adherence to the SEM-DIS it guards us from owning the type of business that may be at significant risk during unexpected or even normal business cycle declines.

One corporate strategy going through considerable change as a result of international trade reform and the pandemic is that of supply chains. Over the last few decades, global supply chains were outsourced with a focus on *cost and efficiency*. Today with less trust among countries, those that can are shifting to insourcing for *control* and *self-sufficiency*. **Apple (AAPL)** is a classic example and currently makes roughly 42% of iPhone components in house, up from 8% five years ago. A strategy cultivated by the late co-founder, Steve Jobs believed owning core technologies gave a business a competitive advantage with more quality control and less risk of product leaks. Custom chips in iPhones and iPads have cut costs, increased performance, and leveraged AAPL's control over future releases. AAPL recently announced it will insource custom chips for the MacBook before year end in a program called Apple Silicon, allowing it to cut $75-$150 off the cost of building a computer. The custom chips, which offer higher performance graphics and more efficiency, will end the company's 15-year partnership with Intel (INTC). Analysts predict this will give AAPL a two-year jump on competitors in device performance since others lack the size and expertise to take on the expensive and time-consuming process of chip design. The chips will improve battery life, allow for faster processing speeds and new security features giving AAPL's products a competitive advantage over its global rivals. With a common architecture, MacBooks will be more open to iPhone developers, creating a seamless integration for mobile apps, special features, and the ability to integrate 5G modem chips in the future. Using insourcing to cut costs while at the same time strengthening its brand, reinforces AAPL's economic moat and ecosystem.

AAPL's powerful ecosystem has an installed base of 1.5 billion active devices, up from 1 billion in 2016. Two-thirds of devices are iPhones, with iPads, Macs, Apple Watches, and Apple TVs representing the difference. Of the 1 billion iPhone users, half only own an iPhone and no other device. These consumers, who are often outside of the U.S., represent a huge opportunity for Apple to continue growing its Services revenue and Accessories like AirPods. In fact, 75% of watch sales in the second quarter were to first time buyers like these. Although we are a small microcosm, all of us at SEM own at least one AAPL product and many intend to upgrade to 5G once it's available. As customers upgrade, they may lean towards less expensive models, but AAPL may still benefit as users increase spending on services such as music, movies, Apple Care as well as accessories like AirPods. Both the Services and Wearable/Accessories segments are growing much faster than iPhones and have higher profit margins, all of which work together once again to reinforce AAPL's ecosystem.

What do Einstein, Buffett and a tortoise have in common? Think and Be Long-Term!

We all know the story of the tortoise and the hare, but nowhere is it more powerful than in investing. Albert Einstein reportedly said "Compound interest is the eighth wonder of the world. He who understands it, earns it." In celebration of Warren Buffett's 90th birthday, Jason Zweig of *The Wall Street Journal* wrote about Buffett's ability to grasp this concept at age 10. Buffett biographer Alice Schroeder wrote that Buffett at that early age recalls telling himself "that's where the money is….the way the numbers exploded as they grew …over time was how a small sum could turn into a fortune."

With a net worth of $82 billion, a long life and this discipline has served Warren Buffett well. We can all benefit from a reminder that building wealth not only depends on the rate of growth, but also *how long* it grows. An investment of $100,000 today compounding at 8% will be worth $147,000 in 5 years, $216,000 in 10 years, $466,000 in 20 years, and amazingly $1 million in 30 years. SEM's service to its investors is progressing nicely along this track; 22 ¾ years in and earning a 9.9% annualized return, we have grown a $100,000 client investment to $856,460, net of fees. We don't know exactly what this amount will be in 2027; but more importantly we look forward to serving our clients beyond the thirty-year mark.

Stay Calm and Carry-On (with proper Protocols) Long Term

The markets are mostly forward looking, though part of the recent optimism in late September may have come from the Federal Reserve's policy decisions. In mid-September the Fed signaled it will hold short term rates near zero for at least three more years, or a point in time when it sees evidence of a tight labor market and inflation surpasses 2%. Low interest rates have many implications including lower costs for consumers and higher valuation levels for equities. The Fed ultimately has less influence on long term rates but the ten-year U.S. treasury rate hovering around historic lows of 0.69% implies that businesses with high quality balance sheets and earnings power, are a better place for long term investors to be generally speaking.

A vaccine and targeted therapeutics for Covid are on the way and we will likely see the FDA, through an emergency use authorization, roll out distribution first and foremost to healthcare workers and residents in nursing homes. In the meantime, hospitals are better prepared today should new spikes in Covid infections occur. The economy has had a reasonable recovery so far, but no one can predict with great accuracy if it will continue. Conversion to digital has accelerated by at least a few years and strengthened the economy, and you can't underestimate the human spirit's desire to get back to a better life. The election will be in the rearview mirror when it comes time for our next quarterly letter; and it promises to be significantly more eventful than the last go around. In this regard, we prefer to share post-game versus pre-game observations.

As we adjust to the election outcome and continue to fight Covid, we must stay focused on the long term, knowing that daily volatility is largely driven by human emotions as well as speculators with a short time horizon (maybe only minutes or hours). SEM will continue, as we always do, to seek to own high quality businesses with above average earnings power. Simply put, in order to build wealth, own a share of stock (business) for the long run and the share price will ultimately follow growth (or lack thereof) in its intrinsic value. As always, thanks for your confidence and trust!

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
YTD (9 Months)	+16.3%	+5.6%	$ 1,162,800	$ 1,055,700
One-Year	+25.7%	+15.2%	$ 1,257,200	$ 1,151,500
Three-Year	+19.9%	+12.3%	$ 1,724,000	$ 1,415,500
Five-Years	+16.2%	+14.2%	$ 2,115,100	$ 1,938,000
Seven-Years	+14.7%	+12.7%	$ 2,607,800	$ 2,306,100
Ten-Years	+15.4%	+13.7%	$ 4,192,800	$ 3,624,400
Inception (22 3/4 Years)	***+9.9%***	***+7.6%***	***$ 8,564,600***	***$ 5,327,000***

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