SUNCOAST EQUITY MANAGEMENT, LLC

January 2, 2019

Dear Client:

SEM ended the year about where it started, with the portfolio up +1.2% versus down -4.4% for the S&P 500. Across our 21 year history, this is one of the widest divergences between earnings growth, which will likely top 20% for the year and portfolio appreciation or lack thereof. In spite of this year tracking to be one of the best in the nine year U.S. economic expansion, investors have become overwhelmed with near term concerns including worries about higher interest rates, trade wars and global economic growth (mostly non U.S. at present). We are less concerned about the first two than the global economy, though we will continue to observe its strengths and weaknesses in the coming year. We have always believed that accurately predicting the near term direction of the economy is not an important factor in achieving satisfying long term investment results.

The focus for **SEM-Disciplined Investment System** (SEM-DIS) remains owning great businesses throughout the economic cycle; so importantly, little else matters other than long term earnings growth on capital. We look back on the most recent twenty year time horizon with a few of our long term holdings and some we don't own. Portfolio activity was minimal sans a large dividend payout by one of our holdings that affected the stock price on the last day of the year. Finally, we enjoy sharing with you how we are on the right side, and have been for years with two of our portfolio companies, as changes in economic moats rise, plateau and erode, disrupting the "Mad Men" of yesteryear.

Earnings Growth Matters Most

No matter if your age is 92, 72, 52 or 32, growth serves an important role in your portfolio. Growth investments over the long term guard against inflation, the erosion of your savings due to the increasing cost of living. To achieve long term results ahead of inflation, we can definitively conclude that owning stocks which achieve higher earnings on capital over time matter most.

If you purchase or start your own business, we believe you would agree the goal is to grow its earnings (and revenues). When the time comes to transition the business to another owner, perhaps as you decide to retire or otherwise wish to exit, you want to get more in return; hopefully a lot more than you put into it, and preferably more than twice as much if you have owned it for ten years or longer. Coincidently, this is in addition to the earnings (and income) you took out of the business throughout your years of ownership.

The goals are very much the same when you invest your savings in the stock market as it is when you own a business privately. Of course there are some interesting differences we experience along the journey of owning publicly traded equities, which we typically do not endure with a privately held business. The most notable difference, as it always has been and will be, is the current offer price (not the value) of your stock investment, flashes in front of your eyes 5 days a week and 8 hours a day. The price is often a reflection of human emotions, especially in the short run, and not the intrinsic value of the company. Recently, negative emotions have seized the day resulting in price below value.

Importantly, earnings determine the value and ultimately the stock price of a business over the long term. This is where we spend most of our efforts executing the **SEM-Disciplined Investment System (SEM-DIS).** Below is a summary of some of the businesses we have been part owners of for several years or more and historical perspective on their earnings and stock price.

Portfolio Holding	SEM Years of Ownership	***Earnings*** 1998 to 2008 (10 Years)	***Growth*** 2008 to 2018 (10 Years)	1998 to 2018 (20 Years)	***Stock Price*** 1998 to 2008 (10 Years)	***Growth*** 2008 to 2018 (10 Years)	1998 to 2018 (20 Years)
Nike	12+	262%	129%	729%	170%	422%	1312%
per share figures		310%	179%	1043%			
Checkpoint	9+	364%	152%	1066%	335%	382%	1995%
per share figures		400%	257%	1683%			
Alphabet (Google)	10+	n/a	556%	n/a	n/a	339%	n/a
per share figures			451%				
Visa	8+	n/a	506%	n/a	n/a	690%	n/a
per share figures		n/a	882%	n/a			

*Stock returns exclude dividends

Nike (NKE), which had a solid earnings report on December 20th, is a business we have owned for over twelve years and its successful contribution to the investment returns in our portfolio are a reflection of the earnings progress of the company. From a twenty year perspective, NKE's earnings per share grew 1043% and its stock price increased 1312%, or annual rates of return of 13% and 14.2% respectively. **Checkpoint Software (CHKP)**, a portfolio holding for nearly a decade, is another example of a twenty year over-achiever. Interestingly, CHKP's earnings advanced 1066%, its earnings per share at a much higher rate of 1683%, and its stock price at a higher rate of 1995%. Earnings per share advanced at a much higher rate than earnings (net income) because the company utilized its generous excess cash accumulation to reduce its shares outstanding to 156 million from 208 million, effectively reducing the number of owners by 25%.

Two household names and also SEM holdings, **Visa (V)** and **Alphabet (GOOG)**, have not been available for public ownership for a twenty year time period, yet they too have generated strong earnings growth and likewise very good returns for our portfolio. Over the most recent ten year period GOOG, which we have owned over 10 years and became public in 2004, grew earnings 556% and earnings per share by 451%, followed by a stock price increase of 339%. Meanwhile V over the same period, which first became public in March 2008 and we first became owners in May 2010, grew earnings 506% and earnings per share 882% while the stock price rose by 690%.

	Earnings Growth 2008 to 2018 (10 Years)	***Stock Price Growth*** 2008 to 2018 (10 Years)
IBM	-12%	13%
per share figures	17%	
GE	-57%	-70%
per share figures	-49%	

Of course, it naturally works the other way as well. In the table above are two "blue chip" companies we do not own that have struggled in the last decade and the stock price correlated accordingly. **IBM** experienced earnings growth from 2008 to 2013, but then earnings started to decline for the next few years. When the company reports this mid January, it will likely show an earnings decline of 12% or so below what it earned over a decade ago in 2008. The stock price barely advanced over the last ten years by 13%, supported by earnings per share increase of 17% as a result of a significant share buyback. At one point one of the most valuable companies in the world, GE is another unfortunate example from the last decade. GE had a high earnings level of $18 billion in 2008 (per *Value Line*'s data), but its earnings collapsed as many companies did in the recession of 2009 down to the $11 billion level. It clawed its way back as the economy recovered and by 2012 earnings were back to nearly $17 billion. Earnings remained essentially flat until 2015 when business for GE started to sour and earnings fell steadily and dramatically for the next few years through the end of 2018. During the last decade GE's earnings have fallen nearly 57% and earnings per share are down 49%. The stock price has eroded by 70%.

Earnings growth and stock price appreciation are directionally correlated but not perfectly so. Additional factors that have an impact include the level of long term interest rates and the time period measured, in this case the start and end dates of today, 2008 (ten year) and 1998 (twenty year) in our tables. We could fill up a few more pages talking about the environments during our start and end dates, though it does not take away from our proven point that the longer the time period the closer the connection between increased intrinsic <u>value</u> and <u>price.</u> Importantly, we hope the above illustrations connect you with our experience that earnings on capital determine the <u>value</u> of the stock and the stock <u>price</u> eventually follows. The long term earnings and <u>value</u> power for SEM's portfolio remain strong, and we like the <u>price</u> offerings today.

<u>Portfolio activity</u>

Portfolio changes were minimal in the fourth quarter. One important event occurred at the end of the quarter when **VMware (VMW),** one of our portfolio companies, paid out an $11 billion dividend to shareholders, or $27 per share. This rather considerable dividend was reflected in the stock decline on the last day of the year. Dell Technologies, which is a private company, owns more than 80% of VMW. In 2016 Dell issued a tracking stock, DVMT, intended to track the economic performance of its ownership in VMW and used to fund the purchase of data-storage firm EMC. In July, Dell announced plans to buy back DVMT using the special dividend from VMW as well as equity in a new Dell Class C share. In early December, Dell received approval from shareholders and the special dividend was paid on December 28th.

This changed VMW's balance sheet shifting it from net cash of $9.3 billion to net debt of $1.7 billion. We are not the least bit concerned about the change in the balance sheet structure as VMW's operating results have been strong due to strength in its hybrid cloud solutions, virtual networking and storage, and higher margins. VWM is helping customers improve security and manage apps and data across multiple cloud vendors. In fact, we estimate VMW's free cash flow accumulation in 2019 to be about $1.5 billion, which will offset the debt; meanwhile we benefitted from the $27 per share dividend which we redeployed into increasing our ownership in **Microsoft (MSFT)**.

<u>Digital disruption of the "Mad Men"</u>

Companies looking to better connect with customers are changing their methods and this shift favors the companies we already own while disrupting the "Mad Men" of the traditional <u>ad agencies</u>. As more companies shift their marketing to digital ads and online shopping, they are increasingly turning to <u>consultants</u> like our two portfolio holdings **Accenture (ACN)** and **Cognizant (CTSH).** Consultants are better equipped to handle large scale projects that connect brands directly with consumers. ACN and CTSH transform customer experiences through website redesign and ecommerce build-out, customer relationship services and content solutions. Stephen Wilmot in *The Wall Street Journal* recently reported that <u>consultants</u> like ACN and CTSH are entrenched with top executives like the CEO, CTO (Chief Technology Officer) and CFO (Chief Financial Officer) and are considered trusted advisors unlike <u>ad agencies</u>, which have recently been hurt by undisclosed fees and inappropriate ads. Traditional <u>ad agencies</u> struggling to adapt include Interpublic, WPP and Omnicom.

Both ACN and CTSH have made several acquisitions to complement their digital services marketing divisions, most recently Adaptly, a digital media service company, and Netcentric, a leading provider of digital experiences and marketing solutions. Accenture Interactive has been ranked the world's largest digital network by Ad Age for the third year in a row and although they don't break out results for Interactive, estimates are that it's growing 20%+. **Adobe (ADBE)** is also benefiting from this digital transformation by creating content for digital advertising, complementary to existing leaders **Facebook (FB)** and **Google (GOOG)** which garner 57% of the digital advertising market per eMarketer.

We are always on the lookout for industries that are undergoing change and where new competitive threats or opportunities may emerge. We will continue to watch trends in digital technology and customer marketing, and we believe our companies are well positioned to take advantage of the changing landscape.

2019 Ahead

Economists identify that consumer spending drives two-thirds of the U.S. economy, and notably the high rate of employment and reasonable borrowing costs underscore that the consumer is in a good operating environment. Holiday spending was +5.1% from November 1st through December 24th, the strongest in six years, and reflects consumers' cheery attitudes. The most recent positive statistics show unemployment at 3.7%, a 49-year low, economic output in the +3% range and inflation in check at +2% or so. This is offset by the investing public's heightened anxiety over what's to come with the Trump administration, and perhaps CEOs holding back on future investments due to the same feelings about everything domestic and global including trade discussions with China. Interest rates are a major topic but still at very low levels with the 10 year U.S. Treasury at 2.7%, and low corporate lending rates continuing to support affordable financing of long term projects. Of course for our clients we are glad to see short term rates up in the 2%+ range as well, so that cash set aside can earn a return. We have had to steer cash investments towards U.S. Treasury securities as money market rates at big banks and brokerage firms woefully lag.

We will keep an eye on the balance sheet of the consumer, as debt is at its highest level with the latest reported figure at $3.9 trillion, of which $2.9 trillion is non revolving (with education loans at $1.6 and auto $1.1 trillion, respectively) and $1.04 trillion is credit card debt. Credit card debt today just barely exceeds the previous record of $1.02 trillion from 2008 (or $8,700 per household). But today it represents 26% of total debt, down from 38% a decade ago. Education loans are a huge thorn and a bit alarming for those feeling the burden. If the borrower fails to make payments the reality is that lenders have no asset as collateral (unlike an auto loan whereby the lenders can take back the car). Mortgage loans also bear watching but are not included in consumer debt statistics as they are considered personal investments in residential real estate. Our U.S. government balance sheet could be materially improved, as well. But this takes some very progressive efforts to restructure spending buckets such as entitlements and hope for a long period of reasonably good economic growth, low inflation and continued low interest rates to service the debt.

The earnings growth outlook for our SEM portfolio is in the +10% range for 2019. That figure seems achievable considering where we are today in the economy and all the worries at present lumped in. Of course we are following a solid year of economic growth and tax reform that drove an above average earnings growth year of 20%+. We don't know exactly how our earnings growth will turn out for 2019. Yet with SEM's lowest earnings growth in our twenty one year history at about +5% during the 2009 recession, even if we only hit that mark, our portfolio today is undervalued. But as always further negative market sentiment in the short run can make it even more attractive.

Thank you for your continued commitment to our journey together, through all the emotional ups and downs, as we make long term progress towards preserving and growing your hard-earned capital. As we enter our twenty-second year of service, we repeat what we said last year as we celebrated the end of our twentieth, "We look forward with great long term optimism and with every hope that over the next 20 years we can generate similarly good results. That means that in 2037 we could potentially tell our clients that we grew $1 million into $25+ million over 40 years!" And during the next twenty years, as in the first twenty grow $1 million into $5+ million. Thanks for your support and best wishes for a healthy, prosperous and peaceful 2019.

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

<u>Time Period</u>	**SEM <u>% Return*</u>**	**S&P 500 <u>% Return</u>**	**SEM - Value <u>of $1,000,000</u>**	**S&P 500 - Value <u>of $1,000,000</u>**
One-Year (2018)	+1.2%	-4.4%	$ 1,011,500	$ 956,200
Three-Year	+8.7%	+9.3%	$ 1,284,700	$ 1,304,200
Five-Years	+8.0%	+8.5%	$ 1,468,500	$ 1,503,300
Seven-Years	+13.2%	+12.7%	$ 2,384,500	$ 2,308,600
Ten-Years	+12.7%	+13.1%	$ 3,315,300	$ 3,430,300
Inception (21 Years)	***+8.4%***	***+6.6%***	***$ 5,428,300***	***$ 3,837,500***

* 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