Perennial.

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Investment and Security Selection

Dear Clients and Friends,

Wealth is a tool of financial freedom – its greatest purpose is to free you from financial fear. Money cannot prevent you from worrying about your health or that of your family; nor can it, as the old adage goes, buy you happiness. But wealth can free you from undue financial worry.

Wealth can provide you with the freedom to live the kind of life that is meaningful to you, even when you no longer work to earn an income. If in retirement your investments, as opposed to your labor, can provide you with sufficient income to live a full and joyful life, then you are truly wealthy because you are financially free. Moreover, if your investments continue to grow, even as you draw from them the retirement income you need, you will be able to impart some measure of financial freedom to the people you love and must eventually leave behind.

Eyes on the Prize

When it comes to your investments, your overarching goal must be to first achieve and then protect your financial freedom. Abstract, but admittedly sexier, goals like 'beating the market' and 'outperforming' are at best pointless distractions and at worst the causes of underperformance or the loss of financial freedom. This is because chasing benchmarks like the S&P 500 inevitably leads to bad behavior and consequently dismal results. Common behavioral mistakes made by investors chasing benchmarks include trading on guesses about the short term direction of the market, remaining too heavily in equities when valuations become elevated, and perhaps the biggest one: selling stocks during bear markets and then buying them all back in bull markets.

Financial freedom is what matters, not the short term outperformance of a benchmark that has no relevance to your personal life. So please, consider leaving the meaningless job of beating the market (over short periods of time) to the so-called professionals and focus on protecting your wealth and growing it at a satisfactory rate over the balance of your life.

As we have written in the past, the real-life returns that you earn from your investments over the remaining decades of your life will, to a great extent, be determined by your behavior – by your ability to stick to your investment plan through thick and thin. Asset allocation, the topic of our last letter, and security selection, the topic of this letter, are no doubt important, but they won't mean much if you cannot stick with the plan, allocations and securities you select, in good times and bad.

Ask Your Doctor if These Investments are Right for You

Let's assume you agree with our premise that good behavior is the linchpin of achieving long-term investment success, and that beating the market (especially over the short term) is the wrong goal for you.

It would follow that, with respect to security selection, you should fill your portfolio with investments that will achieve results appropriate for your long term plan and minimize the probability of bad behavior. Countless books and papers have been written on how best to select securities for an investment portfolio; a list of our favorites appears as an Appendix to this letter. While these books have capably summarized the complex world of security analysis, most of them were written with the same investment goal in mind: beating the market.

Few, if any authors, pay sufficient attention to the personal and emotional factors involved when choosing one's investments. We believe, perhaps unconventionally, that these factors should play a prominent role in the investment process. It is not enough to pick the right securities (which is hard enough); you have to pick securities *that are right for you* (which can be even harder). Because each of us is so different, it is impossible for us to tell you *exactly* which securities are right for you. Ultimately, only you can know that. But what we can do is share with you our straightforward framework for selecting securities, the same one we use when selecting investments on your behalf (and ours).

Security Selection in Eighteen Words

To the maximum extent possible, you must

1. Buy high quality stuff
2. that you understand well and
3. derive 'psychic income' from;
4. then, don't overpay for it.

Before reading on, please take a moment to re-read and ponder this four part framework. Given its brevity and outward appearance of simplicity, you may be inclined to brush it off as too obvious or insufficiently sophisticated. But as you think more deeply about it, and after reading the balance of this letter, we hope you find that it as instructive as we find it.

Consider for a moment your experiences shopping for the goods and services you buy every day. Does this framework not encapsulate the implicit mantra by which you purchase groceries, a phone, a car, or even a home? *Buy high quality stuff that you understand well and derive psychic income from; then, don't over pay for it.* Why should picking your investments be any different? Yet, for many people, it feels very different. Consider, for example, the same person who would spend hours or even days researching the purchase of a lux sound system for his home but will decide to buy shares in a company he has never heard of, just seconds after receiving a tip from someone he barely knows. We believe that stocks should be evaluated no differently than a sound system and that our eighteen word framework works equally well for both.

We, the Perennial investment committee, have over sixty years of combined experience making all kinds of equity investments, with plenty of scars earned along the way. All our experience tells us that the patient and disciplined adherence to these eighteen words offers the best chance, year in and year out, to maximize returns and minimize bad behavior.

Criterion One: Quality ("Buy High Quality Stuff")

Wall Street wants you to believe that assessing the quality of a business is something that only its investment bankers and hedge fund managers can do – that somehow businesses are enigmatic puzzles only decipherable by men in dark suits. We disagree. Each of us, from the time we are very young, acquires an intuitive sense for business, a kind of commercial common sense that is more than sufficient to evaluate the quality of many enterprises (especially those you understand well, the topic of the next section). To help hone this business intuition, we suggest you ask one simple question when attempting to evaluate the quality of an enterprise:

How would you feel if this company were your family business?

Family businesses are not something you simply discard with the click of a mouse; family businesses are not something you buy on a tip from your broker; family businesses are not pieces of paper to be endlessly traded back and forth by market participants. Rather, family businesses are treasured possessions passed with great pride from generation to generation. The best among them, the kinds we are looking to acquire in the equity market, have two simple features: (1) they earn high returns on their capital; and (2) they are built to do so for decades into the future.

High Returns on Invested Capital

Over long periods of time, the owners of businesses cannot outperform the businesses themselves. In other words, a company's stock price cannot rise faster than its profits indefinitely. As a result, there is no better proxy for the return an investor can expect from owning shares in a business than the returns that are earned by that business.

Anyone with internet access and a willingness to do the work can calculate a company's Return on Invested Capital (ROIC). ROIC is the amount of income a company generates as a percentage of the company's total investment in its business. Said another way, ROIC measures a company's efficiency at allocating the capital under its control to profitable investments over time. High return businesses have an essential advantage: as long as they are earning high returns, they can be profitable with less reinvestment and therefore continue to grow in value with considerably less 'effort.' In this sense, ROIC is the single most important metric to examine when evaluating business quality.

Does this company generate high returns on invested capital?

A Very Long Runway

A long record of generating high returns on capital is an important starting point, but you must attempt to peer into the future and gauge the likelihood that those high returns will continue and for how long. The whole game of investing is an attempt to see this. The length of a company's 'runway' – how many years it can continue to earn high returns – will be the dominating factor in determining your investment return over the long term.

How long is this company's 'runway'?

Earnings are valuable when they last, and they last when they are protected. Every company has customers and suppliers, as well as actual and potential competitors; the actions of all these will directly affect the length of its runway. The inimitable Yogi Berra once remarked, "It's tough to make predictions,

especially about the future." Recognizing this, a considerable portion of our research effort is spent thinking about six questions, each an attempt to assess runway length:

What is the relative power of the company's customers?
What are the switching costs for its customers?
What is the relative power of the company's suppliers?
What are the switching costs for its suppliers?
What does the competitive landscape look like now?
What kinds of barriers to entry are there for new competition?

Criterion Two: Depth of Understanding ("That You Understand Well")

The probability that you make behavioral mistakes varies inversely with the depth of understanding of your investments. You are far more likely to sell (at steep losses) poorly-understood investments during tough times than investments you understand well. Thus, time spent enlarging your understanding of what you own is time well spent.

Can you describe in plain language how this company makes money?

We appreciate that for some of you, depending on your personal and professional experience analyzing businesses, this criterion may limit the number of companies in which you can invest, especially when combined with the quality test above. This is not a bad thing. Even a diversified portfolio comprised only of companies whose products you use every day (and thus are more likely to understand) would probably generate satisfactory returns, even before accounting for the behavioral benefits of owning companies you understand. To name a few, Apple, Google and Johnson & Johnson are companies we hold on behalf of clients that could easily populate such an 'understandable, use every day' portfolio.

Criterion Three: Psychic Income ("Derive Psychic Income from Your Investments")

Battlefield generals are fond of saying that even the best conceived plans rarely survive first contact with the enemy. When it comes to investing, 'contact with the enemy' is the bear market. Since the 1950s, we have lived through thirteen of them (or about one every five years) with an average decline of 31%. Thirty-one percent! There is no escaping the fact that you will have to endure many more of these painful periods over the balance of your life. How you conduct yourself during bear markets will have a huge impact on your lifetime returns.

Extending the metaphor, all investing, especially equity investing, is first and last a battle with your emotions. A carefully constructed and diversified portfolio of high quality companies that you understand well is your sword in this battle; 'psychic income' is your shield. Extensively studied by behavioral economists, psychic income – the non-monetary satisfaction you feel from owning something – is a hugely personal thing; only you can know if something you own makes you feel 'warm and fuzzy' inside. Call it what you will: intuition, gut feel, sixth sense, whatever. Use these things to seek out investments that you 'feel good' owning, investments that make you 'sleep well at night.' It is behaviorally paramount that you do.

Does owning this company help you to sleep well at night?

How would you feel about owning this company if you found out that the stock market was shutting down for the next ten years?

To be clear, we are not advocating embracing the 'warm and fuzzies' in the absence of assessing the other three criteria set forth in this letter (identifying a high quality business, fairly priced and well understood); rather, *if* the other criteria are met, it is *also* critical to be able to trust your gut. The investor Peter Lynch once remarked, "The secret to making money in stocks is not to get scared out of them." When the next 2008-2009 comes, when your flight instinct is taking over, the psychic income you derive from your investments will likely be the thing that saves you (from yourself), enabling you to hold a winning, long term investment amidst a short term storm.

Criterion Four: Price ("Don't Overpay")

There is no way around the fact that assessing the value of a business is a somewhat technical and highly subjective endeavor. Those with limited experience doing so will have to rely once again on business intuition and common sense. For this reason, it may be easier to determine if you are overpaying than if you are getting a bargain, which fits acceptably within our framework of *not overpaying*. Assuming you have a long term time horizon, which you must, the price you pay for your shares in a company matters considerably *less* than the ROIC the company earns over your holding period. The purchase of Wells Fargo shares, for example, at the highest price achieved in 1974 versus at the lowest price would have made virtually no difference to the phenomenal return you enjoyed over the following four decades.

The rub with valuation is that if you believe a company to be of the highest quality, chances are you are not alone in your view. In all but extreme market environments, the probability of your uncovering a true bargain among a list of great companies is remote. You may even have to pay a modest 'quality premium,' though, in many cases, you will not. For our part these days, we find most of the high quality companies we follow fairly valued, with many overvalued and very few undervalued. In our view, a long term investor who rightly sees stock investment as owning a fractional share of a business held ideally in perpetuity should always seek a bargain, but stand ready to pay a modest premium for an excellent, well-understood, psychic income generating investment.

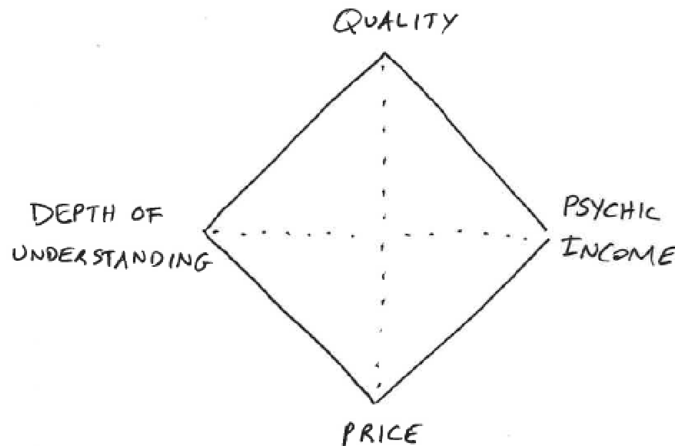
The most commonly used indicative measure for valuing a company's shares is the price-to-earnings ratio (P/E). Anyone with access to a search engine can easily locate this ratio for any publicly traded business. Comparing a company's P/E ratio to that of the S&P 500 will give you a pretty good sense of whether or not you are overpaying relative to the average company. This quick and somewhat naive heuristic should be handled with care given its potential for superficial judgments in a field as potentially complex as securities valuation. Only extensive due diligence and analysis can produce a truly robust appraisal of a company's shares. That said, comparing a company's P/E multiple to that of the S&P 500 is a good starting point for answering the essential question:

Are you paying too much for this company's shares?

All other things being equal, you reduce your risk and add to your piece of mind when you do not overpay for what you buy.

Beware of Sirens

Our four criteria – quality, depth of understanding, psychic income and price – form an interlocking diamond-shaped structure whose strength, similar to a diamond's, is derived from each of its parts working in tandem. If one or more of the parts is missing, it ceases to be robust. Here's a simple sketch of our diamond shaped framework:



Appendix A of this letter provides an illustration of how we use this framework.

We spend our days searching for companies that satisfy *all four* criteria. If any part of the diamond is missing, we do not invest. We recommend you do the same. There are perhaps only a few hundred publicly traded companies in the world that we consider excellent enough to pass through our four part filter. No doubt, the tightness of this sieve explains why we make comparatively few new investments each year.

Yet there are tens of thousands of publicly traded stocks out there continuously tempting investors to 'slum it' and buy them. Since many on Wall Street are far more concerned with the volume of your activity than its economic utility, you will continuously be enticed to buy and sell the latest fads, funds, and fashions. While these sexier-feeling transactions may appear to offer the promise of a faster buck, they require you to sacrifice quality and buy mediocre (or worse) businesses – ones that you would never select as your family business. Similarly, you will be invited to buy, perhaps overpay for, investments you do not understand or that give you little or no psychic income.

The behavioral problems with these purchases is hopefully obvious at this point. Compromising on any of these criteria leaves you owning investments you will rush to sell (at steep losses) when things go wrong or when bull markets devolve into bear markets. As such, these purchases – like the Sirens of ancient Greece, tempting Odysseus to smash his ship upon the rocks – are dangerous distractions from the long term mission.

For our part, we remain steadfast in the mission, committed to buying only those companies that we believe fit firmly within the diamond above. The business of investing is certainly not an easy one, as there is no shortage of experienced investors scouring the planet for things to buy. The good news is that most of these investors have the wrong goal (for you): they are trying to beat the market, especially over

the short term. Your goal should be to grow your wealth at a satisfactory rate over the balance of your life and realize *your* definition of true financial freedom.

Let *others* chase Sirens.

"The fault, dear Brutus, is not in our stars, but in ourselves."
– William Shakespeare

Respectfully submitted,

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APPENDIX A: REPRESENTATIVE EXAMPLES

COMPANY	QUALITY	UNDERSTANDING	PSYCHIC INCOME	PRICE
AMERICAN WATERWORKS (AWK)	• Leading pure-play water utility with excellent management; track record of execution and successful acquisitions • Possesses many of the attributes that make regulated utilities attractive (predictable revenues, high entry barriers, stable dividend), <u>and</u> is also one of very few that has above-average long-term growth prospects • Fragmented $300+ billion industry; trends support further privatization, consolidation	• Largest, most geographically diversified water and wastewater utility in U.S. • Provides over 14 million consumers with drinking water, wastewater and other water-related services • Water bills make up a small amount of household spend so there is less sensitivity to increasing rates relative to other utilities such as electricity	• U.S. water/wastewater rates are among the lowest for developed countries • Investment in water infrastructure is urgently needed; approx. two trillion gallons of treated water lost every year • There is no avoiding AWK in its core markets; and they have a great reputation in the marketplace as a reliable operator • Every U.S. household needs water services	• Trades at a modest premium to the S&P utility index (20x-21x forward EPS) • Well-positioned to take advantage of the long-term trends toward privatization and consolidation • Should see incremental benefits as state and local government finances improve • AWK has a long runway for respectable, steady growth
KRAFT (KRFT)	• Unrivaled portfolio of products in the beverages, cheese, refrigerated meals and grocery categories • Consistently achieves some of the highest returns on invested capital in the S&P 500 • Excellent margins that have meaningful potential to be improved upon • New management team recruited to unlock shareholder value	• One of North America's largest consumer packaged food and beverage companies • Iconic brands include Kraft, Philadelphia, Planter's, JELL-O, A1, Oscar Mayer • Nine brands that each generate greater than $500 million in sales; average 2x the share of the nearest branded competitor	• Non-cyclical business that has proven resilient in past economic downturns • Approximate 98% penetration rate in U.S. households (99% in Canada) • Tremendous brand equity and untapped potential despite mature product portfolio • Competition in packaged foods has increased in the past decade, but KRFT is still a leader in several key categories	• Forward P/E (pre-Heinz announcement) of 18x-19x at the lower end of peer group; reasonable premium to the S&P for a business with a strong moat and some meaningful bond-like characteristics • Mid-to-high single digit earnings growth combined with dividend (pre-Heinz) offers opportunity for high single digit (possibly low double digit) returns with modest risk • Valuation must be reconsidered given the pending merger, but Heinz is a strong business, and the combination offers meaningful cost savings and the potential to accelerate the pace of change at KRFT
MASTERCARD (MA)	• Unusual combination of exceptional returns on capital, long growth runway and significant market position • Consistently high 30%+ ROICs enable profitable growth with little reinvestment • Financial institutions have few options (Visa, AMEX), and switching costs are high (card re-issuance, execution challenges)	• Global credit card and payment leader enabling electronic forms of payment instead of cash and checks • Effectively a toll collector, operating a highly efficient, technology-driven global payment network and facilitating the processing of transactions for a fee • No dependence on extending credit • Processed >55 billion transactions in 2014	• MA's runway, market penetration, global leadership, technology and high ROIC model make it easy for us to sleep at night • Emergence of digital payment has not been disruptive, but is instead facilitating incremental growth • Retailers risk business only accepting cash, especially given the e-commerce explosion • Migration from cash/checks to credit and electronic payment still unfolding globally, especially in developing markets where MA has significant presence	• MA has historically traded at a premium to the S&P due to its above average growth (historically more than 2x the S&P) • Businesses with superior return on capital are worth more to us, all else being equal • Foreign market exposure highlights the exceptional long-term opportunity in emerging and other international markets

APPENDIX A: REPRESENTATIVE EXAMPLES (CONTINUED)

COMPANY	QUALITY	UNDERSTANDING	PSYCHIC INCOME	PRICE
UNION PACIFIC (UNP)	• Few businesses have higher barriers to entry (multi-decade fixed-cost infrastructure investment; meaningful regulation) • Significant bargaining leverage—provides mission critical, low-cost transport function to diversified customer base; controls strategically important rail routes • Impressive ~15% ROIC given capital intensity of a hard asset business	• Largest rail operator in the world, providing critical link in global supply chain • Serves 10,000+ customers in many fast-growing U.S. population centers; only rail serving all six major Mexico gateways • Diversified business mix including agriculture, industrial, chemicals, automotive, coal and intermodal	• Significant infrastructure investment ($22 billion from 2007-2013) and entrenched position built over past century supports exceptionally high entry barriers • Rail remains a cheap and efficient form of freight transport despite innovations in fuel economy and logistics • UNP should be an integral part of U.S. transport infrastructure for the foreseeable future	• Fairly valued at 17x 2015 consensus earnings estimates (in line with S&P) • Benefiting from cyclical upswing in volume across all business groups; upside from increased economic activity with Mexico • ~$7.4 billion operating cash flow in 2014 (relative to ~$100 billion market cap) • Exposure to steadily improving US economy and USD
WABCO (WBC)	• Very well-managed business with a long history of profitably growing market share and generating attractive returns on capital • Proven track record of executing and integrating value-enhancing acquisitions • WBC has a diversified low-cost manufacturing base; products have a high degree of engineering and technology value-add	• Global technology leader in the commercial vehicle industry • Long record of reliably designing and manufacturing breakthrough products for braking, stability, suspension and transmission automation • Continuous demand for technology innovation related to commercial vehicle safety and efficiency • WBC has taken a more strategic focus on the U.S. market—2013 was only the first full year with dedicated senior leadership	• Mission critical components supplier--products and fleet management solutions are integral to improving safety, control and efficiency of commercial vehicles • Switching costs for customers are high • All of the world's leading truck, bus and trailer manufacturers have WABCO technologies onboard • Secular trend of continually increasing regulatory standards in countries such as China, India	• P/E multiple well below average for Russell 2000 (~18x-19x forward earnings; 16x 2016 estimates) • European commercial vehicle production nowhere close to pre-recession levels • Despite cyclical nature of the commercial vehicle industry, strong secular trends to support long-term earnings growth
ZOETIS (ZTS)	• Market leader serving diverse customer base that relies on its drugs and vaccines (pet owners, veterinarians, farmers and ranchers) • Livestock consumption and pet ownership should steadily increase with global economic development and the emergence of new middle-class consumers • Spin-off from Pfizer enables greater focus, alignment and acquisition opportunities	• Largest public animal health and pharmaceutical company in the world • Global leader in the development and commercialization of animal health medicines and vaccines • Roughly two-thirds of revenue from products given to cattle, livestock, poultry; the remainder from companion animal medicines and vaccines	• Economically resilient business with fewer of the regulatory risks and reimbursement challenges typical of pharma/healthcare • Large and stable market (the total population of dogs and cats is now greater than the number of U.S. households) • People love their pets; livestock consumption should increase with time	• ZTS has traded at a significant premium to the S&P since its IPO, consistent with many vet/animal health-related businesses • A premium is warranted given the long-term prospects, attractive market dynamics and high returns on capital • Shares have become more expensive in recent months

The companies and securities discussed in this Appendix A may not be suitable for all investors. The companies and securities discussed above are not necessarily owned by all of Perennial's clients and only represent a portion of those that we may recommend, purchase and/or manage on their behalf. The appropriateness of a particular investment will depend on an investor's individual circumstances and objectives. No investment strategy can guarantee performance results, and there are no assurances that the investment objectives described herein will be met. Past performance is no guarantee of future results. All investments are subject to investment risk, including loss of principal invested. The information above is only as current as dated indicated, may be superseded by subsequent market events or for other reasons. Perennial assumes no obligation to update such information.

Appendix B: Our Favorite Books on Security Selection

Benjamin Graham, The Intelligent Investor, HarperBusiness, 2005

Don't take our word for it: Warren Buffett called this masterpiece "the best book on investing ever written."

Benjamin Graham and David Dodd, Security Analysis, McGraw-Hill, 1934

This is the book that started it all. Graham and Dodd are the grandfathers of value investing. Be sure to buy the 1934 edition as later editions have been "updated and modernized" by other authors, to this great work's detriment.

Peter Lynch, One Up on Wall Street: How to Use What You Already Know to Make Money in the Market, Simon & Schuster, 2000

Written in plain language, this book persuasively argues that anyone, including non-professional investors, can draw from their own experience when choosing investments and achieve good results.

Seth Klarman, Margin of Safety: Risk-Averse Strategies for the Thoughtful Investor, HarperCollins, 1991

Among the best books ever written on security selection, in our opinion. Out of print for over a decade, it has become a collector's item and now sells for $2500 or more. For those feeling justifiably parsimonious, a free PDF version can be found online.

Joel Greenblatt, You Can Be a Stock Market Genius Even if You're Not Too Smart, Touchstone, 1999

Don't be fooled by the overly-simplistic sounding title of this book. Greenblatt is one of the best stock pickers of all time, and he reveals how he does it in this book.

Jane Lowe, Value Investing Made Easy, McGraw-Hill, 1999

As the title suggests, this book is an excellent and straightforward distillation of Benjamin Graham's philosophy.

Benjamin Graham, The Interpretation of Financial Statements, Harper & Rowe, 1937

Geek out and learn from the best how to tear apart a company's financial statements. Can you tell we are big fans of Mr. Graham?

Andrew Tobias, The Only Investment Guide You'll Ever Need, Mariner Books, 2011

Mr. Tobias succeeds at making security selection humorous. The title of this book says it all.

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