Suncoast Equity Management, LLC

July 3, 2018

Dear Client:

For the first six months, the SEM client account composite recorded +9.3% versus +2.7% for the S&P 500. Amidst the ebb of flow of Trump's trade war threats and actions, we remain focused on high quality equity selection. We provide a portfolio update in which we sold two companies from the portfolio and added one. We also introduce how new technologies find their way into our portfolio and how the development of new advances such as blockchain, augmented and virtual reality are making their way into the economy. Finally we highlight the long run by sharing returns among various assets categories and items of personal interest, such as wine and art.

<u>Portfolio update</u>

During the quarter we sold two positions, **Lowe's (LOW)** and **Disney (DIS)**, and welcomed back **Microsoft (MSFT)**. We originally bought LOW on the premise of increasing margins due to their Canadian acquisition of RONA and better execution in the US. After several quarters of progress following our initial ownership, operating margins were lower in the most recent first quarter and the company reported 0.6% same store sales growth, below **Home Depot's (HD)** 4.2% growth for the same period. The catalysts we hoped for with LOW have not materialized as expected and the company has not kept pace with HD in serving professionals or online sales. The valuation gap between LOW and HD also narrowed, so we took the opportunity to sell LOW and concentrate the portfolio in the better executing company, HD. We owned LOW for a much shorter time period than we prefer, a little over two years, though we still achieved an acceptable return of approximately 18% from our original cost.

We shared in some detail our thoughts about Disney (DIS) in our January letter, profiling a bit of history on the business and the industry, and importantly the company's offer in December to purchase various assets of 21st Century Fox. As we said six months ago, DIS's bid, from our perspective is both offensive and defensive and we anticipate that the company could further enhance the value of those assets, including Star India, regaining the foreign rights to the DIS franchise *Frozen* and adding a cast of characters including *The Simpsons*, *Avatar*, Marvel's *X-Men* and the *Fantastic Four*. However, we made the decision to sell our small weighting in DIS in mid June as Comcast made a higher bid and DIS countered with an offer 35% higher than its original bid. Comcast entered the fray immediately following a judge's recent blessing of AT&T's proposed purchase of Time Warner, giving the cable and content company confidence it could get regulatory approval. It is hard to get a fair price when bidding on a publicly traded company, and it gets tougher when you have competition. Price discovery, the actions of market participants, can get out of hand and it is not always connected to value. The boundaries in the business of entertainment and content are being redrawn by very large and financially strong companies that we own, including **Alphabet/Google (GOOG)**, **Facebook (FB)** and some that we don't, Netflix and Amazon. So the rush to acquire other assets by traditional players like DIS and Comcast, versus internally creating and building competitive platforms like streaming, could prove too costly. One recent announcement by FB highlights the shifting boundaries. FB's Instagram, with 1 billion monthly active users, created a new mobile video hub, IGTV, to allow users to post high definition videos and clips. During the roll-out, the Instagram team showed video clips of wildlife explorers and amateur cooks, creating more competition for traditional media.

One of the obvious conveniences of owning a publicly traded company, versus a private or closely held business, is we can easily exit if we have some concerns, as we did with Disney. We always have the opportunity to become owners again in the future, much like we have done by welcoming back **Microsoft (MSFT)** into the portfolio. After more than a decade of ownership, we sold MSFT several years ago as operating margins and net income started to decline and the new CEO, Satya Nadella, was trying to stabilize the business. The **SEM-Disciplined Investment System** (SEM-DIS) seeks growth businesses and net income for MSFT was basically flat from fiscal year 2011 to 2017 as the company dealt with deterioration in its traditional Windows operating system and its Office software installations on corporate and consumer PCs. During that period of transition, Nadella did a much better job than previous management by resetting the foundation from a licensing model (Windows) to a cloud based subscription model (Office 365), as well as embracing open architecture and cloud services through Azure. Net income is now growing again and will reach $29 billion in fiscal 2018, up from the $21 to $24 billion range during the last seven years. In fact, Azure (MSFT's cloud computing platform and infrastructure) grew 93% in its most recent quarter, almost twice as fast as market leader Amazon Web Services (AWS). As a whole, MSFT should generate double digit revenue growth in its Productivity/Business Process and Intelligent Cloud solutions, which represent the majority of its revenue and are its highest margin businesses.

In early June, MSFT announced its plan to acquire GitHub for $7.5 billion in stock. GitHub is an open source platform for programmers and helps them collaborate by allowing them to post projects, track revisions, and share insights about programming trends. With 28 million developers representing 1.5 million companies in healthcare, technology, manufacturing, and retail, GitHub is far and away the market leader. Its clients include Oracle, IBM and AWS. MSFT is currently the largest contributor to GitHub, so this complementary acquisition gives MSFT the ability to not only target ads toward other users, but also analyze competitors' data or perhaps even limit the free service. MSFT insists GitHub will stay independent and continue to foster a culture of developer freedom, openness and innovation. In hindsight, we recognize that we would have benefited from an earlier reentry into MSFT, though our disciplined process requires us to verify positive business momentum and have some patience in doing so. The **SEM-DIS** has served us well over time. With MSFT's renewed business momentum, we expect net income to grow for many years to come and will look for opportunities to increase our position.

For the last two quarters we have explained that some of our fastest growing businesses would incur some hurdles and perhaps some extra expenditures as it relates to improving data protection for their clients. The general sentiment had been that this would be hurtful to these businesses such as FB and GOOG. We had thought just the opposite and that is why we increased our FB weighting in March. Some recent data backs this up. The European Union put into place the General Data Protection and Regulation law (GDPR) that went into effect on May 25th. Evercore ISI reported that daily active user trends for FB were "slightly better" than the previous few months rather than an expectation that they might have declined. FB was also able to absorb the costs necessary to comply with GDPR more easily than smaller competitors, which per Evercore ISI have either exited Europe or scaled down operations to avoid punishing fines. Likewise, *The Wall Street Journal* reported that GOOG drew advertising money to its online ad services and away from competitors that are straining to show they are compliant with GDPR. The early reports showed that GOOG is gathering individuals' consent at far higher rates than many competing online ad services, likely because of greater trust in the GOOG brand.

Blockchain, Augmented and Virtual Reality

Businesses continue to grow profits but not equally, so a good selection process such as our SEM-DIS is paramount. Our process combines high quality quantitative factors (cash flow generating, high return on capital companies with little to no leverage) with high quality qualitative characteristics (strong competitive advantages). This process leads us to companies that create or utilize technologies to build competitive advantages and generate strong earnings growth as a result. One example is the payments evolution from cash to check to credit card (our ownership of **Visa/Mastercard**) and now peer to peer payment systems (**PayPal'**s Venmo which we also own). Another one is how the tradition of writing and mailing letters and photos has changed to family conversations and baby pictures being posted on **Facebook**.

Time erodes most competitive advantages and very few companies no matter how powerful, such as Amazon, FB and GOOG, may find it difficult to position themselves for the next new technology every time. Yet, new technologies improve our standard of living both in quality and cost, and that is what makes the work we do so interesting and why we are eternally optimistic when new technologies appear on the horizon.

Blockchain (not Bitcoin!), augmented and virtual reality are in early stages. Blockchain is a private ledger technology and it is being implemented in food traceability, as well as numerous other applications. Each link of the supply chain posts details from the farm to the table. From every fish to every vegetable, information is linked so that any issues can be quickly pinpointed. Nestle, Dole Food and Unilever are working with their biggest customer, Walmart, to implement a system. In another application, blockchain is being deployed in a pilot project by the city of South Burlington, Vermont to replace the system for recording property transactions, potentially reducing some annoying costs for consumers.

Augmented reality (AR) holds great potential in the operating room, as it blends digital imagery with the physical world. By projecting virtual images on a brain tumor for example, AR reduces errors and eliminates "attention shift" where a neurosurgeon traditionally must switch back and forth between the patient's brain and various 2-D and 3-D screens.

Our process is geared towards finding successful companies with proven track records. Over time we will track these important technologies for new investment opportunities and observe how our existing companies either incorporate them into their products and services, such as **Stryker (SYK),** or benefit by their use in business operations that can potentially improve margins.

Summer Heat and Equities Rule

A year ago rates on one year U.S. Treasury securities were in the range of 1%. With the economy heating up a bit and Fed raising its overnight rates, the yield on the one year has doubled to 2.3%. Money market yields still lag, so we have been purchasing Treasury securities for our clients' cash reserves. Equally interesting is that the spread between the 10 year Treasury at 2.85% and the 2 year Treasury at 2.5% has narrowed. While it is nice to see better yields on short term fixed securities, it is still difficult to commit to bonds with ten years or more unless high quality tax exempt municipals fit your investment allocation or you just prefer lower volatility.

Trump's trade war continues to impact the markets, as we noted in the first quarter letter. According to FactSet, there have been 36 days in the first half of 2018 in which the S&P 500 has moved more than 1% versus 17 days in all of 2017. So we've seen much more volatility this year. But the very low volatility of 2017 that many reference was the anomaly, not 2018. Despite these moves, equities rule in the long run and every so often it is good to review the results. Below is a list of returns for various categories from the period beginning 1900 and ending 2017. At the foundation is the realization that some of these categories are unlike being part owners in a business that generate earnings, since many don't generate any earnings or income like art or fine wines (unless you are selling it by the glass!). We were a bit surprised about the low return on U.S. home prices.

Category	**118 Year Return 1900-2017**	**Growth of $100**
U.S. Stocks	6.5%	$158,454
World Equity Portfolio	5.2%	$37,657
Global Bonds	2.0%	$1,014
U.S Treasury Bills	0.8%	$254
U.S. House Prices	0.3%	$142
Gold	0.7%	$226
Silver	0.0%	$100
Fine Wines	3.7%	$7,016
Diamonds	-0.6%	$49
Postage Stamps	2.6%	$2,015
Rare Violins	2.4%	$1,604

Source: Credit Suisse Global investment Returns Yearbook 2018

Best wishes for a great summer. We thank you and are grateful for your confidence.

Sincerely,

Don *Amy*

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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
First Six Months (2018)	+9.3%	+2.7%	$ 1,092,600	$ 1,026,500
One Year	+24.6%	+14.4%	$ 1,246,400	$ 1,143,700
Three-Year	+11.3%	+11.9%	$ 1,379,100	$ 1,402,300
Five-Years	+13.8%	+13.4%	$ 1,911,100	$ 1,877,000
Ten-Years	+11.3%	+10.2%	$ 2,914,900	$ 2,634,000
Inception (20 1/2 Years)	***+9.0%***	***+7.2%***	***$ 5,863,600***	***$ 4,119,800***

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